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RDN - Radian Group Inc at KBW Mortgage Finance Conference

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PRESENTATION

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Let's start the next session. Next up we have Radian Group. From Radian we have S.A. Ibrahim, the CEO; Cathy Jackson, Controller; and Emily Riley, the Head of Investor Relations up in the front row. So we're just going to do the fireside chat format for this discussion. So I'll just kick it off with a few questions and we can open it up after that.

Actually first just under -- with PMIERs now behind us, can you remind us what kind of ROEs you think you can generate under PMIERs and what that translates to in terms of risk to capital for the business?

S.A. Ibrahim - *Radian Group Inc. - CEO*

Bose, that's a good question. So with the PMIERs now behind, I estimate the capital requirements based over the life of the loans based on the business we are writing today. I think they translate to 14-to-1. And based on that, we expect to generate unlevered after-tax return on capital of between low to mid teens. And that's a blended return including both singles and monthlies and the estimates also are subject to -- are based on several factors, including the potential of reinsurance -- so that sort of.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

And in terms of capital, the 14-to-1, do you think there is a need to keep any buffer related to PMIERs or I guess a seasoning credit kind of provides some buffer.

S.A. Ibrahim - *Radian Group Inc. - CEO*

So at Radian, we expect to keep a buffer. We are evaluating exactly how much we need. Remember we are now accreting capital within our -- because we are profitable -- within our Radian Guaranty entity, but you need capital to accommodate new business you are writing. You need to keep a buffer to deal with loans that may go into default and then trigger higher requirements. So we are in the process of determining that. And I think everyone in the industry will figure out how much they need based on their comfort level.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

And then just in terms of the returns, can you sort of disaggregate the pieces there, the loss ratios, expense ratios, the components of getting to that ROE?

S.A. Ibrahim - *Radian Group Inc. - CEO*

Yes. And I'll ask Cathy to expound on that in greater detail in a second, but keep in mind, like with any estimate, you are making some assumptions and the actual returns you realize may be higher or lower than that. So what we project this is based on what we call our underwriting returns, so we make assumptions on future losses; we make assumptions on prepayments and so on.

And it's interesting and after this I'll let Cathy get into detail -- it's interesting when we look backwards, some of the business that we wrote over the last three years in fact ended up being more profitable than we had expected to do at the time we wrote it, both because credit trends improved as well as we had faster prepayments which made the returns on our singles business higher. Cathy?

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

Sure. So our loss ratio expectations are approximately 20% on the losses expense ratio approximately 25%, so a combined ratio of about 45%. And then in terms of premiums, as a kind of a point of reference, our average premium rate over the last 12 months was about 52 basis points. So that's kind of a good proxy in terms of the premium assumptions.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

In terms of the expense ratios, last quarter, you guys were at 23%. Do you feel like there is room for that to go down or it kind of stays -- that's kind of a normalized run rate?

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

I think it's a good -- that's a good rate in the near term. About 25% is about what we are targeting for the near term. Over the longer-term, we are expecting to realize some efficiencies both on the technology side as well as the process side. So we are looking for that rate to come down over time, but 25% is good for the near term.

S.A. Ibrahim - *Radian Group Inc. - CEO*

As we've mentioned periodically, we have a major technology and modernization initiative underway and as that starts flowing into implementation, we expect to see, over the medium to long-term, improvements in efficiencies as we substitute automation, increase the level of automation we use and we incorporate the benefits of that technology.

And for a separate conversation sometimes, some of the things that we've done in that area are really quite leading, particularly in terms of being able to digitize and capture all of the documentation at the inception of a loan and then we store it on the Amazon cloud and it can be accessed by anybody using Google Access. So in addition to the benefits we can realize from within our own shop, there's potential benefits that some of our customers may be able to realize from that too as we take that and bring it to our customers through the MI business as well us from of the Quaker business.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

And just on the loss ratio, you guys provided some good disclosures last quarter just on how the loss ratio is a seasoning for some of the newer books. Just given that they are peaking at levels that are well below 20%, I guess even under 10% for some of the 2009 books, what does that do for the ROEs at least for the next two years?

