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Radian Group Inc.

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Radian Group Inc.

Major Rating Factors

Counterparty Credit Rating
Local Currency
B-/Positive/--

Strengths:

- Improving long-term fundamentals of the mortgage insurance industry
- Adequate capital resources to support new business writings
- Improved operating performance with breakeven profitability by year-end 2014
- Liquid investment portfolio with modest credit risk
- Improved liquidity and financial flexibility as shown by recent acquisition
- Enterprise risk management (ERM) framework improved since financial crisis

Weaknesses:

- Historically above-average risk tolerances
- Susceptibility to macroeconomic trends that could hurt sector profitability
- Company and industry fundamentals heavily correlated to macroeconomic trends
- Lower quality statutory capitalization given group structure

Rationale

Standard & Poor's Ratings Services' counterparty credit rating on Radian Group Inc. and insurer financial strength ratings on Radian Guaranty Inc. reflect the company's improved financial flexibility and operating performance that resulted from capital raises, and the improved performance of its legacy and current business writings. This is offset by lower quality statutory capitalization due to the structure of the group, along with its susceptibility to macroeconomic trends.

Radian Group reported a net profit of $202.8 million through March 31, 2014, versus a net loss of $187.5 million in the same period in 2013. Radian's performance, however, continues to be hindered by its legacy book of business, which has resulted in net losses of $197 million in 2013, $452 million in 2012, and $1.8 billion in 2010. This was primarily due to higher incurred losses, increased claim activity, and expense overruns in claims processing. Radian's profitability was stemmed from declining notices of default (NODs): 12,113 as of March 31, 2014, from 14,846 in the same period in 2013, primarily associated with Radian's legacy book. To help mitigate losses, Radian entered into a master transaction agreement with Freddie Mac which resulted in a net reduction in primary delinquent loans by about 12.6%. This agreement reduces Radian's total exposure on the group of loans to $840 million. Radian's risk to capital ratio also continues to decline, ending first-quarter 2014 at 19.2:1 and with potential capital infusions from the holding company, we expect risk to capital to remain below 20:1. We also view the risk of reserve strengthening as waning, but if it were to occur, the amount would be relatively minor.

We continue to view the quality of Radian's capital as low since a significant portion of its capital base is debt financed by medium-term maturities. Statutory capital, excluding Radian Asset Assurance, remains nimble at under $200 million, we project organic statutory earnings to remain low to break-even in the coming months due to losses and new business reserving needs, further growing this base. But we view Radian's financial flexibility as predicated on investor optimism in the sector, which can vary based on changes in the overall economy.

Broadly speaking, we see improvements in the fundamentals of the U.S. economy, with the U-6 measure of the unemployment rate at 13.4%, down from 14.3% in April 2012. Housing is also recovering, as higher home prices are giving potential buyers confidence that they will not lose on their investments, thereby stimulating demand. Our data through January 2014 (S&P/Case-Shiller Home Prices Indices) shows that the 10- and 20-City composites rose 13.5% and 13.2%, respectively, year-over-year, consistent with our expectations. Despite these improvements, we expect Radian to become profitable by year-end 2014, with continued earnings improvement through 2016. We expect the loss and combined ratios to continue to decline, with financial leverage metrics moving from their current peak at 51%, down to a level more consistent with investment-grade ratings.

