



Working the Secondary Market to Your Credit Union's Advantage *Look Beyond the Crunch to Future Opportunities*

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

This edition of Signals follows up Bill's initial discussion on balancing Credit Union portfolios in our Winter 2007 Signals issue, "Take Charge of Your Portfolio in 2007."

Economic conditions have changed since the *Signals* issue in which I urged Credit Unions to "Take Charge of Your Portfolio in 2007." Headlines announce foreclosures, delinquencies and a global "credit crunch" triggered by the recent dramatic slowing of the American housing market. Credit Union management are right to wonder: *What are my options in this situation?*

While you may feel pressure for a few months, take a longer view. Many financial institutions are racing to tighten up their underwriting and risk management practices. Credit Unions engaged in only minimal activity in the subprime market, so the quality of Credit Union mortgage loans—as evidenced by their higher credit scores—is preferable to those held by mortgage and banking behemoths. Soon enough, canny investors will be scrutinizing the market again for opportunities and could recognize that Credit Union-financed mortgages represent a risk preference compared to bank-financed ones.

Working Your Portfolio for Multiple-Fee Incomes

When panic subsides, you'll have a great opportunity to replenish your liquidity. Prepare for it by assessing the appeal of your loan portfolio to investors. If you've utilized my advice from the 1st Quarter *Signals*, you now have a pretty good idea of what your portfolio mix is. Separate



Bill Walker is Vice President-National Sales at CMG Mortgage Insurance Company (CMG MI), which exclusively serves credit unions. With two decades of experience in the credit union industry, Mr. Walker has emerged as a leading proponent for building aggressive origination programs balanced by the management of portfolios and sales to investors. Prior to joining CMG MI in 2005, Mr. Walker held various positions, including that of Chief Lending Officer at California Credit Union and Financial Partners Credit Union.

the various loan instruments in portfolio and match them against the criteria of specific investors—Fannie, Freddie, your local CUSO, other Credit Unions, Wall Street. Price them accordingly. The more you knowledgeably stratify in this way, the more incentive investors will have to purchase loans from your portfolio—with greater confidence in the value of what you're selling.

Don't limit yourself to a partnership with just one investor. Each one can offer certain benefits for your Credit Union and Membership. If you're selling the servicing rights to the loans, it's critical to know how each new servicer will handle the

loans—after all, you're turning over your prized relationship with your Member to a third party. Unhappy Members may take their business elsewhere and that jeopardizes any possibility of turning your Credit Union into their Preferred Financial Institution (PFI).

Finally, educate your staff on "the best loan possible" for each Member—one appropriate for their financial circumstances—and "best execution"—selling mortgages into the Secondary Market advantageously. By pursuing both goals, you will maximize Member satisfaction and the most profitable exit strategy for your Credit Union at the time of sale.

Best Execution Strategies

Broadly speaking, there are three principal "best execution" strategies that Credit Unions can adopt, involving different levels of expense and investment for Credit Unions.

Outsource the Mortgage Lending Function to a Trusted Business Partner

This is the quickest way for Credit Unions to get involved in mortgage lending in the first place, but without excessive costs or undue risk exposure. They establish a relationship with a mortgage company or conduit that originates mortgage loans—sometimes this partner maintains an actual physical presence at the Credit Union. When Members approach the Credit Union for a home loan, they can be referred immediately to the third party—essentially, the Credit Union is selling the loan to their partner. While the loan is handled by the partner, the Credit Union supervises the process and subsequent servicing of the

(continued on page 2)

loan, to protect the Member relationship and ensure satisfaction.

For smaller Credit Unions with limited resources, this approach can be beneficial:

- The Credit Union can expand its product offerings available to the Membership base—so Members don't move their mortgage business to banks or other financial institutions.
- By outsourcing mortgage loans while still offering them to Members, the Credit Union may be able to improve its financial performance.