S.A. Ibrahim - *Radian Group Inc. - CEO*

It's a subject of healthy debate in the Company because we've taken the view generally that we would like to see the trends established over a longer period of time before we declare victory. So we tend to be more cautious in terms of seeing more developments on the trends. But you're right. Some of the newest curves of the newest vintages are tracking well below what we are currently modeling. Cathy?

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

Yes. Sure. The 2010 to 2012 vintages are tracking in the upper single digits. 2013 and 2014 not as developed but could be 15% or lower. But like I mentioned before, we are using a 20% loss ratio assumption with respect to our returns, and that ratio is really more of a through the cycle loss ratio. So losses in the current environment are lower than average, lower than 20%, but we expect that if there are -- and I know there will be at some point a downturn such that our long-term expectation is 20% on the loss side. But back to your question in terms of the returns, so obviously to the extent that the loss ratio is less than 20%, there could be some upward mobility in terms of returns in the near term.

S.A. Ibrahim - *Radian Group Inc. - CEO*

And like I mentioned, along with repayments, losses that were lower than what we had projected a few years ago contributed to our profitability in the last few years being higher than what we had expected at inception.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

So let me just check if there's any questions from the audience.

QUESTIONS AND ANSWERS

Unidentified Audience Member

When we talk about the actual -- your imagined projected claim or per new notice, it really went from 16% to 15% I think quarter on quarter if you adjusted it. But when I do the math, it's actually, I'm lower than that even though -- for different reasons I can walk through, I don't want to bother the whole room. But is there a sense of maybe padding these reserves and we -- because my problem here is that this is the longest credit tale there is, right? I mean you have credit cards being one year, this is being like kind of the longest part of the credit. Would it take forever for us to realize these kind of padded provisions and reserves in earnings eventually, or are we just being conservative upfront? Or is there more to it? I don't know.

S.A. Ibrahim - *Radian Group Inc. - CEO*

First of all, I'm glad you think that future losses could be lower than where they are today. The language you used is concerned. Again, we are dealing with estimates, and our challenge is to always have the estimates we believe that are the most accurate and the most defensible because we are required to have best estimates. And ideally, we don't want to be surprised in either direction with those estimates. Having said that, we do admit that we are living in a world where things are improving. So I'll let Cathy talk about exactly extrapolating from those curves we disclose. So we disclosed those curves to give you as much information as we have.

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

Sure. So what we're seeing -- the rate came down from 16% to 15%. We're seeing trends that suggest that the rate is coming down. It could come down further. But like I said, I want to reiterate we are certainly not padding our reserves and we think that we have the best estimate that we have based on the information that's available in examining those trends. It's possible that it could come down further but we wait until we see established trends and observe trends before we lower the rate further. So at this point in time, we don't see enough information, enough of a trend, to lower below 15%.

S.A. Ibrahim - *Radian Group Inc. - CEO*

Suffice it to say we have a fairly rigorous process in place where, to adjust those reserves, we have to have members of the committee that looks at it or be comfortable that that is a number that really -- the trend has established itself to the degree that we're comfortable.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

I'm just thinking. You are paying 2009 right now still. This is like six years after, something, so when this turns to actual time to get paid, this would be about 2020, 2021 or so, and it's just I think kind of the stock goes up as you beat earnings and I think it just can be prolonged.

S.A. Ibrahim - *Radian Group Inc. - CEO*

Yes, the mechanics of our reserves are based on the actual experience we are realizing and Cathy and I aren't going to walk through that, so it still based on the blended vintage losses we are experiencing. So if you take away the history and just go with the newer license, it could be different. But that's what we actually experienced and that's the number we used.