Factors Specific To Holding Company

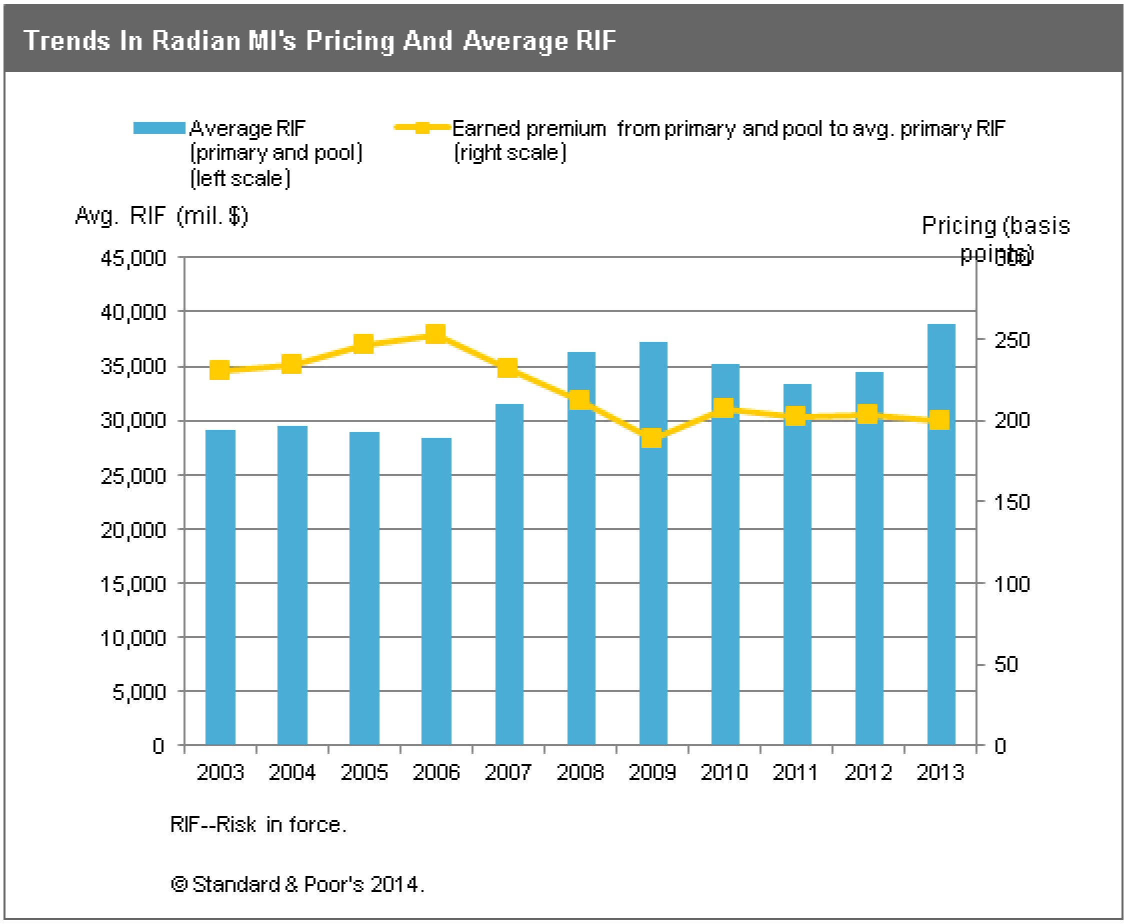
Based on the unrestricted cash and marketable securities of $615 million available as of March 31, 2014, we believe Radian's holding company will have sufficient resources to repay its obligations through 2015. We believe holding company metrics will remain relatively weak through that period with no statutory dividends from the group's mortgage insurance subsidiary. We also expect fixed-charge coverage to remain depressed and leverage elevated until the mortgage insurance subsidiaries become profitable. We believe Radian's recent acquisition of Clayton Holdings LLC will become immediately accretive to earnings, providing excess annual cash flow to the holding company. In light of relatively unclear, government-sponsored entities (GSE) capitalization requirements, Radian may need to make further capital contributions to Radian Guaranty to keep its risk to capital ratio below 20:1, potentially straining liquidity at the holding company.

Table 1

Radian Group Inc. -- Financial Statistics						
	Q1 2014	**2013**	**2012**	**2011**	**2010**	**2009**
Debt plus preferred to capital (%)	47.1	49.7	47.4	40.9	52.9	25.8
GAAP fixed-charge coverage (x)	5.4	0.7	(6.9)	(6.6)	(22.9)	(11.4)
Statutory fixed-charge coverage (x)	(0.0)	(0.0)	0.5	0.6	1.6	0.2

Holding company obligations include $195 million 9% senior notes due 2017, $450 million 3% convertible senior notes due 2017, $400 million 2.250% convertible senior notes due 2019, and the recently issued $300 million 5.50% senior notes due 2019. Debt service as of March 31, 2014, was about $19.9 million.

