Perfect Timing

— by MARY McGARITY —

Recent entrant National MI has a new approach to the private mortgage insurance business. Lenders are taking notice.

Is now a good time to bring a new private mortgage insurance (MI) company to the market? Bradley Shuster and Jay Sherwood, co-founders of new entrant National MI, Emeryville, California, think so—and they raised $550 million to prove it. ¶ In 2011 and early 2012, Shuster, chief executive officer, and Sherwood, chief financial officer, embarked on an investor road show across the United States to promote their idea for a startup mortgage insurer and raised half a billion dollars in private capital. ¶ “We met with 100 different investors,” Shuster says. “Not one of them thought it was a bad idea.” ¶ Indeed, it may actually turn out to be a fantastic time to start a new MI business, for a multitude of reasons. Success, of course, will hinge on not repeating the mistakes of the industry’s recent past—but National MI has some ideas about that, too.

For one thing, the company is taking a unique approach to risk management, which is reflected in National MI's master policy, according to Shuster. Through its signature product, National MI SafeGuard℠, the company is offering lenders increased underwriting protection and the most definitive terms of coverage in the industry, he says. "We're able to do so because we underwrite every loan either prior to closing in our non-delegated channel or during a post-close review in our delegated channel," Shuster notes.

A key tenet of National MI's SafeGuard: Unless there is first-party fraud, National MI will not rescind or deny insurance coverage after borrowers have made their first 18 timely monthly mortgage payments from their own funds, says Executive Vice President and Chief Risk Officer Patrick Mathis. That coverage applies to every loan in both the delegated and non-delegated channels, he adds. "The current industry standard is 36 months, so National MI has cut the time frame in half," he says.

Positive feedback from lenders and correspondents

By providing lenders with more beneficial terms and increased underwriting protection in a much shorter time frame, National MI is "pioneering a new approach to mortgage insurance coverage," Shuster says.

Early feedback from the lending community has been positive. "The re-emergence of private capital into the mortgage market is a welcome sign," says Stan Kurland, chairman and chief executive officer of PennyMac Loan Services, Moorpark, California. "We are excited about the opportunity to work with a new mortgage insurer who brings dependable and efficient processes to the mortgage industry, benefiting both lenders and the overall housing market."

The response from correspondent lenders has also been enthusiastic. Loan aggregators like knowing that National MI's distinct certificate of coverage will travel with the loans from origination on, continuing when loans are sold and pooled into securities, Shuster says. "Whoever ultimately buys the loan will have the same SafeGuard coverage. Correspondent lenders and investors can be reassured that if a loan goes bad, our certificate ensures that that the loan bears National MI's strong underwriting protection and that 18-month time frame for coverage certainly still applies," he adds.

Seeds of an idea

What was the genesis of National MI? It began when Shuster and co-founder Sherwood first met in 1991. The two share a mutual accounting background, and were introduced when Shuster, then a partner at Deloitte, recruited Sherwood from the University of California–Los Angeles (UCLA).

"Brad was a partner and I was hired as a staff accountant. We became friends and later, after leaving Deloitte, we kept in touch," Sherwood recalls. Their friendship continued over the next two decades.

After Deloitte, Shuster furthered his career as an executive in domestic and international mortgage insurance operations. He served as president of international and strategic investments at The PMI Group (PMI), and as chief executive officer of PMI Capital Corporation. Shuster was responsible for PMI's international operations, coordinating both acquisitions and *de novo* operations in diverse markets including Australia, Canada, Europe and Hong Kong. He retired from PMI in 2008.

Sherwood moved to investing, with a 15-year stint at RS Investments, formerly Robertson Stephens Investment Management, and Eastbourne Capital Management LLC, which at one time was Milwaukee-based Mortgage Guaranty Insurance Corporation's (MGIC's) largest shareholder.

Over the years, Shuster and Sherwood discussed the idea of starting a private mortgage insurance company, taking note of what wasn't working and coming up with the ways they would approach the business differently. All the forces seemed to come together in 2011. Shuster was coaxed out of an early retirement and, along with Sherwood, began making the rounds of calling on investors to present their concept for National MI.

By spring 2012, Shuster and Sherwood had raised $550 million, largely through the investment of mutual funds and hedge funds. National MI has approximately 50 investors, including Kyle Bass, founder, managing director and principal of Dallas-based Hayman Capital Management LP. "The fact that we were so successful in raising that amount of capital is clear evidence of the strong confidence investors have in National MI's concept and our leadership," Sherwood says.

