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Credit Opinion: Radian Guaranty Inc.

Global Credit Research - 08 Jan 2015

Philadelphia, Pennsylvania, United States

Ratings

Category	**Moody's Rating**
Rating Outlook	RUR
Insurance Financial Strength	Ba2
Radian Group Inc.	
Rating Outlook	RUR
Senior Unsecured	B3

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Key Indicators

Radian Guaranty Inc.

	2013	2012	2011	2010	2009
New Insurance Written	47,251	37,061	15,510	11,558	16,969
Risk in Force	40,017	34,372	30,692	31,461	33,765
Insurance in Force	161,240	140,265	126,185	129,566	144,268
Market Position					
Avg. NIW as a % of Total Industry NIW	10.7%	7.7%	4.3%	3.4%	5.5%
Prime loans % RIF	91.5%	88.3%	84.7%	82.6%	80.2%
Client Concentration	20.6%	27.0%	32.2%	35.4%	34.3%
Geographic Concentration	27.1%	26.3%	25.7%	26.5%	28.3%
Capital Adequacy					
Adjusted Risk to Capital	31.0	37.7	37.0	29.4	30.1
Profitability					
Return on Capital	-11.8%	-30.0%	15.8%	-79.8%	-5.3%
Combined Ratio (SAP)	111.7%	154.3%	217.2%	232.3%	186.1%
Financial Flexibility					
Cash Flow Coverage	.x	.x	.x	.x	.x
Financial Leverage	50.4%	48.6%	41.8%	53.6%	26.6%
Total Leverage	52.8%	52.3%	47.7%	63.8%	33.8%

Opinion

SUMMARY RATING RATIONALE

The insurance financial strength (IFS) ratings of Radian Guaranty Inc. (Radian Guaranty, Ba2, review for upgrade) and its wholly owned subsidiary, Radian Mortgage Assurance Inc. (RMA, Ba2, review for upgrade) reflect: 1) improved profitability due to high levels of profitable new insurance written (NIW) and lower incurred losses on the insured portfolio; 2) stabilization of, and increased visibility into, losses on the legacy mortgage insurance portfolio; 3) continued improvement in US housing fundamentals, including unemployment and house prices; and 4) the group's consolidated financial resources, in excess of our base case losses.

Radian Group's B3, review for upgrade, senior debt rating reflects the holding company's substantial debt burden, despite its improved liquidity position and demonstrated ability to access capital markets. Despite its steadily improving profitability, dividends from Radian Guaranty are unlikely for the foreseeable future given its weak regulatory capital position and substantial, but declining legacy losses. However, the holding company's liquidity is enhanced by expense-sharing agreements it has with its principal operating subsidiaries. These agreements, approved by the respective state insurance regulators, allow for a portion of interest expense to be allocated to the regulated subsidiaries. In addition, the group expects to receive a modest dividend from new subsidiary, Clayton Holdings LLC (Clayton).

On December 23, 2014, we placed the ratings of Radian Guaranty, RMA, Radian Asset Assurance and Radian Group on review for possible upgrade, following the announcement by Radian Guaranty that it had entered into a Stock Purchase Agreement to sell 100% of the issued and outstanding shares of Radian Asset Assurance (Radian Asset, Ba1, review for upgrade), its financial guaranty insurance subsidiary, to Assured Guaranty Corp. (AGC, A3 IFS, negative), a subsidiary of Assured Guaranty Ltd. (NYSE: AGO, senior debt at Baa2, stable) for a purchase price of approximately $810 million. The purchase price is payable in cash consideration on the closing date, which is expected to occur in the first half of 2015, subject to satisfaction of customary closing conditions including regulatory approvals.

In July, 2014, Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs), issued proposed, updated capital requirements for mortgage insurers, included within the private mortgage insurer eligibility requirements (the "PMIERs"). While Radian expects to be fully compliant with the PMIERs by the end of a transition period, the company estimates that it will have a shortfall in PMIER Available Assets of approximately $400 million after taking into consideration the anticipated $790 million in net proceeds from the sale of Radian Asset and unencumbered holding company cash of approximately $770 million that Radian has earmarked for capital contributions to Radian Guaranty. However, we consider there to be competing demands on the holding company cash, which will be required to support repayment of approximately $645 million in senior and convertible debt due in 2017, unless the company is able to refinance or otherwise extend the term of that debt.

Having moved past the worst of the effects of the financial crisis, Radian has amended its strategy to include diversification beyond US primary mortgage insurance on GSE-conforming loans. While in the early stages, Radian recently embarked on two initiatives in furtherance of this strategy. On June 30, 2014, Radian acquired all of the outstanding equity interests of Clayton Holdings LLC, a provider of outsourcing services to the mortgage industry, for a cash purchase price of approximately $312 million. We believe that the acquisition provides a good opportunity for Radian to expand its franchise beyond its core mortgage insurance business, while remaining within its field of expertise. However, we believe that the contribution of capital to non-core operations presents a distinct risk. Also, in July 2014, Radian Group invested $20 million to capitalize a newly formed, wholly-owned insurance subsidiary of Radian Group. The strategic objective of this investment is to offer various mortgage insurance-related products, which are currently in a developmental stage.