Chart 1



Outlook

The positive outlook reflects our expectation that Radian's operating performance will improve, becoming profitable in 2014 and beyond, while the group maintains its market position. We expect Radian to report full-year 2014 pretax operating income of $150 million-$200 million and combined ratio of 90%-95% including planned spending on technology-related investments. We expect Radian to continue to boost earnings through 2015 to more than $200 million, assuming no unexpected loss development or increased claims activity.

We also expect Radian's capital base to improve as a direct result of retained profits in the mortgage insurance segment, with continued statutory capital growth through 2015. We anticipate the risk-to-capital ratio to remain at or below 19:1 through 2014, with further improvement in 2015 (assuming no change in GSE capitalization requirements). Our forecasts for Radian's earnings and capital reflect our views of the U.S. macroeconomy, including improved housing starts and lower unemployment, which could lessen insured mortgage losses. We expect financial leverage to fall to less than 45% by year-end 2015 from 51% as of year-end 2013 and about 53% following the most recent issuance.

Competitive Position: A Private Mortgage Insurance Industry Leader

Radian has maintained a strong market share in the mortgage insurance industry since 2010. The sector has historically produced attractive but volatile returns. With its strong brand name, Radian maintained a 27% market share as of year-end 2013, making it one of the largest writers of private mortgage insurance. We expect for Radian's market share to decline slightly over the next 12-24 months due to new market entrants, such as National MI and Essent Guaranty, while the mortgage origination market continues to contract due to the slow down of the refinancing boom.

In light of the Mortgage Bankers Assn.'s (MBA) projections for a decline in originations, we expect Radian's business writings to focus more on profitable recurring-premium business rather than on the single-premium business, which jumped to elevated levels in 2011-2013. As of year-end 2013, Radian's single- and recurring-premium businesses moderated to 32% and 67% of the portfolio, respectively, a sharp drop from the respective 41% and 59% at year-end 2011. We believe Radian's strategic pivot to the single-premium business has higher credit quality and lower expected losses than the legacy business written prefinancial crisis. The profitability of this block, however, is relatively untested and will depend primarily on refinancing rates and macroeconomic assumptions built into pricing.

The mortgage insurance sector recovery and to a greater extent Radian's market position maintenance are functions of the industry's commoditized nature which relies heavily on the housing market and overall economic conditions. Recent growth has stemmed from home refinancing due to record-low mortgage rates, but we are unsure of the policyholder behavior and historical assumptions used in mortgage insurance pricing, which could affect the group's profitability.

Like its peers, we expect Radian's competitive position to contract through 2015, but we expect Radian to remain an industry leader. We also expect the single-premium business to decrease at a more rapid pace than the industry due to a drop in both mortgage originations and refinancing, and for growth to rely on continuous improvement in the housing market, unemployment rate, and overall U.S. economy.

Table 2

Radian Mortgage Insurance Co. -- Competitive Position Statistics						
(Mil. $)	**Q1 2014**	**2013**	**2012**	**2011**	**2010**	**2009**
Net primary insurance in force	162,368	161,240	140,363	126,185	129,566	144,268
Net risk in force						
Primary	40,432	40,017	34,372	30,692	31,461	33,765
Pool	1,600	1,604	1,834	2,068	2,453	2,698
Other	93	97	148	214	455	1,000
Total	42,125	41,718	36,354	32,974	34,369	37,463
Net premiums earned	199	781	702	681	740	724
Net income	--	--	(215)	(644)	(1,143)	(338)
Pre-tax income\(loss)	101	(93)	(245)	(561)	(986)	(514)
GAAP assets	3,137	3,121	3,575	3,470	4,802	4,969
Statutory capital (surplus plus contingency reserve)	N.A.	1,481	989	869	1,399	1,613

Table 2

Radian Mortgage Insurance Co. -- Competitive Position Statistics (cont.)						
Combined ratio (%)	53.60	106.10	157.80	214.80	253.60	204.80
Risk to capital (x)	23	23.9	29.9	30.9	19.4	17.5

N.A.--Not available.

