

RADIAN GROUP INC  
Form 10-K  
March 01, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K**

(Mark One)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2006

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-11356

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**RADIAN GROUP INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

23-2691170  
(I.R.S. Employer Identification No.)

1601 Market Street, Philadelphia, PA  
(Address of principal executive offices)

19103  
(Zip Code)

(215) 231-1000

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

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<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
<b>Common Stock, \$.001 par value per share</b>	<b>New York Stock Exchange</b>
<b>Securities registered pursuant to Section 12(g) of the Act: None</b>	

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ☒ NO ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES ☐ NO ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ☒ NO ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

State the aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. As of June 30, 2006, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$5,040,251,427 based on the closing sale price as reported on the New York Stock Exchange. Excluded from this amount is the value of all shares beneficially owned by executive officers and directors of the registrant. These exclusions should not be deemed to constitute a representation or acknowledgement that any such individual is, in fact, an affiliate of the registrant or that there are not other persons or entities who may be deemed to be affiliates of the registrant.

### (APPLICABLE ONLY TO CORPORATE REGISTRANTS)

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 79,934,586 shares of common stock, \$.001 par value per share, outstanding on February 26, 2007.

### DOCUMENTS INCORPORATED BY REFERENCE

List hereunder the following documents if incorporated by reference and the Part of the Form 10-K (e.g., Part I, Part II, etc.) into which the document is incorporated: (1) Any annual report to security holders; (2) Any proxy or information statement; and (3) Any prospectus filed pursuant to Rule 424(b) or (c) under the Securities Act of 1933. The listed documents should be clearly described for identification purposes (e.g., annual report to security holders for fiscal year ended December 24, 1980).

#### Document

Definitive Proxy Statement for the Registrant's 2007 Annual Meeting of Stockholders

#### Form 10-K Reference

Part III

(Items 10 through 14)

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### **Forward Looking Statements   Safe Harbor Provisions**

All statements in this report that address events, developments or results that we expect or anticipate may occur in the future are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934 and the U.S. Private Securities Litigation Reform Act of 1995. In most cases, forward-looking statements may be identified by words such as may, will, should, expect, intend, plan, goal, contemplate, believe, estimate, predict, project, potential, continue or the negative or words and other similar expressions. These statements are made on the basis of management's current views and assumptions with respect to future events. Any forward looking statement is not a guarantee of future performance and actual results could differ materially from those contained in the forward looking information. The forward-looking statements, as well as our prospects as a whole, are subject to risks and uncertainties, including the following:

changes in general financial and political conditions, such as extended national or regional economic recessions, changes in housing demand or mortgage originations, changes in housing values, population trends and changes in household formation patterns, changes in unemployment rates, changes or volatility in interest rates or consumer confidence, changes in credit spreads, changes in the way investors perceive the strength of private mortgage insurers or financial guaranty providers, investor concern over the credit quality and specific risks faced by the particular businesses, municipalities or pools of assets covered by our insurance;

economic changes or catastrophic events in geographic regions (both domestic and international) where our mortgage insurance or financial guaranty insurance in force is more concentrated;

the loss of a customer for whom we write a significant amount of mortgage insurance or financial guaranty insurance or the influence of large customers;

the aging of our mortgage insurance portfolio, which could cause losses to increase, and changes in severity or frequency of losses associated with certain of our products that are riskier than traditional mortgage insurance or financial guaranty insurance policies;

changes in persistency rates of our mortgage insurance policies caused by changes in refinancing activity, appreciating or depreciating home values and changes in the mortgage insurance cancellation requirements of mortgage lenders and investors;

downgrades or threatened downgrades of, or other ratings actions with respect to, our credit ratings or the insurance financial strength ratings assigned by the major rating agencies to any of our rated insurance subsidiaries at any time, which actions have occurred in the past;

heightened competition for our mortgage insurance business from others such as the Federal Housing Administration and the Veterans Administration or other private mortgage insurers, from alternative products such as 80-10-10 loans or other forms of simultaneous second loan structures used by mortgage lenders, from investors using forms of credit enhancement other than mortgage insurance as a partial or complete substitution for private mortgage insurance and from mortgage lenders that demand increased participation in revenue sharing arrangements such as captive reinsurance arrangements;

changes in the charters or business practices of Federal National Mortgage Association and Federal Home Loan Mortgage Corp., the largest purchasers of mortgage loans that we insure;