In May 2014, Radian issued approximately 17.8 million shares of its common stock and $300 million in aggregate principal amount of 5.5% senior unsecured notes maturing on June 1, 2019. Radian used the net proceeds of $541.8 million from both transactions combined to fund the purchase of Clayton, the redemption of all the remaining 5.375% Senior Notes due in 2015, and for working capital. Interest on the $300 million senior notes is paid directly by Clayton and does not place a demand on holding company liquidity.

Credit Strengths

Credit strengths of the company include:

- Higher quality new business and improved production volume;

- Improving visibility about performance of legacy book and continued decline in new delinquencies;

- Increased holding company liquidity enables a greater degree of capital support of main insurance subsidiaries, if necessary.

Credit Challenges

Credit challenges for the company include:

- Radian Guaranty's significant shortfall to assets required under the draft PMIER requirements;

- Legacy portfolio still susceptible to stress in housing market and adds to PMIER capital requirements;

- Increasing competition among private mortgage insurers given new entrants;

- Significant debt load at the holding company and competing priorities for holding company cash and investments.

Rating Outlook

On December 23, 2014, we placed the ratings of Radian Guaranty, RMA and Radian Group on review for upgrade, following announcement of the agreement, subject to regulatory approval, to sell Radian Asset. In addition to waiting for regulatory approval and close of the transaction, Moody's review will focus on the extent to which the proceeds from the sale of Radian Asset improve Radian Guaranty's overall capital adequacy, and its ability to address the remaining shortfall to PMIER Required Assets.

What To Watch For:

- Finalization of the GSEs' private mortgage insurer eligibility requirements (PMIERs) currently expected to be finalized in 2015.

- Additional clarity about Radian's ability to access holding company cash resources for PMIER compliance, given the upcoming debt maturities.

What Could Change the Rating - Up

The following factors could result in an upgrade:

- Regulatory approval and consummation of the sale of Radian Asset to AGC;

- Injection of additional capital that meaningfully improves the firm's capital adequacy and level of available assets to meet PMIER requirements;

- Greater clarity about the Radian's ability to attain PMIER compliance.

What Could Change the Rating - Down

The following factors could result in a downgrade or confirmation of the rating:

- Cancellation of the agreement to sell Radian Asset;

- Capital deficiency relative to its Ba rating threshold that remains uncorrected;

- Radian's inability to meet PMIER requirements;.

- Deterioration in Radian Group's ability to meet its debt service requirements over the next few years.

Notching Considerations

The four-notch spread between Radian Group's B3, review for upgrade senior unsecured debt rating and the Ba2, review for upgrade IFS rating of its principal operating subsidiary, Radian Guaranty, is one-notch wider than Moody's standard notching for senior unsecured debt. The wider notching reflects Radian's substantial debt burden, relative to holding company resources, and the absence of dividend flow from Radian Guaranty for the next few years.

DETAILED RATING CONSIDERATIONS

Moody's currently rates Radian Guaranty Ba2 for IFS, which is based on an analysis of the key rating factors described below:

MARKET POSITION: Baa - STRONG POSITION WITHIN PRIVATE MI MARKET AND IMPROVING PORTFOLIO CHARACTERISTICS

US PMIs have been gaining share from the FHA since 2011 after the FHA repeatedly increased its prices and tightened up terms and conditions. The PMIs' market share was approximately 44% of the overall MI market at September 30, 2014, compared to around 65% during early 2000 and 80% in 2006. Radian, like its peers, has not yet returned to pre-crisis levels of market penetration, although it has increased its issuance of new business significantly since the post-financial crisis low.

The Baa score reflects Radian's strengthening market presence, its well-diversified insured book and healthy exposure to higher quality loans. As of September 30, 2014, Radian's insured book was comprised of 92.9% in prime loans, which tend to exhibit lower delinquency rates than non-prime mortgage loans. Due to Radian's solid growth in NIW, the proportion of post-2008 book, at 66.9%, of business exceeds the legacy business by a healthy margin, going a long way to help reduce the effect of legacy losses.

While Radian is currently one of the leading PMIs, in terms of market share, it is possible that Radian's significant shortfall relative to asset levels required under the PMIERs could cause some erosion of its market share due to the high hurdle to attaining PMIER compliance.

