CMG MI Signals

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Coming Soon to Your Credit Union — Mortgage Lending Risk

Popularity is Tempting and Perspective is Essential

By Brian Shepherd, Senior Vice President and General Manager, CMG Mortgage Insurance Company

In recent months, the mortgage market has experienced declining collateral values, rising foreclosures and a painful credit crunch that is affecting home-buyers across the country. Credit Unions are not immune to these events!

Yet for many Credit Unions, they add up to an opportunity that seems too good to miss. While some lenders are busy backtracking and trying to recoup their ill-advised forays into the subprime market, Credit Unions are in a much better financial position. They have assets to lend and a whole new group of potential mortgage borrowers to serve. Homebuyers turned away from lenders will be looking for more accommodating mortgage providers.

Yes, It's a Rush — and Remember the Risk

Credit Unions may feel overwhelmed by the sudden reversal — instead of having to market mortgages to Members lured away by banks or brokers, they find themselves actively sought out as the first choice by Members and non-Members who want to buy homes or refinance their existing mortgages. Even brokers and Realtors®, searching for institutions with funds, want to reach out to Credit Unions. The danger is that this excitement and outpouring of enthusiasm may lead Credit Unions to make some poor choices in their mortgage lending, particularly if they are not knowledgeable about competitor offerings.

Brian Shepherd, AMP, is Senior Vice President and General Manager of CMG Mortgage Insurance Company (CMG MI), which exclusively serves Credit Unions. With two decades of experience in the Credit Union and mortgage insurance industries, Mr. Shepherd is familiar with the challenges of managing a mortgage lending business in a wide range of economic circumstances.

Credit Unions need to maintain perspective in evaluating the mortgage loans they are asked to make. Otherwise, they may burden their portfolios with loans that are not only unsalable, but actually challenge the Credit Union's asset liability management (ALM) strategy.

It's important to remember the background to this sudden popularity. The collapse in the housing bubble stems in large part from lenders making poorly considered loans to borrowers who had significant credit problems. As a result, lending standards have tightened considerably outside the Credit Union market. Higher-risk borrowers excluded under these new underwriting rules have to find another source of funds — and you don't want it to be your Credit Union.

Even Members who approach your Credit Union may want a loan with certain non-standard features — low or no documentation, interest-only, lower credit score or higher LTV — that could be a questionable loan in the current and projected economic environment.

These marginal loans might have made sense in a market with appreciating home values — but are problematic in a market where home values have been suspect since 2005.

For example, an initial 100% LTV loan from 2002 may have become a 97% LTV loan in 2003 as a result of appreciation in property values. In a rising market, borrower cashflow problems, whether due to job loss or excessive spending, were remedied by the sale of the home for more than the remaining mortgage balance, so the Credit Union holding the mortgage had few worries.

Now last year's 100% LTV mortgage may be a 105% LTV loan due to dropping property values, with all the attendant risk. If the Member runs into trouble, the slowdown in the housing market means that the only option may

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be foreclosure. Even if the Member can still make payments, the Credit Union will have to keep the mortgage in portfolio for much longer than originally estimated, especially if the mortgage is not salable on the secondary market because of its high-risk profile.

Embrace Selectivity

Credit Unions nurtured in the philosophy of "people helping people" and who are now seeing a rare opportunity to grow mortgage loan business quickly may find it difficult to adopt a rigorously selective approach to the mortgage loan applications flooding in.

Selectivity, however, is essential. Long-term loan quality must not be sacrificed for short-term market share. Credit Unions need to ask themselves in each case:

Is this a loan we should approve in a weak market? Or are we approving it only because we now have the opportunity to do so?

Credit Unions should be comfortable approving the loan, not stretching to find a rationale for doing so. In addition, they should reexamine the ALM implications. Credit Unions set limits on how much they can loan against their deposits, and a few are rapidly approaching those limits.

Once they approach the loans-to-assets limit, Credit Unions have the options of: either (1) selling current loans in portfolio or (2) acquiring more assets, in the form of deposits. With the current consumer savings rate in the United States at all-time lows, selling loans into the secondary market may seem the most feasible plan. Are the loans on your books salable to investors already shying away from mortgage-related investments? Or are your current mortgage lending practices simply adding more unsalable loans to an unsalable portfolio?

Credit Unions should reexamine portfolios and their appeal to the secondary market. Lending standards are in transition; if you need to sell loans, make sure the investor is still buying them and applying the same guidelines. Consider adopting underwriting standards that meet the criteria of independent investors, even though they currently can be more rigorous than Fannie Mae's or Freddie Mac's. And make sure your risk criteria are appropriate to your Credit Union and the community you serve.

The need to sell loans in portfolio requires Credit Unions to scrutinize their current approach to mortgage insurance (MI) coverage. If your policy has been to only insure mortgages at 85% LTV and above, reassess that policy. Also, reassess your MI coverage levels for current market conditions. At the rate that housing prices have declined, 85% LTV may no longer be sufficient as the baseline for MI coverage: The old 85% LTV loan is now the new 97% LTV loan. Be aware as well that mortgage insurance providers are tightening up their standards like everyone else in the industry. Loans formerly eligible for MI coverage may no longer qualify.

Avoid Adverse Selection

The present cycle may take two or three years to fully complete. With lenders scrambling to put their houses in order, Credit Unions will experience heightened demand for their mortgage lending services. They should also be aware of the potential pitfalls.

Above all, they must avoid being "adversely selected" by low-quality borrowers or brokers. Your competitors are not simply developing more stringent standards to ward off high-risk loans — they are actively trying to avoid becoming the lender of choice for low-quality business. Credit Unions, if they decide not to apply greater selectivity to their mortgage lending, are liable to attract poorer business quality in the mortgage market.

The Credit Union Advantage

Selectivity in mortgage loan approvals is the only way to prudently take advantage of the opportunities afforded by the present credit crunch. Mortgage brokers have in many cases been unable to weather the situation. Realtors are looking for reliable partners who can provide the needed financing. Credit Unions, who have pursued Realtor relationships with limited success in the past, can move smoothly into this role while maintaining a rigorous approach to quality.

Credit Unions have always possessed the trump card of knowing their borrowers and their communities. By using this knowledge, Credit Unions are better positioned to assess the risk posed by the Members and non-Members who now approach them.

CMG Mortgage Insurance Company (CMG MI) is the leading provider of mortgage insurance products and services to Credit Unions. The company's financial strength was recently acknowledged by Fitch Ratings, which affirmed CMG MI's "AA" rating with a Stable Outlook. You can read the Fitch Report posted at www.cmgmi.com/whatsnew.

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