

Research

Research Update:

Radian Group Inc. And Subsidiaries Upgraded On Revised Mortgage Insurance Criteria; Outlook Positive

Primary Credit Analyst:

Patrick C Wong, New York (1) 212-438-1936; patrick.wong@standardandpoors.com

Secondary Contact:

Marc Cohen, CFA, New York (1) 212-438-2031; marc.cohen@standardandpoors.com

Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Criteria And Research

Ratings List

Research Update:

Radian Group Inc. And Subsidiaries Upgraded On Revised Mortgage Insurance Criteria; Outlook Positive

Overview

- We have reviewed Radian Group Inc. and its subsidiaries under our revised mortgage insurance criteria.
- We are upgrading Radian Group Inc., Radian Guaranty Inc., Radian Mortgage Assurance Inc., and Radian Mortgage Insurance Inc.
- The positive outlook reflects our view of the company's improving operating performance and capitalization, and its sustained market shares.

Rating Action

On March 9, 2015, Standard & Poor's Rating Services raised its financial strength ratings on Radian Guaranty Inc., Radian Mortgage Assurance Inc., and Radian Mortgage Insurance Inc. to 'BB' from 'BB-'. We also raised our counterparty credit rating on Radian Group Inc. to 'B' from 'B-'. The outlook is positive.

Rationale

The upgrade reflects our view that, under the new criteria, Radian maintains a satisfactory business risk profile (BRP) and weak financial risk profile (FRP). The BRP assessment is based on our view that Radian can compete effectively and is profitable in the mortgage insurance market, but it has no significant sustained advantage over its competitors in the market. Our assessment of Radian's BRP also incorporates our view of the intermediate risk inherent in the U.S. mortgage insurance industry associated with the structural aspect of the mortgage and housing markets and U.S. macroeconomic factors.

Our FRP assessment is primarily based on the company's 'BB' capitalization, as measured by our capital model, offset by high financial leverage, high susceptibility of earnings, and capital volatility in the U.S. mortgage insurance sector.

Our rating on Radian Group Inc. is supported by our standard holding-company notching. The high financial leverage ratio is captured in our assessment of financial flexibility in Radian's group credit profile.

Radian faces intermediate industry and country risk. Our view of the company's

very low country risk stems from the good economic growth prospects, relatively effective and stable political institutions, sophisticated financial systems, and strong payment culture in the U.S. We believe Radian's mortgage operations are exposed to moderate industry risks primarily because of the inherent product risk from its underlying exposure to the mortgage market. The susceptibility to earnings volatility caused by correlation with the performance of the economy and the housing sector also exposes Radian to risk. Since the financial crisis, Radian's portfolio quality has improved considerably. The improving U.S. economy and recovering housing market are supporting the MI sector's recovery. However, this is offset by structural aspects of the mortgage market, such as mortgage interest deductibility for tax purposes, lack of full recourse, and potential for reversion to increased risk taking as the market's risk-appetite expands. Although initiatives such as Qualified (Residential) Mortgages (QM/QRM) should provide guardrails, the efficacy of such initiatives in the longer term is uncertain. In addition, the fragmented nature of the regulatory jurisdiction and lack of a unified regulator for banking and insurance that can more effectively deal with systemic risks and failures of MI companies further affects our view.

We do not believe Radian has a significant and sustainable advantage over its competitors in the mortgage insurance market. The commoditized nature of the products, the sector's dependence on government-supported entities such as Fannie Mae and Freddie Mac, and the regulated environment mean all market participants have similar capital requirements and product costs.

Nevertheless, Radian differentiates itself from its peers through its No. 2 market position by sales and its well-established distribution relationships and technology platforms with geographically diversified national and regional banks. It will take several years for new market entrants to develop similar capabilities, and we expect Radian's market share to remain about 20%. The company had \$37.4 billion in new insurance written (NIW) in 2014, with 53.6% coming from the top-10 states. These are relatively high-quality businesses with 61.7% having a FICO score of more than 740. As a result of writing high-quality new business and declining losses from the legacy business, operating performance has improved significantly in the past 18 months. New notices of delinquencies and delinquency inventory have declined, with the overall loss ratios declining to 29.1%, compared to 72% a year ago. The improved loss ratio also reflects higher-quality new business written. These improvements together contributed to the company's adjusted pretax operating earnings of \$342.4 million in 2014, improved from a pretax operating loss of \$67.4 million in 2013. We expect profitability to stabilize in the range of \$300 million-\$350 million in the next two years, helped by fewer new delinquencies and less delinquency inventory from legacy business, as well as higher-quality new business.