HOUSING MARKET ATTRIBUTES: Baa - INCREASING DEMAND FOR PRIVATE MORTGAGE INSURANCE AMID AN IMPROVING HOUSING ENVIRONMENT

I. Demand for Mortgage Insurance: Ba

The mortgage insurance industry is well established in the US with mortgage insurers benefiting from the GSEs' requirement, under their federal charter, to use credit enhancement on mortgages with loan-to-value (LTV) in excess of 80%. The proportion of mortgage originations insured by private and government-sponsored insurers (i.e., FHA/VA) has climbed to 36.9% in the third quarter of 2014 from 28.9% in 2009. As Radian Guaranty and its peers recover from the 2008-09 financial crisis, they continue to recapture market share from the FHA. The private mortgage insurance industry's market share of insured loans decreased to a low of 15.4% in year-end 2009 from 77.3% in year-end 2007 and back up to 43.9% in the third quarter of 2014.

Private mortgage insurers' franchise may come under pressure as a result of housing market reform. A contemplated narrower role for, or termination of, the GSEs would reduce or eliminate the mortgage insurers' core franchise, forcing them to compete against other sources of mortgage credit enhancement. The timing and extent of housing finance reform could also affect demand for mortgage insurance.

The proposed PMIERs require private mortgage insurers to hold significantly more capital relative to their risk-in-force, than is the case under existing capital requirements. In addition, the proposed measures are determined on a risk-weighted basis, with meaningfully higher capital required to support legacy exposures. As a result, we expect to see some differentiation in profitability between private mortgage insurers, and possibly capacity to write new business once the PMIERs are implemented. Overall, we consider the PMIERs to be credit positive.

II. Generic Loan Attributes: A

The score reflects the continued tight mortgage underwriting standards, the partial recourse nature of mortgage lending and improving servicing practices in the US. Since the financial crisis, US mortgage insurers have been writing business almost exclusively in the prime, first-lien segment of the mortgage market. We expect underwriting standards to remain fairly conservative despite some anticipated loosening as the industry recaptures market share from the FHA and GSEs provide more clarity on putback agreements that can increase mortgage origination to lower tier borrowers.

Insured mortgage loans in the US are typically long-term, fixed-rate products with partial recourse to the borrower. While residential mortgage loans in the US are secured by the underlying property, lenders generally have no recourse beyond the property itself. The mortgage insurers also insure a material amount of high LTV loans, though their LTV>95% new production has greatly declined since 2009. Historically, exposure to high LTV loans has made mortgage insurers particularly vulnerable to housing downturns.

As property prices have increased, borrowers' equity positions have improved, reducing default rate and loss severities. During the housing crisis, the US mortgage servicing industry experienced problems with delays in collections, loan modifications and foreclosures, and bad practices such as shoddy recordkeeping. Lender practices have improved, driven in part by greater regulatory oversight, including by the Consumer Financial Protection Bureau (CFPB).

III. Housing Market Conditions: A

The score reflects our view that the US economic recovery is gaining traction, though it still faces the challenges of a large foreclosure pipeline and uncertain impact of the global economy. House prices continue to stabilize, in part aided by limited available existing home inventory and relatively low new construction levels. Housing affordability, while still good by historical standards, is moderating because of housing price appreciation and rising interest rates.

CAPITAL ADEQUACY: Ba - PENDING SALE OF RADIAN ASSET PROVIDES A MEANINGFUL INCREASE IN AVAILABLE CAPITAL

In addition to the adjusted risk-to-capital scorecard metric, Moody's estimates Radian's future losses through an assessment of the company's own loss projections and application of various scenarios, stress tests and adjustments that we consider appropriate. While the sale of Radian Asset for an amount less than statutory book value will reduce Radian Guaranty's statutory capital, the sale will increase Radian Guaranty's liquidity and estimated capital resources given the discount applied to its investment in Radian Asset. We believe that Radian's claims paying resources, which over the past year have improved relative to estimated losses, are in excess of base case claims at a level consistent with a Ba rating.

New high quality business production and burnout of losses on the legacy book have driven improvement in capital adequacy over the past year, to the extent that we believe Radian Guaranty's claim paying resources would adequately cover current expected losses on the existing insured book absent new business writings. At the current Ba capital adequacy score, we consider the risk of non-compliance with the PMIERs to present limited downside risk to Radian Guaranty's capital adequacy profile.

However, Radian Guaranty estimates that it will have a shortfall in PMIER Available Assets of approximately $400 million after taking into consideration the anticipated $790 million in net proceeds from the sale of Radian Asset and unencumbered holding company cash of approximately $770 million that Radian has earmarked for capital contributions to Radian Guaranty.

The group has earmarked the majority of its approximately $770 million in holding company cash and liquid investments for capital contributions to Radian Guaranty. While there are significant resources at the holding company, the group has $650 million of convertible and senior notes due in 2017, repayment of which is dependent on these resources. If Radian were to contribute the holding company resources to Radian Guaranty before refinancing its debt due in 2017, it would be fully dependent on capital markets access to repay the 2017 debt. This would place meaningful pressure on the group's credit profile.