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heightened competition for financial guaranty business from other financial guaranty insurers, from other forms of credit enhancement such as letters of credit, guaranties and credit default swaps provided by foreign and domestic banks and other financial institutions and from alternative structures that permit insurers to securitize assets more cost-effectively without the need for the types of credit enhancement we offer;

the application of existing federal or state consumer, lending, insurance and other applicable laws and regulations, or changes in these laws and regulations or the way they are interpreted; including, without

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limitation: (i) the possibility of private lawsuits or investigations by state insurance departments and state attorneys general alleging that services offered by the mortgage insurance industry, such as captive reinsurance, pool insurance and contract underwriting, are violative of the Real Estate Settlement Procedures Act and/or similar state regulations (particularly in light of public reports that some state insurance departments are investigating captive reinsurance arrangements used in the mortgage insurance industry), or (ii) legislative and regulatory changes affecting demand for private mortgage insurance or financial guaranty insurance;

the possibility that we may fail to estimate accurately the likelihood, magnitude and timing of losses in connection with establishing loss reserves for our mortgage insurance or financial guaranty businesses or to estimate accurately the fair value amounts of derivative financial guaranty contracts in determining gains and losses on these contracts;

changes in accounting guidance from the Securities and Exchange Commission or the Financial Accounting Standards Board (in particular changes regarding income recognition and the treatment of loss reserves in both the mortgage insurance and financial guaranty industries);

our ability to profitably grow our insurance businesses in international markets, which depends on a number of factors such as foreign governments' monetary policies and regulatory requirements, foreign currency exchange rate fluctuations, and our ability to develop and market products appropriate to foreign markets;

legal and other limitations on the amount of dividends we may receive from our subsidiaries;

vulnerability to the performance of our strategic investments;

changes in the availability of affordable or adequate reinsurance for our non-prime risk; and

risk and uncertainties associated with our proposed merger with MGIC Investment Corporation ( "MGIC" ), including, without limitation: the ability to complete the transaction on the proposed terms and schedule; the risk that the two companies and their businesses will not be integrated successfully; customer attrition and disruption from the transaction making it more difficult to maintain relationships with customers, employees or other business relationships; the risk that the cost savings and any other synergies from the transaction may not be fully realized or may take longer to realize than expected; the risk that potential sales of assets in connection with the merger may negatively impact the financial performance of the combined company; and the possibility that the merger may not be completed, whether due to the failure to receive the requisite stockholder or regulatory approvals or otherwise, which may have an adverse effect on our customers, employees and other business relationships, and may have a materially adverse impact on our financial results and prospects.

For more information regarding these risks and uncertainties as well as certain additional risks that we face, you should refer to the Risk Factors detailed in Part I, Item 1A of this report. We caution you not to place undue reliance on these forward-looking statements, which are current only as of the date on which we filed this report. We do not intend to, and we disclaim any duty or obligation to, update or revise any forward-looking statements made in this report to reflect new information or future events or for any other reason.

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### Part I

#### Item 1. Business

##### I. General

We are a global credit enhancement company. Our strategic objective is to prudently grow our core mortgage credit enhancement business while providing value to our clients in the acquisition, management and distribution of credit risk, both in domestic and international markets. We develop and deliver innovative financial solutions by applying our credit risk expertise and structured finance capabilities to the credit enhancement needs of the capital markets worldwide.