Doing their homework

What about National MI attracted investors like Bass? A chief appeal is the fact that the company isn't facing the losses from the housing downturn that some competitors are dealing with, notes Sherwood. "We're not distracted by rescissions and claims, and are in a position to deploy capital that will effectively expand home financing," he says.

National MI executives also did their homework. Their research showed very favorable demographics for the private MI industry over the next 10 years. They found the average age of first-time homebuyers in the United States is 34, according to data from the National Association of Home Builders (NAHB), Washington, D.C., and the U.S. Census Bureau.

"We then looked at the average selling prices of homes across the country, as well as the average amount of money that 34-year-olds had saved," Shuster says.

"When we compared home selling prices to the savings of the average 34-year-old, we found very few have saved enough for a 20 percent down payment. In fact, it would take 15 years on average for a 34-year-old to save enough for a 20 percent down payment. We saw a great need for more private mortgage insurance products."

Wall Street analysts agree it's an opportune time for a new mortgage insurer to enter the market. Today, the MI business is back to being as profitable as it was prior to the housing crisis and mortgage meltdown.

"It's a good business to be in," says Bose George, managing director and mortgage finance analyst at Keefe, Bruyette & Woods, New York. "There are a limited number of competitors because of high capital barriers. If, like National MI, you don't have to worry about any legacy mortgage insurance issues, you can focus on running the company to generate maximum profits and ROE [return on equity]."

A rebound for MIs

Many observers had all but written off the private mortgage insurance business a few years ago, so the rebound of MIs—both existing and newly formed—has taken some by surprise.

In recent months, trade and national news media alike have touted the recovery of the private mortgage insurance industry, and the stock of mortgage insurance companies has been on the rise.

"MIs were very profitable last year," says Jason Stewart, managing director and head of research at Compass Point Research & Trading LLC, Washington, D.C. "They generated an ROE over 20 percent on their recent vintage underwriting. They will have more modest returns this year and next, but still in the high teens. With a lot more capital coming into the industry, profits will come down slightly."

Stewart points out, "With the capital National MI has raised, it seems like a very good time for the firm to start writing mortgage insurance. They have the right people—all industry veterans—to be successful."

In January, National MI passed a major hurdle by gaining the approval of Fannie Mae and Freddie Mac. The company issued its first mortgage insurance commitments in April, and as of early May had been approved in 47 states and the District of Columbia. When this article went to press, the approval of the remaining three states was expected in the near term, and the company had approved more than 100 master policies with customers.

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"National MI is well-capitalized with $550 million, and should generate solid returns. Overall, [private mortgage insurance] is a very profitable and well-capitalized industry," says KBW analyst George.

The recent capital raise by other private MIs certainly bears this out. In February, Philadelphia-based Radian Group raised more than $700 million in capital from sales of common stock and bonds for its mortgage insurance business. In March, MGIC raised more $1.1 billion in new capital from the sale of $695 million in common shares and another $450 million from senior convertible notes.

According to George, Radian, MGIC, Greensboro, North Carolina–based United Guaranty Corporation and other mortgage insurers are producing ROEs in the high teens—17 to 18 percent, which is the historical norm for the industry. They have the potential to generate ROEs higher than 20 percent on some of the monthly books of business they are writing now, he says.

National MI executives might argue that while it's a good time to be in the private MI business, it's a great time to start a brand-new MI—a company with unencumbered capital and without the hangover of claims from the housing downturn.

The company also isn't hampered by a legacy technology platform. National MI invested in a modern system assembled by technology experts who have first-hand knowledge of existing mortgage insurance systems, says Stan Pachura, National MI's chief information officer.

"It's the next generation in MI technology, and the only modern platform where every aspect of the technology is new and not patched by band-aids over the years," says Pachura. The system is also user-friendly—lenders need only a single login for everything from underwriting to servicing to claims. The cost-efficient systems platform gives National MI more financial flexibility to focus on innovations that benefit customers, he notes.

A clear and fair approach to coverage terms

According to Chief Risk Officer Mathis, National MI's unique approach to risk management is a critical component of the company's value proposition. "Our master policy is one of the most clear, reliable policies in the industry," he says. Lenders are drawn to the company's offering of increased underwriting protection in a shorter time frame, Mathis adds.