The strengths of Radian's market position are partially weakened by the fact that about 28% of insurance-in-force is from single-premium business. We believe single-premium businesses have lower earnings quality than monthly premium businesses, with higher premium revenue volatility, and more susceptibility to mispricing due to uncertainties in refinancing activities,

given the already low interest rates. This may lead to lower operating performance compared to peers' with less single-premium business. Our competitive-position assessment also reflects our negative view of Radian as a monoline insurer focused in a highly competitive sector with commoditized, price-sensitive products and subject to significant sector cyclicality and volatility.

Based on the draft Private Mortgage Insurer Eligibility Requirements (PMIERS), we expect Radian to have about a \$350 million funding gap (after the sale of Radian Asset). We expect the company to close the funding gap through earnings and holding-company resources. We expect the company to be in full compliance with PMIERS and we have factored this expectation into our competitive position assessment. We can revise the score if our assessment changes.

Our assessment of Radian's capital and earnings is lower adequate. The assessment reflects Radian's current 'BB' capitalization, as measured by our capital model, and improving operating performance to about \$300 million - \$350 million per annum, as well as improved quality of capital after the sale of Radian Asset. We expect capitalization to improve as operating companies retain material earnings generation, the risk on the legacy portfolio continues to run off, and new business boosts the company's credit quality.

Radian's risk position is in line with the rest of its peers', hindered by the insurance sector in which it operates. We believe Radian's risk position is moderate as it is prone to earnings and capital volatility associated with insured mortgage losses that can be exacerbated by the macroeconomic cycle. The single largest security exposure is U.S. treasuries, which is approximately 21% of the portfolio.

We view Radian's financial flexibility as less than adequate due to the company's high leverage of 40% as of year-end 2014, despite its ability to access the debt capital market during the financial crisis. We expect the relatively high leverage ratio to remain within the rating horizon. Partially offsetting this weakness is the improving fixed-charge coverage as the company's operating performance significantly improved. We expect the fixed-charge coverage to remain at about 5x.

We view Radian's management and governance as satisfactory. The management team has retained its market-leading position in the mortgage insurance sector. We believe, however, this is offset by historically high risk tolerances and higher-risk, single-premium businesses, 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.

We view Radian's enterprise risk management (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 to the 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 cyclical nature of mortgage insurance business losses and the high correlation with macroeconomic factors show that Radian and its peers had outside risk tolerances related to credit and underwriting during this past cycle. Radian failed to exercise appropriate underwriting discipline and risk selection 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 its ability to assess and quantify its risk vulnerabilities.

We regard Radian's liquidity as strong, as reflected by its high liquidity ratio according to our liquidity model, as well as a highly liquid asset portfolio.

Outlook

The positive outlook reflects our expectation that the company's capitalization will continue to strengthen, and operating performance to improve in the next few years. We also expect the new notices of delinquencies from the legacy business to continue declining and for losses from new post-financial-crisis business to remain very low.

Downside scenario

We could affirm the rating if we no longer believe Radian's capitalization will improve to the 'BBB' level, likely due to lower-than-expected operating performance, or if Radian is unable to address its PMIERS capital constraint and this affects the company's ability to write new business.

Upside scenario

We could upgrade the company if operating performance continues to improve beyond our expectations while the company maintains its market share and underwriting discipline. Alternatively, we can also upgrade the company if it significantly improves capitalization and sustains it above the current 'BB' level.

Related Criteria And Research

- Key Credit Factors For The Mortgage Insurance Industry, March 2, 2015
- Methodology: Mortgage Insurer Capital Adequacy, March 2, 2015
- Group Rating Methodology, Nov. 19, 2013
- Insurers: Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Upgraded

| | To | From |
|--------------------------------|----------------|-----------------|
| Radian Group Inc. | | |
| Counterparty Credit Rating | | |
| Local Currency | B/Positive/-- | B-/Positive/-- |
| Senior Unsecured | B | B- |
| Radian Guaranty Inc. | | |
| Radian Mortgage Insurance Inc. | | |
| Radian Mortgage Assurance Inc. | | |
| Counterparty Credit Rating | | |
| Local Currency | BB/Positive/-- | BB-/Positive/-- |
| Financial Strength Rating | | |
| Local Currency | BB/Positive/-- | BB-/Positive/-- |

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.

Copyright © 2015 by Standard & Poor's Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P. The Content shall not be used for any unlawful or unauthorized purposes. S&P, its affiliates, and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.