Based on this foundation of credit risk evaluation and expertise, we offer products and services through three business segments mortgage insurance, financial guaranty and financial services:

Our mortgage insurance business provides credit protection for mortgage lenders and other financial services companies on residential mortgage assets through traditional mortgage insurance as well as other mortgage-backed structured products.

Our financial guaranty business insures and reinsures credit-based risks and provides synthetic credit protection on various asset classes through credit default swaps.

Our financial services business consists mainly of our ownership interests in Credit-Based Asset Servicing and Securitization LLC ( C-BASS ) a mortgage investment and servicing firm specializing in credit-sensitive, residential mortgage assets and residential mortgage-backed securities and in Sherman Financial Services Group LLC ( Sherman ) a consumer asset and servicing firm specializing in credit card and bankruptcy-plan consumer assets.

The following shows the contribution to net income and equity created by our three business segments in 2006:

	Net	
	Income	Equity
Mortgage Insurance	49%	55%
Financial Guaranty	23%	34%
Financial Services	28%	11%

A summary of financial information for each of our business segments and a discussion of net premiums earned attributable to our domestic and international operations for each of the last three fiscal years is included in Segment Reporting in Note 2 of Notes to Consolidated Financial Statements.

*Background.* We began conducting business as CMAC Investment Corporation, a Delaware corporation, following our spin-off from Commonwealth Land Title Insurance Company through an initial public offering on November 6, 1992. On June 9, 1999, we merged with Amerin Corporation and were renamed Radian Group Inc. On February 28, 2001, we entered the financial guaranty insurance business through our acquisition of Enhance Financial Services Group Inc. ( EFSG ), a New York-based insurance holding company. Our principal executive offices are located at 1601 Market Street, Philadelphia, Pennsylvania 19103, and our telephone number is (215) 231-1000.

*Proposed Merger with MGIC Investment Corporation ( MGIC ).* On February 6, 2007, we and MGIC entered into an Agreement and Plan of Merger pursuant to which we agreed, subject to the terms and conditions of the merger agreement, to merge with and into MGIC, with the combined company to be renamed MGIC Radian Financial Group Inc.



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Subject to the terms and conditions of the merger agreement, which has been unanimously approved by the boards of directors of both companies, upon the completion of the merger, each share of Radian common stock

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will be converted into 0.9658 shares of MGIC common stock, with cash to be paid in lieu of fractional shares of MGIC common stock. Radian stock options and other equity awards will automatically convert upon completion of the merger into stock options and equity awards with respect to MGIC common stock, subject to adjustment to reflect the exchange ratio.

Completion of the merger, which is expected to occur in the fourth quarter of 2007, is subject to various conditions, including (1) receipt of approvals of the holders of Radian and MGIC common stock, (2) receipt of regulatory approvals, (3) the absence of any law or order prohibiting the closing, and (4) effectiveness of the Form S-4 registration statement relating to the MGIC common stock to be issued in the merger and listing of the MGIC common stock to be issued in the merger on the New York Stock Exchange.

The merger agreement contains certain termination rights for both us and MGIC. Under certain circumstances, including those relating to competing business combination proposals, termination of the merger agreement may result in a party paying a termination fee of \$185 million.

*Additional Information.* We maintain a website with the address [www.radian.biz](http://www.radian.biz). We are not including or incorporating by reference the information contained on our website into this report. We make available on our website, free of charge and as soon as reasonably practicable after we file with, or furnish to, the Securities and Exchange Commission ( SEC ), copies of our most recently filed Annual Report on Form 10-K, all Quarterly Reports on Form 10-Q and all Current Reports on Form 8-K, including all amendments to those reports. In addition, copies of our guidelines of corporate governance, code of business conduct and ethics (which includes the code of ethics applicable to our chief executive officer, principal financial officer and principal accounting officer) and the governing charters for each committee of our board of directors are available free of charge on our website, as well as in print to any stockholder upon request.