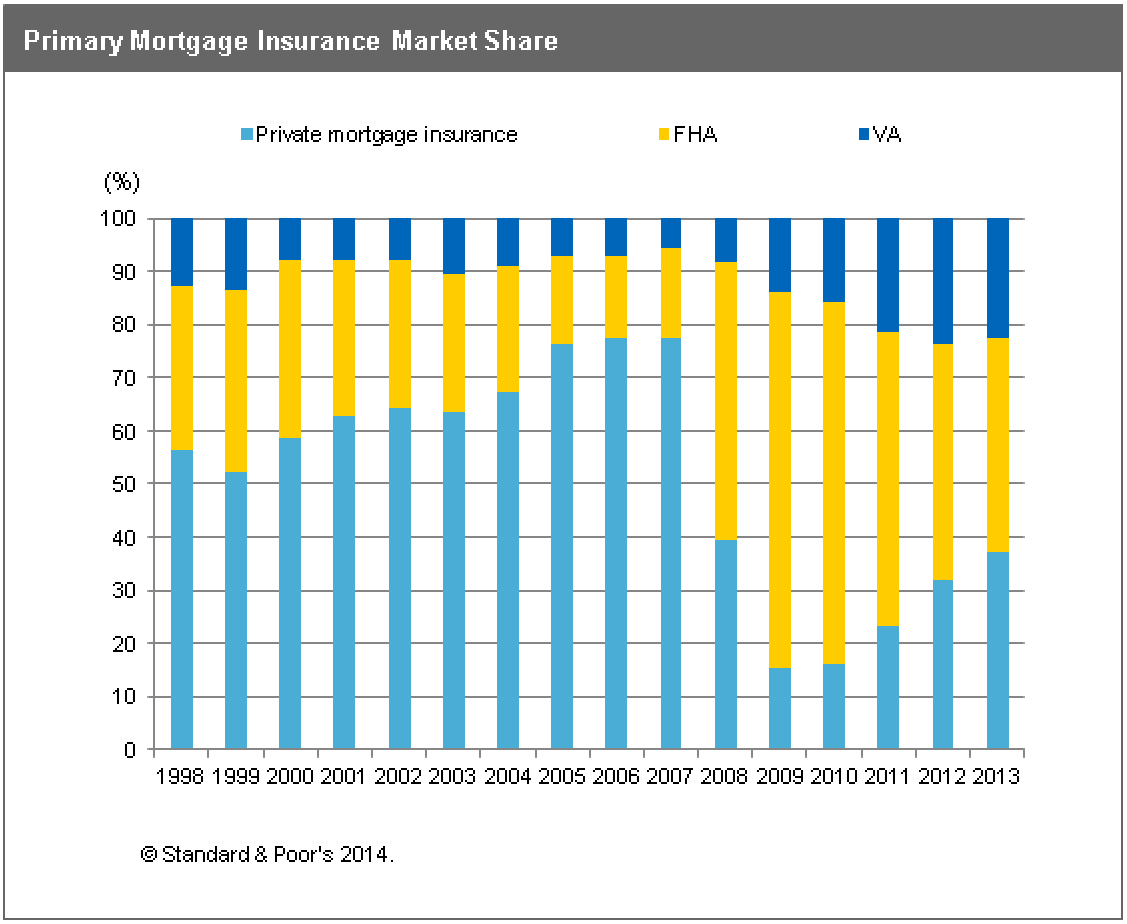
Table 3

Radian Guaranty/Traditional Primary Market Share

(%)	2013	2012	2011	2010	2009
United Guaranty Corp.	28.10	28.40	23.90	16.30	15.40
Radian Guaranty Inc.	27.10	28.20	21.80	20.90	22.10
Mortgage Guaranty Insurance Corp.	17.00	18.40	20.30	22.10	26.10
Genworth Financial	12.70	12.50	14.90	17.00	10.00
Essent Guaranty	12.10	8.60	3.90	N.A.	N.A.
CMG MI	3.00	3.90	3.30	N.A.	N.A.
Run-off entities	N.A.	N.A.	11.90	N.A.	N.A.
PMI Mortgage Insurance Co.	N.A.	N.A.	N.A.	15.60	16.00
Republic Mortgage Insurance Co.	N.A.	N.A.	N.A.	8.10	10.30
Triad Guaranty Insurance Corp.	N.A.	N.A.	N.A.	0.00	0.00

Source: Inside Mortgage Finance. *Year 2011 and before includes HARP transactions. N.A.--Not available.

Chart 2



Management And Governance: Experienced Management Team

We view Radian's management and governance as fair. Under CEO S.A. Ibrahim's and CFO Bob Quint's leadership, the company has retained its market-leading position in the mortgage insurance sector. We believe, however, this is offset by historically high risk tolerances. This has led to outsized losses from the group's historical rescission and denial levels, exposure to nontraditional products, and high single-premium volume, which we view as more aggressive than industry peers. Since the financial crisis, Radian has revised its risk tolerances to better react to worsening market conditions and create a more disciplined approach to underwriting and risks related to capital deployment strategies.

Financial management (consolidated group)

Radian's financial management is conservative, the portfolio is made up mostly of short-term (about 29%) and Treasury investments, with a weighted average asset rating of 'A'. The company has no significant concentrations in the invested asset base and, given their short- to medium-term nature, these liabilities have a relatively shorter duration than peers'.

Enterprise Risk Management: Focus On Risk Mitigation, But Further Seasoning Is Necessary

We view Radian's ERM framework as adequate. The company's ERM program focuses on risk mitigation, culture, and ownership across all divisions of the group. Radian has also developed methods of monitoring, controlling and identifying key risks, while avoiding the errors it made during the financial crisis. Radian is committed to further improvements in risk management across the organization and holds monthly risk committee meetings. These committees quantify risks across the organization and report them quarterly to the ERM executive committee, then board of directors. Radian has translated lessons learned from the financial crisis into the ERM framework, tying compensation to risk mitigation, while ensuring senior management is accountable for decisions made outside the framework.