And lenders will find National MI's delegated channel offers a far better experience than what they may have been used to in the past, he says. Based on their past experiences when the housing bubble burst, many lenders are still wary of delegated underwriting, where essentially MIs turn the task of underwriting over to the lender and the lender warrants that it is in accordance with the MI's underwriting criteria. Because a small sample of loans were typically audited six to 12 months after MI coverage was placed on the loan, many loan defects weren't caught—and MIs were able to push back the loans on lenders when they became delinquent.

"During and right after the housing downturn, that was often a lender's experience with MI underwriting," explains Claudia Merkle, National MI's executive vice president and chief of insurance operations. National MI, however, is reviewing all the loans either prior to the closing or post-closing—which will ultimately make for a smoother process and drastically reduce the chances that the lender will be asked to buy back loans.

Once National MI reviews and approves the file, either prior to close or in the post-close review, the company won't rescind or deny coverage based on an issue that its underwriting review should have uncovered, which includes the underwriting of the appraisal, according to Merkle. "We are committed to taking a fair business approach with our customers, and that includes providing strong underwriting protection starting from day one," she says.

According to Merkle, National MI is well aware of the hesitancy on the part of lenders when it comes to a delegated product. "A lot of these lenders are just coming out of the credit crisis. They will learn with National MI that our review is not punitive; it's accretive. It's not a 'gotcha' moment," she says.

Prospective customers have found the transparency that the upfront reviews provide particularly appealing, Merkle says. By moving the review upfront, lenders also gain more control over any loan manufacturing defects. Any issues will be caught early in the process, Merkle says.

Optimistic about private capital's future

Not surprisingly, the housing meltdown in 2007 and 2008 prompted scrutiny by state insurance departments of the regulatory and capital requirements governing the MI business, says Glen Corso, executive vice president and general counsel.

State regulators, acting through their umbrella group, the National Association of Insurance Commissioners (NAIC), Washington, D.C., have organized a committee that will perform a thorough examination of capital standards and regulations governing mortgage guaranty insurers, he says. National MI, in concert with other mortgage insurance companies, has already begun to provide input to the NAIC committee.

GSE Risk Sharing—*A New Opportunity*

A possible profitable undertaking for mortgage insurers sits on the horizon: a $30 billion target for credit-risk-sharing transactions each with Fannie Mae and Freddie Mac as directed by their regulator, the Federal Housing Finance Agency (FHFA) in its 2013 Enterprise Scorecard.

Much of that money for single-family loan deals will be devoted to expanding mortgage insurance coverage, but not all. Some will go toward credit-linked securities and senior subordinated securities, too.

"FHFA sees an enlarged role, with deeper mortgage insurance coverage, for the MI [mortgage insurance] companies, which will help to scale back Fannie Mae and Freddie Mac," says Bose George, managing director and mortgage finance analyst at Keefe, Bruyette & Woods, New York. "The risk sharing will create an interesting opportunity for National MI [Emeryville, California] and the other mortgage insurance companies."

Wall Street analysts said that the goal of FHFA is to bring more private capital into the mortgage market, which in recent years has been heavily government-financed due to the dominant market share of the Federal Housing Administration (FHA) and the government-sponsored enterprises (GSEs). But now that recovering housing markets have turned Fannie Mae and Freddie Mac around, allowing them to feed profits into the Treasury, there could be less impetus in deficit-ridden Washington to wind them down and provide more opportunity for private capital.

Mortgage insurers also likely will benefit from the shaky financial state of the FHA's insurance fund.

However, the FHFA has requested from both Fannie Mae and Freddie Mac loan-level credit performance data so private-sector institutions, including mortgage insurers, can evaluate the data to structure risk-sharing transactions. On March 21, Freddie Mac provided its loan-level data to FHFA. The agency said it expected Fannie Mae to shortly follow suit.

Edward Pinto, resident fellow at the American Enterprise Institute, Washington, D.C., and former chief credit officer at Fannie Mae, points out that the credit risk-sharing transactions offer additional benefits beyond reducing taxpayer exposure to the government-sponsored enterprises (GSEs). "They also will provide information to set guarantee fees high enough for private capital to manage their risk coverage," he says.

