



Steering a Safe Course in 2006

Credit Unions Need to Reevaluate Risk

By **Brian Shepherd**

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By industry standards, 2005 was a tumultuous year for credit unions. While Hurricanes Katrina, Wilma and Rita devastated communities across the South - pushing regional credit unions and their members to the limit - credit unions also came under renewed scrutiny in Congress, as banks pushed to have their tax-exempt status revoked. Meanwhile, short-term interest rates climbed steadily upward throughout the second half of the year.

2006 already promises to bring more challenges — but also opportunities. Credit unions involved in mortgage lending must prepare themselves to make substantial adjustments in the way they do business. This year could be critical for credit unions in terms of remaining an active participant in mortgage lending, as well as safeguarding portfolios and reducing risk exposure.

Mortgage Lending Outlook

Most analysts agree that the overall economy should post a good year in 2006, with robust growth and low unemployment. Against this economic background, housing activity is generally expected to weaken as the year progresses, due to the pressure of higher mortgage rates. Respected economist Mark Zandi joins other experts in predicting that mortgage originations will lose momentum, especially in the first quarter of 2006, and states that volumes will decline this year from an estimated \$3 trillion to a range closer to \$2.3 to \$2.5 trillion. He also anticipates

that refinancing activity will also decline sharply as the year progresses, while purchase volumes will level off.

Fannie Mae foresees slowing activity in the mortgage markets as well. According to the January 18, 2006, edition of Berson's Monthly Outlook posted on www.fanniemae.com, the GSE predicts that originations will drop by more than 20% in 2006, while home price gains dwindle to single digits.

Fannie Mae is among the more optimistic observers on the interest rate front, anticipating only slight upward movement from the Fed throughout the year. However, as Mark Zandi cautions, even a moderate rise in interest rates will have a substantial impact on the housing market. "The small hike in rates to date has undermined affordability, given the very high house prices that currently prevail in many markets," he said. "First-time homebuyers are being locked out, while investors are re-thinking their investment strategies." With short-term interest rates still rising more rapidly than long-term ones, Fannie anticipates that the flattening yield curve will produce a rise in the number of fixed-rate mortgages as the start rates of adjustable-rate mortgages (ARMs) move closer to them.

Risk Emerges as Key Factor in Housing Market

Potentially the biggest problem ahead was created by the thriving mortgage market of previous years. Popular and enthusiastically embraced by consumers,

mortgage lending's so-called "exotic products" - like interest-only, no-money-down, option ARMs, for example - represent substantially higher risk to lenders who keep these loans in portfolio, particularly in a rising interest-rate environment.

Remember, one important trend that helped drive the boom in mortgage lending was rapid home price appreciation. However, while many experts are forecasting a "soft landing," it's evident that appreciation is slowing down in some key markets, especially along the East and West coasts.

The Winter 2006 issue of the *Economic and Real Estate Trends (ERET) Report*, published by PMI Mortgage Insurance Co. (one of CMG MI's parent companies), cautions that 11 regions in the United States have a 50% or greater chance to experience home price declines in the next two years. Credit unions need to take this into consideration when recommending appropriate loan products to their members - not only to protect membership, but portfolios. Homebuyers with adjustable-rate loans that have no interest rate caps or who have interest-only loans could be caught in a double bind as interest rates continue to rise: squeezed by rising rates but unable to sell their homes at a profit due to stagnating or declining house values. These borrowers represent a substantially higher risk of default when payment shock sets in.

The National Credit Union Association (NCUA) has taken a very firm stand recently against the surge of risk in mortgage markets and the lending practices behind it. Supervisory Letters were sent to NCUA field staff in May 2005 ("Risks Associated with Home Equity Lending," 05-CU-07) and October 2005 ("Increasing Risks in Mortgage Lending," 05-CU-15). The October release sternly noted that "in many cases, institutions' credit risk management practices for home equity lending have not kept pace with the product's rapid growth and easing of underwriting standards." The Credit Risk Management Guidance for Home Equity Lending that accompanied the May Supervisory Letter went on to say that "financial institutions should ensure that risk management practices keep pace with the growth and changing risk profile of home equity portfolios." Furthermore, in December, a proposed guidance on nontraditional mortgages was distributed for comment.

Protecting Your Credit Union in 2006

While the news about risk may seem alarming, it actually means that 2006 is the perfect time for credit unions to begin the process of safeguarding portfolios and reducing liability in originating new loans. Credit unions have a real opportunity to plan a stable, secure future for themselves and their members.

The widespread practice of retaining loans on their books has exposed many credit unions to undue risk. What can be done? First, you need to reexamine the value of mortgage insurance relative to your own portfolio, as recommended by the NCUA's Credit Risk Management Guidance for home Equity

Lending: "When appropriate, consideration should be given to the use of risk mitigants, such as **private mortgage insurance** [emphasis added] ..." The document goes on to point out that "Over the past few years, new insurance products have been introduced to help financial institutions mitigate the credit risks of [high LTV] loans. Insurance policies that cover a 'pool' of loans can be an efficient and effective credit risk management tool."

CMG Mortgage Insurance Company (CMG MI) is committed to providing our credit union customers with the critical tools and support they need to succeed in a year that looks particularly challenging. What's your perspective on the situation - 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.

Besides protecting your level of exposure, mortgage insurance can also help make portfolios saleable to the GSEs and investors, enhancing your credit union's liquidity. This could be a crucial advantage the next time a regional economic downturn strikes your members' communities. Even without a downturn, greater liquidity can help protect your margins - and for credit unions, in an environment where net interest margins have been dropping for the past 5 years, that's an important consideration.

At the same time, the range and variety of mortgage insurance products —

including expanded guidelines, no-down-payment loans, and underwriting flexibilities — make them a viable alternative to piggybacks with a variable-rate second and interest-only loans, with fewer attendant risks. Whether your members are homeowners with adjustable-rate seconds, or first-time homebuyers seeking to maximize their purchasing power, mortgage insurance can provide a low-risk solution that meets their needs and yours.

Credit unions can also use the situation as an opportunity to educate both members and your own loan officers about prudent mortgage lending. Explain the current mortgage lending climate and how too great a reliance on "exotic" loan products can jeopardize not only your members' household budgets, but the future of your credit union as well.

Members look to you, as their trusted financial advisor, to provide information about all the options. Once the potential for payment shock is explained to them, as well as the current rate scenario and the likelihood of only modest appreciation, they'll appreciate hearing about an alternative that can eliminate their worry about rising rates, assuring them of a stable, fixed monthly payment in the current uncertain environment.

Brian Shepherd is Senior Vice President and General Manager of CMG Mortgage Insurance Company (CMG MI), which exclusively serves credit unions. Mr. Shepherd has nearly two decades of experience in the mortgage insurance industry and has considerable knowledge of the credit union industry.



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