Notwithstanding our improved view of Radian's ERM, the cyclicality of mortgage insurance business losses and the high correlation with macroeconomic factors show that Radian and its peers had outsized risk tolerances related to credit and underwriting during this last cycle. Radian failed to exercise appropriate underwriting discipline and risk selection during a period when mortgage origination credit quality declined. The positive momentum in Radian's ERM is offset by the historical ineffectiveness of the overall program due to a lack of consideration for economic indicators and consequences. We believe that, as Radian further executes and develops its ERM framework, it will use its knowledge of the mortgage and housing sectors, along with the benefits from the Clayton Holdings acquisition, to bolster Radian's ability to assess and quantify its risk vulnerabilities.

Accounting Considerations

Premium deficiency reserves

Each mortgage insurer calculates the net present value of its insured loan portfolio quarterly. If the net present value is negative, the company must record this amount as a premium deficiency reserve, which lowers earnings in the period the reserves are established. If the assumptions underlying the premium deficiency reserve are correct, then the reserve will decrease over time as premiums, claims, and expenses arise. So, a decrease in the premium reserve increases earnings. As of March 31, 2014, Radian reported $1 million in premium deficiency reserves related to their legacy book of second-lien business in its mortgage insurance segment.

Losses incurred and loss reserves

Under both generally accepted accounting principles (GAAP) and statutory accounting practices, mortgage insurers may not establish loss reserves for policies that have not yet become delinquent. As a result, changes in new notices of default can lead to significant volatility in incurred losses and loss reserves. Losses incurred and loss reserves can differ among mortgage insurers depending on reserving methodologies and to the extent a company incorporates its expected rescission and claim denials.