### **A. Mortgage Insurance Business (General)**

Our mortgage insurance business provides credit-related insurance coverage, principally through private mortgage insurance, and risk management services to mortgage lending institutions located throughout the United States and select countries outside the United States. We provide these products and services through our wholly-owned subsidiaries, Radian Guaranty Inc. ( Radian Guaranty ), Radian Insurance Inc. ( Radian Insurance ), Amerin Guaranty Corporation ( Amerin Guaranty ) and our foreign mortgage insurance subsidiaries, Radian Europe Limited ( Radian Europe ), and Radian Australia Limited ( Radian Australia ).

Private mortgage insurance protects mortgage lenders from all or a portion of default-related losses on residential mortgage loans made mostly to home buyers who make down payments of less than 20% of the home's purchase price. Private mortgage insurance also facilitates the sale of these mortgage loans in the secondary mortgage market, most of which are sold to the Federal Home Loan Mortgage Corp. ( Freddie Mac ) and the Federal National Mortgage Association ( Fannie Mae ). We sometimes refer to Freddie Mac and Fannie Mae collectively as Government Sponsored Enterprises or GSEs.

Our mortgage insurance business, through Radian Guaranty, offers private mortgage insurance coverage on residential first-lien mortgages. We use Radian Insurance to provide credit enhancement for mortgage-related capital market transactions and to write credit insurance on mortgage-related assets that monoline mortgage guaranty insurers such as Radian Guaranty are not permitted to insure, including net interest margin securities ( NIMs ), international insurance transactions, second-lien mortgages and credit default swaps (collectively, we refer to the risk associated with these transactions as other risk in force ). We also insure second-lien mortgages through Amerin Guaranty. At December 31, 2006, other risk in force was 26.7% of our total mortgage insurance risk in force. We expect to use Radian Europe and, when licensed, Radian Australia, to offer a variety of mortgage credit risk solutions, including traditional mortgage insurance, financial guaranty and other structured transactions involving residential mortgage assets.

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Premiums written and earned by our mortgage insurance business for the periods indicated were as follows:

	Year Ended December 31		
	2006	2005	2004
	(In thousands)		
Net premiums written:			
Primary and Pool Insurance	\$ 723,213	\$ 752,194	\$ 751,604
Seconds	57,935	56,092	62,480
NIMs	34,215	40,318	48,421
International	23,861	25,612	3,546
Domestic credit default swaps	9,778	3,132	
Financial guaranty wrap	109	284	
Net premiums written	\$ 849,111	\$ 877,632	\$ 866,051
Net premiums earned:			
Primary and Pool Insurance	\$ 715,136	\$ 712,538	\$ 688,875
Seconds	52,588	50,043	64,777
NIMs	28,251	39,877	59,555
International	10,644	3,338	1,346
Domestic credit default swaps	5,287	817	
Financial guaranty wrap	109	284	
Net premiums earned	\$ 812,015	\$ 806,897	\$ 814,553

### 1. Traditional Types of Coverage (General Mortgage Insurance)

**Primary Mortgage Insurance.** Primary mortgage insurance provides mortgage default protection on prime and non-prime mortgages at a specified coverage percentage. When there is a claim, the coverage percentage is applied to the claim amount which consists of the unpaid loan principal, plus past due interest and certain expenses associated with the default to determine our maximum liability. We provide primary mortgage insurance on both a flow basis (which is loan by loan) and a structured basis (in which we insure a group of individual loans). Some of this business is written in a second-loss position where we are not required to pay until a certain amount of losses have already been recognized. See Types of Transactions below. In 2006, we wrote \$40.1 billion of primary mortgage insurance, of which 63.2% was originated on a flow basis and 36.8% was originated on a structured basis, compared to \$42.6 billion of primary mortgage insurance written in 2005 of which 60.1% was originated on a flow basis and 39.9% was originated on a structured basis. Primary insurance on first-lien mortgages made up 89% of our total first-lien mortgage insurance risk in force at December 31, 2006.

