



## Take Charge of Your Portfolio in 2007

*Will You Choose the Mix — or Will Your Members Make the Call?*

By Bill Walker, Vice President, National Sales, CMG Mortgage Insurance Company

In 2007, credit unions need to take stock of their portfolios and make some decisions. Proper portfolio risk management is the key to success for any real estate lending operation, as well as for the overall growth of credit unions engaged in this activity.

The following steps can help credit unions weather a variety of economic scenarios and structural challenges and continue to make loans available to Members:

- Undertake an inventory of existing strengths and weaknesses
- Analyze the portfolio mix to determine how best to balance risk and enhance liquidity
- Assume an active role in managing the portfolio going forward

First, let's look at the current situation. Credit unions have, to a large extent, avoided the trap that many large lenders have fallen into over the last few years — that of using too many “exotic loan products” in order to qualify home-buyers who were marginal at best. This is due to both the higher credit quality of most credit union Members and the more conservative lending practices of credit unions themselves. Credit unions should certainly heed the warnings recently issued by regulators on the risks posed by interest-only and other “exotic” loan types; on the whole they have avoided the levels of



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exposure faced by many large financial institutions.

However, credit unions still face challenges. Their portfolios may include a significant number of adjustable-rate loans without mortgage guaranty insurance, whose rates are due to reset in the near future. These loans are especially vulnerable in regions with declining home prices. These resets mean higher mortgage payments for members and consequently a higher risk of default. Some credit unions

may also retain many fixed-rate loans in portfolio — mortgages that invite refinancing at lower interest rates and consequently reduce the value of the portfolio.

Credit unions also need to consider the state of their reserves. The heavy demand for mortgage loans over the past 5 or 6 years, coupled with dwindling growth in deposits has driven up the credit union loan-to-share ratio and threatens the ability of many credit unions to continue originating mortgage loans.

Portfolio risk management is the key to solving both problems.

### Mix It Up

In addition to your current home mortgage clients, you may be seeing the return of Members who have mortgage loans with other financial institutions. The impact of higher interest rates and declining appreciation is an opportunity for credit unions to offer alternatives that can help these Members out of their difficulties. What's the motivation to do this? Remember, your Member is likely to have other loans or credit cards with your credit union. Foreclosure by their mortgage holder will jeopardize the performance of your loans as well. However, credit unions need to make sure that their mortgage loan solution is appropriate to the Member, won't aggravate his or

her existing financial problems and won't expose the credit union's portfolio to unacceptable levels of risk.

When recommending loan types to current or returning Members, your first, most important step is to assess your credit union portfolio's inventory. Healthy portfolios are built on a mix of loans that perform — or are insured against non-performance. Good portfolio risk management begins by examining the existing portfolio and its mix — the balance of different loan types, fixed versus adjustable, geographic concentration, etc. Is there a good balance? Or is there an excess of loans in any one category?

If the balance is too heavily tilted in favor of any one loan type, you must devise a strategy that will result in a better, more diversified mix for your portfolio. Don't let your Members decide your portfolio mix for you. Once you've decided on your approach, talk to your Members, assess their personal financial circumstances, weigh this against your risk management strategy, and create a mortgage loan solution that works for both of you. Popular opinion shouldn't drive portfolio risk management.

### **Underwriting, Pricing and Selling to Manage Your Portfolio**

Underwriting is typically the way most credit unions reduce their portfolio's exposure to the risk posed by individual Members seeking mortgages. To do this successfully, you should know your market and how it is changing, then implement that knowledge through your underwriting guidelines.

For example, during the recent boom, homes were affordable because

interest rates were low and market appreciation was high. To qualify as many homebuyers as possible, the industry loosened its standards: loans required only minimal documentation of income and assets, loan-to-values increased and widely implemented automated underwriting systems involved only minimal human reviews. Conditions have changed, however, and credit unions should make sure that their underwriting guidelines take full account of the current economic conditions: higher interest rates, declining appreciation and widespread concerns on consumer debt loads. Through careful underwriting, you can reduce the degree of credit risk and collateral risk that show up in your portfolio of loans.

Another important strategy is to price appropriately for risk. Even better, price aggressively to redress the balance of loan types in your portfolio and attract the business you want, whether ARMS vs. fixed-rate, seconds vs. first, special affordable housing programs, HELOCs vs. equities, etc. At the same time, be careful to recommend only those loan products that your Member will be able to afford, given his or her individual circumstances.

Who sets the pricing at your credit union? Perhaps it's time to review the process. Pricing decisions made by loan committees may be adversely

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influenced by individual experiences and irregular or delayed meetings. While committees can set guidelines, senior management should play a strong role in determining rates at your credit union. Among the possible factors to consider when pricing, you should include loan volume, the ability to sell the loans on the secondary market and your return on investment.

It is very important to investigate secondary market sale opportunities for your loans in portfolio. This is a proven strategy to enhance your credit union's liquidity, acquire a valuable source of revenue and improve the mix in your portfolio. By selling off some of those loans that you have in excess, you transfer the attendant risk to a third party and free up capacity to make more loans of the type you want.

2007 is an excellent time to start taking charge of your portfolio by assessing the current mix and deciding on your strategy. Once you've adjusted your underwriting to match your strategy and introduced appropriate pricing, it will be time to think about the next step — working with the secondary market to sell your loans as needed.

The Summer 2007 edition of *Signals* will explore the options available to credit unions in the secondary market. The issue will cover the most popular strategies that can be used to protect liquidity, hedge pipelines and leverage the value of loan portfolios to derive multiple-fee income. It's a must-read!



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