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

Keep in mind that most of the defaults that we are seeing now are still defaults from the legacy book, 2005 through 2008. So there is still -- when you talk about new defaults, it's a little bit different than talking about our new assumptions on new business losses. So there still is some uncertainty related to those books in terms of the development. And like you said, it is fairly long.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

I'd like to ask about the loss rates you noted for 2010 to 2012, around 10% relative to 20% expectation and higher more like mid-teens for 2013 and 2014. What's leading loss rates to increase and what's your expectation for this year and beyond?

S.A. Ibrahim - *Radian Group Inc. - CEO*

Cathy?

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

I think, in terms of the expectations for this year, I think that that information that we showed now with the cumulative loss rates for each of the vintage, you can see how each vintage is tracking and that 10% to 12% at peak, they now are coming down, so we obviously expect those rates to be below 10%. With respect to the newer vintages, I think we're -- I don't think we would say we expect them to be below 15%, but they could be below 15%.

Unidentified Audience Member

How are they tracking relative to interest growth?

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Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

They are tracking -- it's pretty early, but they are tracking fairly similar at this point.

Unidentified Audience Member

Do you expect it to be fairly different?

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

Not necessarily.

S.A. Ibrahim - *Radian Group Inc. - CEO*

It's just that the curves -- there's not enough points of data on the curves to say they have matured. And while it's very unusual for curves going at a certain level to have a spike, under certain economic scenarios, we've seeing that happen in the past. So we can't, like I said, declare victory until there's enough points.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

I guess maybe along these lines but sort of taking a look at the other side of things, so obviously this is -- we go through cycles, and at some point, if you guys are modeling 20% and we are at 10% or 15% today, sometime those ratios are going to look more like 25% or 30%. What -- and obviously there's been a lot of changes in the industry. You addressed that. But what have you guys done or what are you thinking about internally to not repeat what happened last time kind of thing? But also just to say, okay, we are -- these are modeling a certain way, that's great. We are going to be more profitable today and then what can we do down the road? Obviously, you talked about the buffer. Are there other things you guys can do to sort of mitigate the cycles?

S.A. Ibrahim - *Radian Group Inc. - CEO*

Yes, that's a very good question and it kind of talks about -- let me just address three dimensions of it. First, in terms of data and analytics, we have a lot more data of loans that perform during the down cycles and those loans that didn't perform. So we've used that data to develop an internal credit model we call Radar which actually -- I used to talk about the fact, having come from a consumer credit/credit department consumer background way back in my career, I used to talk about the fact that, in the mortgage industry, it was hard to build accurate models because there weren't enough bad loans. Now everyone has enough bad loans to build a more robust model. So we've used that data and those analytics to build those models to guide us. We also have -- we track developments a lot more closely, so we monitor the mix of business we are getting from lenders. We make sure we are not being adversely selected in terms of credit criteria. We monitor the business that is being written through external data. We monitor performance by lender and by loan type and by geography every month and we look at and see whether it warrants any actions and we are not averse to taking actions if we see any trends get out of line. So that's just on the analytics side and the discipline around analytics.

Second, from a governance side, we have stepped up governance in terms of the way we approach the credit process. We have greater importance of credit in the Company, including at the Board level, so the credit policy committee gets involved in examining our data much more vigorously.

We, at Radian, right after the downturn, even blend -- changed our compensation structure with the short-term bonuses given for the year just ended. 50% of the bonuses given now are based on projected credit performance. The other 50% is delayed until we get 18 months of data performance a year later. So if the credit varies from what we projected it to be, let's say earlier this year projected credit performance for last year's book to perform in a certain way and now we have 18 months data, it's different. People can get zero on that 50% of the bonus that's delayed or get it paid all or paid at slightly better levels if it performs better. And then our long-term incentives programs pick up and they are also very sensitive to credit performance. So that's from a governance point of view that we picked up.