**Pool Insurance.** We offer pool insurance on a selective basis. Generally, pool insured mortgages are similar to primary insured mortgages. Pool insurance differs from primary insurance in that our maximum liability is not limited to a specific coverage percentage on each individual mortgage. Instead, an aggregate exposure limit, or stop loss, generally between 1% and 10%, is applied to the initial aggregate loan balance on a group or pool of mortgages. In addition to a stop loss, many pool policies are second to pay or second-loss meaning that the insured must incur losses on the pool above a specified amount or deductible before any claim payments under the policy will be made. The deductible and stop loss features are effective in limiting our exposure on a specified pool.

Premium rates for our pool insurance business are generally lower than primary mortgage insurance rates due to the aggregate stop loss. Because of the generally lower premium rates, lack of exposure limits on individual loans, and the greater concentration of risk in force associated with much of our pool insurance, the rating agency capital requirements for this product are generally more restrictive than for primary insurance. In

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2006, we wrote \$359 million of pool insurance risk, compared to \$569 million of pool insurance risk written in 2005. Pool insurance on first-lien mortgages made up 11% of our total first-lien mortgage insurance risk in force at December 31, 2006.

We write the majority of our pool insurance in the form of credit enhancement on residential mortgage loans underlying residential mortgage-backed securities, whole loan sales and other structured transactions. An insured pool of mortgages may contain mortgages that are already covered by primary mortgage insurance, and the pool insurance is secondary to any primary mortgage insurance that exists on mortgages within the pool.

*Modified Pool Insurance.* We also write modified pool insurance, which differs from standard pool insurance in that it includes a stop loss feature for the entire pool as well as an exposure limit on each individual loan.

## **2. Non-Traditional Forms of Credit Enhancement (General Mortgage Insurance)**

*Second-Lien Mortgages.* In addition to insuring first-lien mortgages, to a lesser extent, we also provide primary or modified pool insurance on second-lien mortgages. Beginning in 2004, we began focusing our participation in these transactions to situations (1) where there is a loss deductible or other first-loss protection that precedes our loss exposure or (2) where a lender otherwise is required to share in a significant portion of any losses. We wrote \$280 million of second-lien mortgage insurance risk in 2006. Most of this represents business in which we are in a second-loss or shared-loss position. At December 31, 2006, we had \$592 million of risk in force on second-lien mortgages in a first-loss position and \$610 million of risk in force where we are in a second- or shared-loss position, compared to \$591 million of risk in force in a first-loss position and \$638 million of risk in force in a second- or shared-loss position at December 31, 2005.

*Credit Enhancement on Net Interest Margin Securities.* We provide credit enhancement on NIMs. A NIM represents the securitization of some of the excess cash flow from a mortgage-backed security. The majority of this excess cash flow consists of the spread between the interest rate on the mortgage-backed security and the interest rate on the underlying mortgages. Historically, issuers of mortgage-backed securities would have earned this excess interest over time as mortgages age, but recent market efficiencies have enabled these issuers to sell a portion of their residual interests to investors in the form of NIM bonds. We provide credit enhancement on these bonds. In 2006, we wrote \$502 million of insurance risk on NIMs compared to \$99 million in 2005. At December 31, 2006, we had \$592 million of risk in force on NIMs, compared to \$261 million at December 31, 2005. These transactions are typically rated BBB and are all rated between A- and BB by Standard and Poor's Insurance Rating Service (S&P) and Fitch Ratings Service (Fitch).

