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## > MORTGAGE LENDING AFTER THE MELTDOWN – LESSONS FROM THE UNITED STATES

As we begin to understand the extent of the U.S. mortgage crisis, we are also beginning to understand some of the excesses that occurred during the boom. However surprising - or not - these should not obscure the fact that there was a healthy period of growth in this market, during which home-ownership expanded at an unprecedented rate for low- to moderate-income and minority families, many of whom continue to be successful home-owners.

While we're now in a period of retraction, low down payment lending isn't going away. Home prices around the globe are high, making it difficult for many borrowers to save down payments. The challenge is to learn from the recent past and figure out how to do it better. I believe a renewed focus on the fundamentals of credit risk management - five simple components - can provide a foundation.

**Borrower Equity** - First, some equity - even as little as 3 percent - helps everyone. For lenders and investors, it's a cushion that offers some protection against the downside, which is important for the long-term health of the loan. For borrowers, it indicates that they've thought about the step they're taking and that they feel ready to assume the commitment of owning a home. For the mortgage finance system, it's a stabilizing force that helps ensure long-term health. This doesn't mean that 100 percent of financing goes away completely - there are times when it is appropriate. But like other niche products, it needs to be matched with the borrowers whose individual circumstances make it appropriate, and who are likely to be successful with that type of product.

**Financial Resources** - A borrower must have the financial resources to make their mortgage payments. For borrowers to be successful, and for lenders and other industry participants to thrive over the long term, home-ownership has to be sustainable. This means verifying income, monthly cash flow, and the borrower's ability to repay the loan. In the United States, new federal regulations requiring lenders to qualify borrowers for loans at the fully indexed rate will help ensure borrower preparedness. In the UK, Prime Minister Brown is looking at removing early withdrawal penalties from long-term

mortgages in order to help borrowers get into longer-term, sustainable mortgage products. But while the solutions may differ, the goal is the same: help ensure borrowers are able to succeed over the long term.

**Credit History** - A borrower must have exhibited a history of responsible credit behavior. A home purchase transaction, and related mortgage, is the largest financial transaction most people ever make. It means taking on a large obligation and to be successful a borrower will need to manage his or her finances carefully. Careful attention to a country's leading authority for rating a consumer's credit history is one of the best indicators we have to help us determine a borrower's ability to repay debt. Borrowers who have demonstrated a willingness and ability to manage their debt are more likely to be prepared to assume the financial obligations of home-ownership.

**Valuation** - The valuation or appraisal of a home is a critical part of the lending decision. And, while they've been shrouded in controversy, the UK's new Home Information Packs do at least provide a level of assurance for borrowers who want to know they are paying a fair price for their home. Regardless of the vehicle, lenders need to know that they can trust an appraisal on the value of a home so that they understand the risk they are taking. In light of changing market conditions, appraisers should consider carefully the factors that lead to a valuation.

**Underwriting** - Careful underwriting ties these other components together. Experienced underwriting is required in order to review the loan characteristics, balance the various factors involved, and determine whether all the pieces fit the requested loan. Automated systems can help with this task, but they often can't interpret nuances or identify potential problems the way an experienced underwriter can. Experienced, quality underwriting ensures that the borrower has the willingness and ability to repay the loan on a properly valued home.

Whether the location is London, New York, or Hong Kong, purchasing a home involves hopes and dreams as well as communities and families. Honoring the hopes and dreams of our customers and countrymen

means that we need to have the same goal: sustainable home ownership that benefits everyone—the lender, the borrower, and all those in between. For the system to be vibrant—for borrowers to be successful, for lenders and other industry participants to thrive over the long term—home-ownership must be sustainable. Remembering the fundamentals of credit risk management can help us get there.

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