And then the third thing I'll talk about is the external dimension. There are external governors in place we didn't have before the downturn such as Dodd-Frank and the Q1 levels. And we find even within the slightly greater credit room that is available to lenders today, the lenders for the most part aren't even -- are reluctant to go to the level of room that we offer them as in industry. They write to much tighter levels because they themselves are very focused on credit levels. And granted, some of these good things would change over time, but there important differences in terms of certain products that existed in the past that contributed mainly to the outlying performance in the past not existing today, and maybe the regulatory environment is not allowing them to come back.

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

One additional thing in terms of external factors also that I'll just expand on that S.A. just mentioned is that the PMIERs financial requirements are much more stringent and also potentially could adjust if there are trends or a macro environment change that is warranted. So that's another kind of governor with respect to our preparedness for a downturn.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Just a related question on the loss ratios. In order for it to sort of go back to normal, whatever it is, 20s% or higher, do you think it's something that's good right now, the credit box is tight and the macro is sort of cooperative. So it seems like does one of those have to change before you can normalize to a higher loss ratio?

S.A. Ibrahim - *Radian Group Inc. - CEO*

You know, internally, in terms of quality of the business we've written, we are very happy with what we've returned. But if there is any change, it has to come from external factors. Historically, the two biggest drivers of that have been the unemployment rate, which seems to be pretty benign in the forecast we are seeing, and home prices. And there are certain markets in which there's concern but nothing to really worry about very seriously. So, there are factors that we keep monitoring, but to your point, we would have to see an economic event for them to significantly spike up.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Let me throw out one more if there is --

Unidentified Audience Member

I've got one more, actually, just shifting gears a little bit -- competitive landscape. Can you guys just talk about -- you've got a couple of smaller competitors trying to take share. How is that affecting you? I know, in some regard, you guys have had an opportunity to probably move up the credit quality spectrum. And maybe talk about some of the things you are seeing in the competitive landscape and how you guys are addressing it?

S.A. Ibrahim - *Radian Group Inc. - CEO*

Our industry has been an industry that has varied from five the same period to less than that -- to maybe seven or eight players in the industry and now we are on the high side of that equation so we are used to competing in all of those environments, the difference being this time there are more newer players.

We think the competitive environment we are in is more intensive than in normal periods but, again, the way we manage our business is through the competitive environment. We focus on the blended return we try to generate which is in the low to mid teens, and we pass on business opportunities that changed our overall blended return that we are achieving.

And the biggest thing you need to keep in mind is our franchise value. So we want to come out of this intensive competitive period protecting the value of our franchise because that's what is going to generate future business for us over the long-term. So we try and preserve and protect as many of those relationships as we can.

Ultimately, I think the way competition works is all of us have to at some point or the other stand behind our performance and you need to look at the performance we've delivered over the past and whether it's newer players, older players, if somebody writes business that's not going to deliver that performance, they are not going to be able to continue to be in business. Sooner or later, you have to generate through your performance internal capital to keep writing more business or external or run out of capital and access the external capital market, at which point your ability to access that capital and the terms at which you access it will be dependent on the kind of business you've written.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Just following up on competition, can you talk about the single premium market and what your pricing strategy is? How you think about market share, if you think there's going to be any evolution in the regulatory framework for capital requirements in that area, and what implications that might have for that part of the business?

S.A. Ibrahim - *Radian Group Inc. - CEO*

First of all, we are very comfortable with writing some level of singles business and we've been doing so for the last so many years, and you can see the result of that reflected in our performance. So we are not just saying something that is not substantiated by results we have delivered.

And our philosophy in terms of singles tends to be that we believe that some level of singles, maybe around a third of our business, allows us to achieve the right balance in any interest rate environment. There are always, even in rising rate environments, bouts where interest rates dip and cause refinancing and in other environments they don't. So having said that, the fact that we are comfortable with singles, we are comfortable with some level of singles.

The other factor we use is we try to achieve that blended return. So we are not comfortable with singles business to the extent that it will make us deviate from that blended return, but if we can write some level of singles within the range we are comfortable that allows us to deliver that blended rate of return, then we are fine with it. And that's dependent on the market factors.