*Domestic Credit Default Swaps.* In our mortgage insurance business, we sell protection on residential mortgage-backed securities through credit default swaps. A credit default swap is an agreement to pay our counterparty should an underlying security or the issuer of such security suffer a specified credit event, such as nonpayment, downgrade or a reduction of the principal of the security as a result of defaults in the underlying collateral. A credit default swap operates much like a financial guaranty insurance policy in that our obligation to pay is absolute. Unlike with most of our mortgage insurance and financial guaranty products, however, our ability to engage in loss mitigation is generally limited. Further, in a credit default swap structure, there is no requirement that our counterparty hold the security for which credit protection is provided. This has the effect of greatly increasing the volume and liquidity in the market. In 2006, our mortgage insurance business wrote \$32 million in notional value of credit protection on residential mortgage-backed securities in credit default swap form, compared to \$180 million in notional value written in 2005.

*International Mortgage Insurance Operations.* Our International Mortgage Group carefully reviews and assesses international markets for opportunities to expand our mortgage insurance operations in areas where we believe our business would produce acceptable risk adjusted returns. Currently, our primary geographical focus is on locations in Europe and Australia. We are in the process of establishing a separately licensed, capitalized, and

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rated on-shore entity in Australia. We also are actively pursuing interests in India and Canada and have been exploring opportunities in other countries as well. In 2006, we wrote \$86 million of mortgage insurance risk related to our international business compared to \$7.6 billion in 2005.

International mortgage insurance transactions can take the form of primary or pool mortgage insurance, reinsurance or credit default swaps. In the fourth quarter of 2005, we wrote \$7.3 billion in notional value of credit protection in credit default swap form on two large AAA tranches of mortgage-backed securities, one in Germany and one in Denmark.

Early in 2005, we entered into a relationship with Standard Chartered Bank (Hong Kong) Limited, a subsidiary of Standard Chartered Bank and one of the largest mortgage lenders in the Hong Kong market. Through this relationship, we became the exclusive provider (on an offshore basis) of mortgage insurance for Standard Chartered in Hong Kong. In September 2006, Radian Insurance received a license authorizing it, through a local branch, to fully transact both mortgage insurance and financial guaranty business, including credit enhancement of structured transactions involving residential mortgage assets, in and from Hong Kong.

In March 2006, Radian Europe received authorization to conduct mortgage insurance operations in the United Kingdom and, subject to compliance with the European Union passporting rules, several other European Union jurisdictions.

We formed Radian Australia in November 2006 and filed an application to conduct mortgage insurance business with the Australian Prudential Regulation Authority (APRA) in December 2006. We have several reinsurance arrangements in place in Australia, including a recent transaction with St. George Insurance Australia, a wholly owned subsidiary of St. George Bank, Australia's fifth largest bank. The license we are seeking for Radian Australia will authorize it to fully transact both mortgage insurance and financial guaranty business in and from Australia.

### ***3. Types of Transactions (General Mortgage Insurance)***

Our mortgage insurance business provides credit enhancement mainly through two forms of transactions. We write mortgage insurance on an individual loan basis, which is commonly referred to as flow business, and we insure multiple mortgages in a single transaction, which is commonly referred to as structured business. In flow transactions, mortgages typically are insured as they are originated, while in structured deals, we typically provide insurance on mortgages after they have been originated and closed. For 2006, our mortgage insurance business wrote \$25.4 billion of flow business and \$14.7 billion in structured transactions, compared to \$25.6 billion of flow business and \$17.0 billion in structured transactions for 2005.

In structured mortgage insurance transactions, we typically insure the individual mortgages included in the structured portfolio up to specified levels of coverage. Most structured mortgage insurance transactions that we insure involve non-traditional mortgages, such as non-prime mortgages or mortgages with higher than average balances. A single structured mortgage insurance transaction may include primary insurance or pool insurance, and an increasing number of structured transactions have both primary and pool components.

We also insure mortgage-related assets, such as mortgage-backed securities in structured transactions. In our residential mortgage-backed securities transactions, similar to our financial guaranty insurance business, we insure the timely payment of principal and interest to the holders of debt securities, the payment for which is backed by a pool of residential mortgages. Unlike our traditional flow and structured transactions, in our residential mortgage-backed securities transactions, we do not insure the payment of the individual loans in the pool, but rather that there will be aggregate payments on the pool of loans sufficient to meet the principal and interest payment obligations to the holders of the debt securities. Some structured transactions include a risk-sharing component under which the insured or a third-party assumes a first-loss position or shares in losses in some other manner.