However, this type of strategy generates the lowest net income per loan for the Credit Union.

“Broker Out” the Loan through a Wholesale Relationship

Credit Unions that offer mortgage lending may still hesitate to approve loans whose risk is above tolerable levels—both the interest risk and the credit risk. To avoid assuming those risks, they can “broker out” these loans on a flow basis to a wholesaler who will fund them. It's the easiest way to offer Members a broad range of loan products at a lower cost, especially during peak volume periods.

By adopting this strategy, the Credit Union can generate fee income from both originating the loan and, typically, selling the servicing rights.

Selling for Cash or Swapping for Securities

This Secondary Market strategy is better suited to larger, high-volume Credit Unions with more resources, experience and staff. It also means greater risks and potentially higher costs.

Portfolio loans can be sold directly to investors for cash or swapped for securities as they are originated. The Credit Union usually retains the servicing rights for these loans, so the benefits are significant:

- Credit Union retains control over Member relationship by retaining servicing.

- Fee income is generated from both the origination and servicing rights.

However, it requires skilled staff to handle both the servicing and the Secondary Market transactions. There will also be significant interest-rate risk to consider while the loans remain in portfolio.

Servicing Released or Servicing Retained?

When selling mortgage loans, Credit Unions need to consider the question of retaining or releasing the servicing rights.

With *Servicing Released*, Credit Unions originate a mortgage loan and then sell the whole loan (including the mortgage servicing rights, or MSR) to a third party, earning a “servicing-released” premium in the process. Under this strategy, a Credit Union benefits by:

- Having greater control over loan transactions
- Obtaining fee income immediately once the loan is sold
- Reducing responsibility for future servicing
- Requiring no expenditure on servicing systems or staff
- Having quick implementation

However, the fee income is a one-time windfall. Moreover, it is by servicing that the relationship with Members is preserved (remember the PFI!). Consequently, Credit Unions need to think carefully before relinquishing their servicing rights. Make sure that the third-party investor will provide a standard of service equal to that of your Credit Union. Plus, the servicer may also allow a competitor to cross-sell to these Members, thus undermining the

valuable relationship your Credit Union has developed with them.

Servicing Retained

By retaining the rights to service a loan, the relationship with the Member is preserved and servicing income secured over the lifetime of the loan. It's a more expensive strategy, which requires the Credit Union to support an ongoing servicing obligation through investments in qualified staff, technology, etc., and as such may not be a realistic option for smaller Credit Unions.

Manage Your Cashflow Using the Secondary Market

Through astute management of their assets and a disciplined strategic approach, Credit Unions can use the Secondary Market to:

- Manage interest-rate risk
- Tap into a vital source of liquidity
- Increase their return on assets through fee and/or service income
- Create fee income, a servicing revenue stream and cross-selling opportunities (by retaining servicing rights)
- Establish their Credit Union as their Members' PFI

The Secondary Market is a valuable tool for Credit Unions. Developing your Secondary Market “best execution” strategy should be as essential to your Credit Union as ordering an appraisal on a property—both are key to managing your cashflow and provide a hedge against financial shortfalls.

An appraisal provides the formula for another method of loan repayment if a Member's scheduled payments are not received. The Secondary Market can fund the Credit Union's future mortgage business when available cash runs short. The next economic cycle is upon us—so use it to your advantage, by leveraging your opportunities in the Secondary Market.



CMG Mortgage Insurance Company

A Joint Venture between PMI Mortgage Insurance Co. and
CUNA Mutual Investment Corporation

www.cmgmi.com • 800.909.4264

CMG Mortgage Insurance Company (CMG MI) supports the mission to expand homeownership across America—through products and services that enable Credit Unions to make low-down-payment loans with confidence. What are the challenges to homeownership in your community—and how can we help? Let us know what you think and what we can do for you by contacting your CMG MI Account Executive or sending an e-mail to CMGMortgage.InsuranceCo@cmgmi.com