CMG MI Signals

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Mortgage Lending in the New Economic Environment

Creating Sustainable Homeownership is the Goal — and Equity is Critical

By Kathy Schroeder, Senior Vice President and General Manager, CMG Mortgage Insurance Company

Kathy Schroeder is Senior Vice President and General Manager of CMG Mortgage Insurance Company (CMG MI), which exclusively serves credit unions. Ms. Schroeder has nearly three decades of experience in the mortgage insurance industry and has considerable knowledge of the credit union industry. Prior to her CMG MI assignment in 2002, she served in leadership positions at PMI Mortgage Insurance Co. in Servicing Operations, Credit Policy and Corporate Underwriting.

Much of the current economic turmoil in the United States was initially triggered by the collapse of the subprime market during the summer of 2007. The mortgage market is in the middle of a sizable correction, with large unsold inventories, an ongoing credit crunch and rising rates of delinquency all contributing to the difficulties facing lenders.

Credit Unions, however, are in a better position, with significant opportunities to increase their share of the mortgage market (see the 4th Quarter *2007 CMG MI Signals*). However, Credit Unions are also considering "best practices" they can implement to ensure that both they and their Members don't face undue exposure to risk in home loans.

For guidance, Credit Unions can look to a recent speech by the Federal Reserve's Chairman, Ben Bernanke. On March 14, 2008, he delivered a significant address on "Fostering Sustainable Homeownership" at the Annual Meeting of the National Community Reinvestment Coalition. It's a theme that many lenders, mortgage insurers, regulators and other concerned parties are embracing as the fallout from the 2002-2006 mortgage boom continues.

What is Sustainable Homeownership?

Sustainable homeownership means a home purchase that can be supported over the long term by the Member. In other words, it's about not just putting people in homes but making sure they will be able to stay there.

Helping Members to be successful homeowners continues to be the mission for Credit Unions that offer mortgage lending. Sustainable homeownership benefits not only the Member and the Credit Union, but also the neighborhood and the larger community. It acts to stabilize home prices and prevent the kind of community-wide depreciation that has been experienced by many MSAs recently.

To make sustainable homeownership possible, Credit Unions can first examine the overall quality of the loans they are receiving. With other lenders withdrawing from the marketplace due to lack of funding, Credit Unions are receiving a much higher volume of loan applications, some of them representing poor loan quality.

A "Back to Basics" approach is necessary. The Four Cs — Capital, Capacity, Character and Collateral of traditional underwriting — are an excellent way to gauge the quality of a loan application, if the temptation to modify standards in order to approve a marginal loan is resisted.

Let's start with Capital. The most salient observation about the current mortgage crisis is how many delinquencies are linked to borrowers who provided either very low or no down payments at closing. According to Bernanke, "appropriate attention to the borrower's ability to repay is a fundamental feature of good underwriting."

The Value of Equity

The ability of the Member to repay the loan is critical. One of the best indicators is the amount of equity they can contribute in the form of a down payment. In Bernanke's words, "…far too much of the lending in recent years was neither responsible nor prudent. The terms of some subprime mortgages permitted homebuyers and investors to purchase properties beyond their means, often with little or no equity."

While Credit Unions were for the most part not involved in subprime business, during the mortgage boom smaller and smaller down payments became the rule even in prime lending as a variety of loan products emerged to accommodate the borrower's lack of equity. Even as little as 10% or even 5% equity in a home purchase can be a critical indicator for the long-term sustainability of the loan. It's evidence of what industry insiders call "skin in the game," a sign that the distressed borrower will not simply walk away from his or her commitment even if the home value depreciates, rates reset or other economic factors decline.

Statistically, high-LTV loans represent a higher risk of default. With little equity in their home, even willing borrowers are unable to refinance when the crunch comes, or if the Member faces any financial adversity. The mortgage business is cyclical. Veterans know that the housing market tends to experience stress about every 12 to 15 years. When home prices are distressed, as they are currently in many markets, equity can make the difference for both the Member and the Credit Union.

Equity is important beyond the Member-Credit Union relationship. Investors, badly burned by the recent revelations on mortgage-backed securities, are backing away from purchasing loans that are 100% financed, even if they are insured with mortgage insurance. At the same time, the mortgage insurance industry is revising its guidelines to encourage lenders and Credit Unions to prefer those loans that are supported by 5% or 10% down payments. These new policies may be onerous to cope with in the short term, but investors and mortgage insurers are taking these steps to ensure the overall health of the mortgage finance system going forward.

In certain cases, 100% financing can still be appropriate, but only if matched carefully to the borrowers who meet other essential criteria. Not all loan products are good for every Member. A customized approach, based on the individual Member's credit history, financial circumstances, and other factors, is recommended.

More "Back to Basics"

According to Bernanke, "The deterioration in underwriting standards that appears to have begun in late 2005 is another important factor underlying the current crisis. A large share of subprime loans that were originated during this time featured high combined loan-to-value ratios and, in some cases, layers of additional risk factors, such as a lack of full documentation or the acceptance of very high debt-to-income ratios. In 2006, for example, the HMDA data suggest that nearly 40 percent of higher-priced home-purchase loans involved a piggy-back loan or second mortgage."

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Careful underwriting is now more important than ever. In fact, it's pivotal if the mortgage industry is to recover from the present situation and continue to fulfill its mission to help people buy homes. Standards loosened or even abandoned by mortgage lenders during the boom have demonstrated their value again and again in promoting sustainable homeownership.

Besides **Capital** in the form of equity, **Capacity** needs to be revisited. The Member's actual cash-flow should be verified as a matter of course. While low-documentation loans have their application in qualifying certain groups, in Bernanke's words, "we found that the prevalence of 'stated-income' lending led to many borrowers receiving mortgages that they could not afford. Consequently, we would require lenders to verify the income or assets they rely on to make credit decisions for higher-priced loans — standard industry practice, in fact, for most lending until quite recently."

Character deserves scrutiny. Since a home purchase is the largest financial transaction that most people make in the course of their lives, it's only reasonable to expect that their credit history testify to their willingness and ability to manage their debt load.

Collateral completes the Four Cs. As home prices continue to depreciate in many regions, appraisers have come under fire. A trustworthy appraisal is vital information for a Credit Union considering a mortgage loan application.

One more lesson from the current situation: Automated systems, while helpful, are incapable of assessing nuances or interpreting data beyond what is fed into their fields. Too many lenders have relied on their AUS instead of doing the necessary underwriting footwork themselves.

Members are looking to you, their Credit Union, to be their financial adviser. That means steering them to an appropriate loan instrument that offers their best chance for success in this uncertain economic environment.

Sustainable homeownership is the watchword for the 21st century. We've all learned that while making home loans can be easy, making bad ones can have very serious consequences — not just for a Credit Union or borrower, but for the wider U.S. economy and even the global economy. Equity is your starting point. Mortgage lenders, mortgage insurers, investors, borrowers and economists all agree: Equity can prevent a lot of problems from developing into a crisis. Once again, equity and traditional underwriting are the best guides in making mortgage loan decisions.