As to whether singles will increase as a percentage or not, it depends on several external factors, including to some extent on the refi mix of the business but also to some extent on what's happening in the overall marketplace. All I can see is, in the most recent months, we have seen the singles percentage, as we expected, come down from where it was in the first quarter.

Unidentified Audience Member

On the regulatory front?

S.A. Ibrahim - *Radian Group Inc. - CEO*

On the regulatory front, not directed exactly at singles but close enough. The FHFA has said that it is going to come out with new guidelines on lender paid mortgage insurance. And lender paid has some heavy correlations with singles. And what they come out with -- what they are going

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to come out with we don't know, but we expect to get clarity on that by the end of this month. And that may influence the percentage of singles business that is available to lenders as a result of that.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

You talked about the unlevered returns at 14%. Is there any desire to lever up the hold-co, considering you keep getting upgraded and the cost of debt is probably pretty cheap?

S.A. Ibrahim - *Radian Group Inc. - CEO*

With clarity of PMIERs and the fact that we have a strong liquidity position, we are in a position to opportunistically evaluate capital structure alternatives. But having said that, it's very important for us also in terms of evaluating alternatives to project balance sheet strength going forward, and that results in a natural limit as to leverage.

Unidentified Audience Member

Most of my questions ended up being could be see (inaudible) increases then going forward or some other capital to shareholders?

S.A. Ibrahim - *Radian Group Inc. - CEO*

Look, as we move forward into more profitability and greater certainty with PMIERs and capital position and having the position, we will evaluate all alternatives out there appropriate at the right time. And I can't say yes or no to any of those factors, but the fact is we are a company that has, not just in terms of capital structure but in terms of business opportunities, always we've been a company that has always been open-minded about evaluating everything and then determining what we believe is in the best interest long-term of our shareholders. That even goes for our business mix, let alone our capital mix. And there's been no question around how we expect to benefit from the Clayton model. But one of the things that I'm very encouraged even at our early stages as we now started cross-selling Clayton products to the MI customers, while it's too early to see it captured in the results and that may show over time, the response we are getting from MI for some of the Clayton's products is amazing.

A couple of weeks ago in New York, there was a national secondary mortgage conference, MDA conference, and we showcased two of Clayton's unique product at that conference. One is called Glatt, which is our unique technology of allowing lenders to monitor our services where servicing based loans can service them by lives creating data daily on how their loans are being serviced. And the others are through our Red Bell acquisition, a valuation model which we believe is one of the most accurate valuation models in the industry. So we had something like six sessions scheduled for lenders and my lender customers to come and get educated on the Red Bell evaluation model. I think we held more than 20-plus sessions and the demand was so great we had so much follow-up sessions and we are starting to see early sectors cross-selling it.

Now, mind you, we are very excited about the Clayton products. We want to grow that business as a percentage of our overall business to be meaningful, but our first love and first focus is still MI. And what I like about this is it allows us to deepen our relationship with our MI customers and if the early trends continue and translate into success, we will have accomplished that.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

We have time for one more. Let me just ask one then. On the mortgage services segments, how big you think that could be over time?

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S.A. Ibrahim - *Radian Group Inc. - CEO*

Right now, that segment is around 10% for our mix. Our goal is to grow it, mainly organically. Here and there we like, with Red Bell and with Flax we will add a few capabilities that we don't have. The goal is to provide our customers solutions that they need that end up in better loans because better loans are created not just through better credit criteria but in the actual execution of the operational manufacturing process that results in better loans in the monitoring and development -- and servicing of those loans in the right way and valuing the collateral properly. So in an ideal environment, while growing it we will get benefits on the MI side because not only will we make fee income through the Clayton services but if that results in better loans, we in short we will benefit from fewer claims on those loans down the road. Hopefully get two bites of that apple.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. Great. Our time is up. Thanks very much.

Cathy Jackson - *Radian Group Inc. - SVP, Corporate Controller*

Thank you.