Derivatives

GAAP accounting practices require companies to mark their positions to market prices, or a modeled estimate of market prices. Companies must then recognize unrealized gains and losses on derivatives in the current period's earnings. Radian's exposure to derivatives is limited, but portions of its insured financial guarantee credits are required to be accounted for as derivatives.

Contingency reserves

Statutory accounting practices require mortgage insurers to establish contingency loss reserves equal to 50% of premiums earned. The insurers cannot release these reserves for 10 years, except as insurance regulations or state insurance regulators permit. Changes in contingency loss reserves affect the statutory statement of operations, but not GAAP financials. The contingency reserve does not consider the effect of refinancing and other prepayments that remove risk.

Investments And Liquidity: Conservative, Liquid Investment Portfolio

Radian's investment portfolio is conservative and backs the company's near- to medium-term mortgage insurance liabilities that are not marked to market. The company side-steps major risk in the asset portfolio, avoiding name, geographic and sector concentrations in the general account. Credit quality remains strong--29% is held in short-term liquid assets and 68% in fixed income securities. The average rating in the portfolio is 'AA', with moderate concentrations in Treasuries and average duration of about four years. We expect Radian to maintain a well-diversified and risk-adverse portfolio, focusing on regulatory compliance, liquidity, and maximizing return for nominal risk.

Operating Performance: Improvement Will Continue

Radian reported net income of $202 million as of March 31, 2014, up from the net loss of $196.6 million reported at year-end 2013. Earnings as of March 31, 2014, came in ahead of our break-even expectations for year-end 2014--the company's first quarterly profit since 2009. Improvements in earnings stemmed from lower-than-expected new notices of default, higher-than-expected current delinquencies cure rates, and the continued roll-off of legacy business. The mortgage insurance segment's incurred losses continued to decline, by 60% compared with the the same period in 2013. Through 2014 and 2015, we expect earnings to continue improving, with profits above $150 million in 2014. We do expect performance to drop slightly through the remainder of 2014, with adverse seasonal volatility arising in the rest of the year, absent seasonally benign second and third quarters, leading to moderate losses.

Table 4

Radian Mortgage Insurance Co. -- Operating Statistics						
(Mil. $)	**Q1 2014**	**2013**	**2012**	**2011**	**2010**	**2009**
Premiums earned	199	781	702	681	740	724
Losses incurred and losses after expenses	49	565	922	1,294	1,731	1,301
Underwriting expenses	57	265	187	168	177	168
Net underwriting income	92	(49)	(406)	(781)	(1,168)	(744)
Change in premium deficiency reserve	1	(2)	0	(7)	(15)	(62)
Change in fair value derivatives	-	1	0	(1)	32	(14)
Net investment income	14	62	63	94	104	130
Pretax income	101	(93)	(245)	(561)	(986)	(514)
Net income	N.A.	N.A.	(215)	(644)	(1,143)	(338)

Table 4

Radian Mortgage Insurance Co. -- Operating Statistics (cont.)						
Net income/average assets (%)	N.A.	N.A.	(6)	(15.6)	(23)	(7)
Loss ratio (%)	24.7	72.2	131.2	190.1	229.6	181.6
Expense ratio (%)	28.9	34	26.6	24.7	24	23.2
Combined ratio (%)	53.6	106.1	157.8	214.8	253.6	204.8
Default rate (%)	6.3	7.3	12.1	15.2	16.5	18
Average direct paid claim, primary only (actual dollars)	44,500	47,300	47,800	50,000	46,000	44,500

N.A.--Not available.

Offsetting factors include uncertainty surrounding losses that can potentially come through rescission and denial activity. Historically, about 30% of rescissions and denials go to claim, but the trend has been increasing as lenders become more attune to Radian's claim processes. The housing recovery and rising home values provide further motivation for lenders to submit claims, but we still are not certain what exact percentage of late-state delinquencies will ultimately go to claim. Radian's late-stage delinquency bucket has some properties that lack required documentation or have violated one or more terms of the company's master policy. With these uncertainties, there are difficulties in reserving adequately for losses, but third-party actuaries have reviewed Radian's reserving methodology and said the company has adequately reserved for its liabilities.