Mortgage insurers can develop a large role in the credit-risk-sharing transactions. By expanding the coverage of mortgage insurance on GSE loans from the usual 20 percent to 25 percent of the loan's balance in case of default to 30 percent, Pinto notes, more risk could be transferred to private mortgage insurers. This also would allow Fannie Mae and Freddie Mac to reduce their loan-level pricing adjustments. "This is the easy way to do risk-sharing," he adds.

Another way to set up a single-family risk-sharing transaction would be to mimic what Freddie Mac recently has structured in multifamily loan risk-sharing deals, selling a portion of the risk to private buyers of subordinated bonds, Pinto says. "Private mortgage insurance companies could take on part of that risk, too, in these bond deals," he says. "FHFA already has said this type of transaction is feasible for the single-family risk-sharing transactions."

Pinto notes that mortgage insurers today are more than adequately capitalized to handle the FHFA risk-sharing deals. The way private MIs reserve capital on their insurance business is far superior to the low static capital requirements for banks and the GSEs prior to federal conservatorship. Mortgage insurers accumulate capital over the years during the up-and-down cycles of real estate markets by reserving at least 50 percent of the premiums in every book of business each year for a 10-year period. And they cross-collateralize older books of insurance with newer books, which is very helpful in the current cycle where the newer books have much stronger credit characteristics than the 2006–2008 vintages.

Mortgage insurers also likely will benefit from the shaky financial state of the Federal Housing Administration's (FHA's) insurance fund.

"The FHA's role has traditionally been to insure mortgages for first-time homebuyers and others looking for affordable housing," says Jason Stewart, managing director and head of research at Compass Point Research & Trading, Washington, D.C. "I think more people in Washington are thinking FHA's mission is not to insure $750,000 mortgages. If any FHA reform comes to pass, it will likely lessen FHA's competition with private mortgage insurance companies."

Pinto says FHA currently insures a lot of mortgages that are in the bottom range of loans that private mortgage insurance companies can price and handle effectively—those with FICO® scores of 680 to 710. "Instead of crowding out the private sector and doing business MIs are willing to do," he says, "FHA should focus on its core mission of providing insurance for means-tested borrowers with FICO scores that don't appeal to the private sector."

—Marshall Taylor

By all accounts, the emphasis of Washington policymakers today is on how to engineer the return of private capital to be in a first-loss position in the mortgage market to replace, or at least stand in front of, the U.S. government guaranty, he says. "We are very confident that the process to reform the housing finance system will include an affirmation of the role of private mortgage insurance as private capital in a first-loss position, and potentially an expansion of that role through the risk-sharing policies announced by the Federal Housing Finance Agency (FHFA) for the GSEs," Corso says (see sidebar).

"Given that policy-making direction, we are very confident private mortgage insurance has a viable—indeed a very bright—future," he adds.

Currently, there is speculation that MIs will be dealing with multiple secondary market investors setting requirements if the GSEs are replaced or their role is reduced. However, Corso believes that scenario is looking less likely given FHFA's recently announced plans to combine the securitization platforms of the GSEs into a single platform. "With the existence of one platform, we think it is far more likely that you would have a single, uniform standard for private mortgage insurance companies," he says.

Even if it turns out otherwise, Corso points to the experience that National MI's senior management team—most notably Shuster—has building a mortgage guaranty insurance business for the Australian market, which has a number of large banks as the primary issuers of mortgage-backed securities (MBS). "Each of those banks set their own standards and there is no government-chartered or affiliated secondary mortgage market entity. Key members of this management team have the experience to build a successful, profitable business in a multi-issuer market," Corso says.

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Taking the show on the road

That's part of the reason Corso, as well as Shuster and Sherwood, are more than confident as they launch the new company.

When it came time to put together National MI's sales team, Executive Vice President and Chief Sales Officer Pete Pannes, a veteran of the MI industry, relished the opportunity. "You don't often get a chance to work for a startup in the mortgage insurance business," he says. "We are doing things differently and in a way that benefits both National MI and our customers."

As he's hired people for his sales force, Pannes looked for industry leaders who had a superior reputation in their local marketplace. "The most successful of those tend to approach their territory as their own practice or regional franchise," he explains.

With "the right people with the right experience" in place, National MI is primed for success, says Shuster. "The time is right, we've done our homework, and the industry is ready for new blood that will push the MI industry forward to expand the availability of financing for homeownership." MB

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