Moody's notes that RMA and Radian Guaranty, although separate legal entities, are evaluated jointly for capital adequacy. RMA and Radian Guaranty entered into a cross guaranty agreement in 1999 that remains in place. Under the agreement, if RMA fails to make payment to policyholders, Radian Guaranty will make the payment, and vice versa. The obligations of both parties are unconditional and irrevocable, though any payments are subject to regulatory approval.

PROFITABILITY: Ba - PROFITABILITY FROM NEW PRODUCTION OVERTAKES LEGACY LOSSES

While an average of Radian's historical profitability metrics over the past five years remains depressed due to slowly declining, elevated losses in the legacy portfolio, the group was profitable for the nine months ending September 30, 2014, due mainly to lower incurred losses on the mortgage insurance business. The key factor contributing to decreasing incurred losses is the steady decline in new delinquencies, due to burnout of the legacy book and the general improvement in underlying housing finance conditions. In addition, the increasing level of new, profitable business being written contributes meaningfully to Radian's return to profitability. During the second and third quarters of 2014, Radian generated significant profits, which we expect will continue as losses in the legacy book decline and Radian Guaranty continues to write meaningful amounts of new high quality business.

FINANCIAL FLEXIBILITY: Ba - HIGH DEBT BURDEN, BUT DEMONSTRATED ACCESS TO CAPITAL MARKETS

Moody's scores Radian Ba for financial flexibility to reflect the holding company's improved liquidity position and demonstrated ability to access capital markets, following capital raises in both 2013 and 2014. The below investment grade financial flexibility score reflects the meaningful debt burden relative to holding company liquidity and the lack of dividend capacity at Radian Guaranty for the foreseeable future. The quota-share reinsurance agreement helps to alleviate some near-term regulatory capital pressure, and the debt exchange offer pushes maturity back to 2017 on a significant amount of debt; both these measures, however, come at a cost to earnings.

Dividends from Radian Guaranty are unlikely for the foreseeable future given the large unassigned deficit in its US Statutory financial reports, and we believe that, despite the significant addition to liquidity from capital raises over the past year, the holding company may not be able to meet all of its senior debt obligations without further improvement in the performance of its subsidiaries. As of September 30, 2014, Radian had unrestricted cash and liquid investments of approximately $770 million before considering any further capital contributions to Radian Guaranty to help attain compliance with the PMIERs.

Moody's also notes that Radian Group has expense-sharing agreements in place with its principal operating subsidiaries that require that these subsidiaries pay their share of holding company expenses, including interest expense on debt. However, these arrangements could be terminated at the discretion of the insurance regulator, and such termination would increase expenses for the holding company. The expense sharing agreement with Radian Asset will terminate on finalization of the sale to AGC; this will likely increase the expense load on Radian Guaranty.

Radian Group Inc. reported pre-tax income of $534.2 million for the nine months ended September 30, 2014, versus a pre-tax loss of $242.5 million for the same period in 2013. Radian's mortgage insurance operations reported an adjusted pre-tax operating income of $326.9 million for the nine months ended September 30, 2014, compared to an adjusted pre-tax operating income of $1.2 million for the same period in 2013.

In the absence of unexpected adverse macroeconomic developments, we expect Radian's financial results to continue improving as it continues to write profitable new business, and losses on the legacy book decrease due to burnout of the book, and a steady decline in new delinquencies.

Rating Factors

Radian Guaranty Inc.

Financial Strength Rating Scorecard [1]	**Aa**	**A**	**Baa**	**Ba**		**Score**	[2]**Adjusted Score**
Factor 1: Market Position (20%)						**Baa**	**Baa**
Avg. NIW as a % of Total Industry NIW			**10.7%**				
Prime Loans (% of RIF)		**91.5%**					
Client Concentration			**20.6%**				
Geographical Concentration		**27.1%**					
Factor 2: Housing Market Attributes (25%)						**Baa**	**Baa**
Demand for Mortgage Insurance				**x**			
Generic Loan Attributes		**x**					
Housing Conditions		**x**					
Factor 3: Capital Adequacy (30%)						**Ba**	**Ba**
Adjusted Risk-to-Capital Ratio				**31.0x**			
Factor 4: Profitability (15%)						**Caa**	**Ba**
Return on Capital (after-tax)					**-21.0%**		
Combined Ratio					**181.0%**		
Factor 5: Financial Flexibility (10%)						**B**	**Ba**
Cash Flow Coverage				**0.0x**			
Adjusted Financial Leverage					**50.4%**		
Total Leverage					**52.8%**		
Aggregate profile						**Ba**	**Ba2**

[1] Information based on statutory and GAAP financial statements as of 12/31/2013, unless noted [2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations are incorporated into the analysis

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