Chart 3

Primary Default Rate Comparison

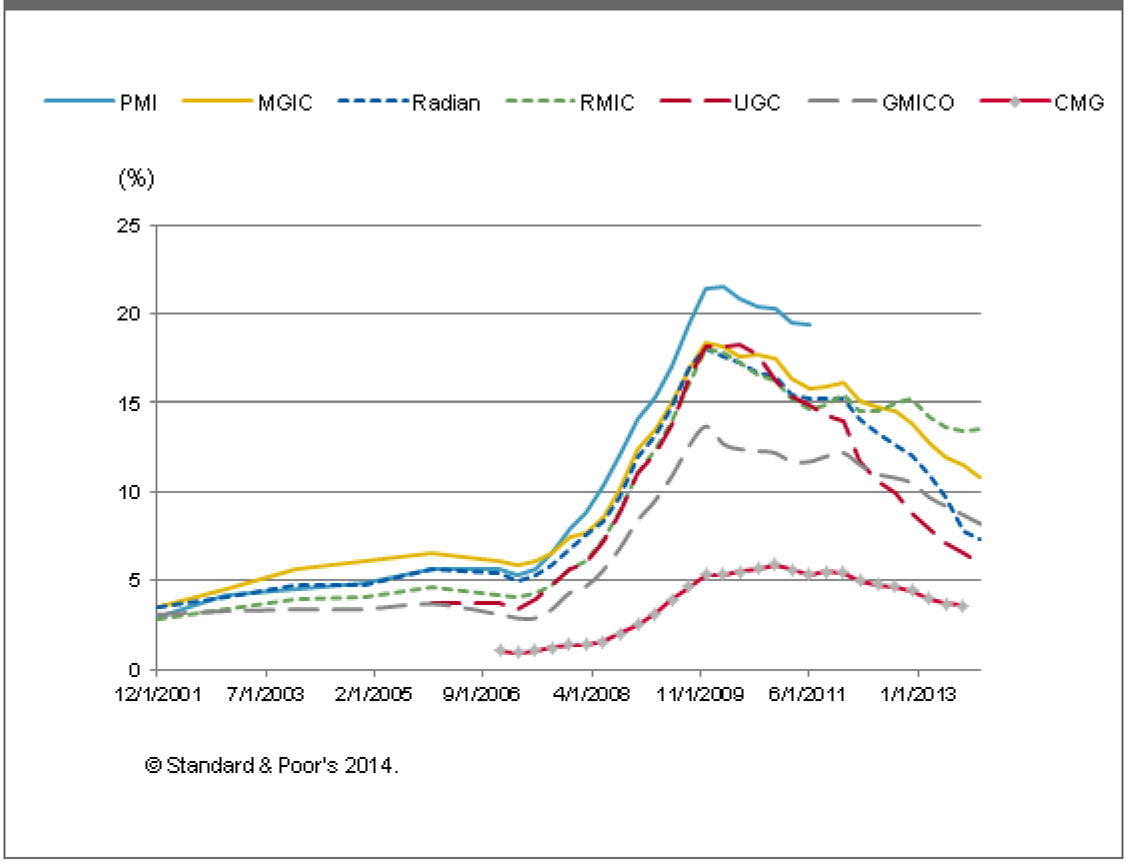


Table 5

Radian MI/Loss Reserve and Claim Statistics						
(Mil. $)	**Q1 2014**	**2013**	**2012**	**2011**	**2010**	**2009**
Total mortgage insurance loss reserves	1,868	2,126	3,000	3,096	3,302	2,829
Primary loss reserves*	1,332	1,538	2,666	2,732	2,709	2,489
Delinquent loans*	53,119	60,909	93,169	110,861	125,470	151,998
Reserve per delinquent loans*	25,076	25,246	28,617	24,640	21,590	16,376
Paid claims rate (%)§	10.1	24.2	17.1	19.4	16.9	15.2
Average paid severity*	44,489	47,294	48,294	50,152	45,987	44,763

*Refers to primary insured loans only. §Paid claims rate is the number of claims paid during the year/delinquent loans at beginning of year.

Based on the declining losses in Radian's legacy book and increased earnings due to post-2009 business, we expect operating performance to continue to improve. While we expect Radian to report consolidated group earnings above $100 million in 2014, with continued improvement in 2015, there is also a risk of adverse reserve adjustment, but we view Radian's liquidity as being sufficient to handle this.

Capitalization: Improved Risk-To-Capital And Capitalization Metrics, Albeit With A Weak Base

We view Radian's capitalization as a relative rating weakness and less than adequate vis-à-vis peers due to the low quality of its statutory capital base arising from the company's "stacked" structure, which limits Radian Guaranty's ability to use Radian Asset's capital base to service policyholder claims. As of Dec. 31, 2013, the statutory capital base was $1.4 billion, about $1.2 billion from Radian Asset. The base continues to grow as capital accretion becomes more substantial.

Table 6

Radian Mortgage Insurance Co. -- Capitalization Statistics					
(Mil. $)	**2013**	**2012**	**2011**	**2010**	**2009**
Total assets	3,121	3,575	3,470	4,802	4,969
Policyholders surplus	1,377.00	968	869	1,378	860
Contingency reserve	103.9	21	0	21	771
Capital	1,481.00	989	869	1,399	1,631
Risk to capital (x)	23.9	29.9	30.9	19.4	17.5
Capital adequacy ratio	N.A	N.A	111.8	102.4	83.9
Conditional claim rate	N.A	N.A	10.2	11.8	13.7

Radian's consolidated loss reserves decreased to $2.1 billion as of Dec. 31, 2013, from $3.0 billion at year-end 2012. Despite the decline, Radian's reserve per delinquency grew to $26,717 from $26,408 at year-end 2012. Radian's claims paid as of year-end 2013 increased to $1.4 billion primarily due to a one-time claim payment of $255 million related to the agreement with Freddie Mac. This agreement limits Radian's total loss exposure on these loans (about $840 million) currently in default.We believe Radian's capital base remains highly exposed to adverse deviation, albeit many of the company's default metrics show improvement, the risk remains notable.

We expect Radian's risk-to-capital (absent any GSE capital requirements) to remain below 19:1, and statutory earnings to improve through 2015, attributing further to Radian's capital base. Our view of the quality of its statutory capital is not likely to improve until Radian reports significant and sustainable improvement in its MI subsidiary.

Financial Flexibility: Enhanced Due To Market Interest In The Mortgage Insurance Sector

We view Radian's financial flexibility more favorably after issuances in March 2013 and May 2014. The company raised $541.1 million in net capital through debt and equity issuances, which garnered significant interest from market participants that perceive the mortgage insurance sector to be well positioned to benefit from a continued housing recovery. Radian's financial leverage as of year-end 2013 was 51%; we expect this to increase to about 53% in 2014. Financial leverage remains high relative to similarly rated peers, but we expect oleverage will decrease in the next 12 to 24 months as Radian becomes profitable.

Related Criteria And Research

- Enterprise Risk Management, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Principles Of Credit Ratings, Feb. 16, 2011

Ratings Detail (As Of June 10, 2014)		
Radian Group Inc.		
Counterparty Credit Rating		
Local Currency		B-/Positive/--
Senior Unsecured		B-
Counterparty Credit Ratings History		
27-Feb-2014	*Local Currency*	B-/Positive/--
09-Jul-2013		B-/Stable/--
28-Feb-2013		CCC+/Stable/--
15-Oct-2012		CCC+/Negative/--
02-Aug-2012		CCC-/Negative/--
30-Jan-2012		CCC/Negative/--
24-May-2010		CCC+/Negative/--

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.