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Opportunities for structured transactions depend on a number of macroeconomic factors, and thus, the volume of structured transactions we enter into can vary significantly from year to year. In 2006, we wrote \$14.7 billion of primary mortgage insurance in structured transactions, consisting of approximately 27.1% prime loans and 72.9% non-prime loans, compared to \$17.0 billion of primary new insurance written in structured transactions in 2005, of which 33.3% was prime loans and 66.7% was non-prime loans. Also in 2006, we wrote \$324.3 million of pool mortgage insurance risk in structured transactions, compared to \$533.2 million in 2005.

### **4. Types of Mortgage Risk (General Mortgage Insurance)**

*Prime Loans.* We define prime loans as loans where the borrower's Fair Isaac and Company ( FICO ) score is 620 or higher and the loan file meets fully documented standards of our credit guidelines and/or the GSE's guidelines for fully documented loans. Prime loans represented 71.9% of our total primary mortgage risk in force at the end of 2006 and made up 56.3% of our primary new insurance written in 2006, compared to 69.3% of our total primary mortgage risk in force at the end of 2005, or 58.3% of primary new insurance written in 2005.

*Non-Prime Loans.* We believe that non-prime lending programs continue to represent an area of future growth in the mortgage insurance industry, and we are prudently managing our insurance written in this area. Non-prime loans represented 28.1% of our total primary mortgage risk in force (59.4% of which was Alternative-A or Alt-A ) at the end of 2006, compared to 30.7% of total primary mortgage risk in force at the end of 2005 (56.9% of which was Alt-A). During 2006, non-prime business accounted for 43.7% of our primary new insurance written in our mortgage insurance business (80.2% of which was Alt-A), compared to 41.7% in 2005 (63.3% of which was Alt-A).

Within our non-prime mortgage insurance program, we have defined three categories of loans that we insure: Alt-A, A minus and B/C loans. We use our own proprietary statistical models to price our mortgage insurance business to produce appropriate risk-adjusted rates of return. We continue to limit our participation in these non-prime markets to mostly Alt-A and A minus loans rather than B/C loans, and we have targeted the business we insure to specific lenders that we believe have proven results and servicing experience in this area.

We define Alt-A loans as loans where the borrower's FICO score is 620 or higher and where the loan documentation has been reduced or eliminated. Because of the reduced documentation, we consider Alt-A business to be more risky than prime business, particularly Alt-A loans to borrowers with FICO scores below 660. We insure Alt-A loans with FICO scores ranging from 620 to 660, but we have measures in place to limit this exposure, and we charge a significantly higher premium for the increased default risk associated with these loans. Alt-A loans tend to have higher balances than other loans that we insure because they are often more heavily concentrated in high-cost areas. Alt-A loans represented 16.7% of total primary mortgage risk in force at the end of 2006, compared to 17.5% at the end of 2005, and made up 35.0% of our primary new insurance written in 2006, compared to 26.4% of primary new insurance written in 2005.

We define A minus loans as loans where the borrower's FICO score ranges from 575 to 619. This product comes to us both through structured transactions in which the insurance typically is lender-paid and through flow business in which the borrower pays the insurance premium. We also classify loans with certain characteristics originated within the GSE's automated underwriting system as A minus loans, regardless of the FICO score. Our pricing of A minus loans is tiered into four levels based on the FICO score, with increased premiums at each descending tier of FICO score. We receive a significantly higher premium for insuring this product that we believe is commensurate with the increased default risk. A minus loans represented 9.5% of our total primary mortgage risk in force at the end of 2006, compared to 10.5% at the end of 2005, and made up 7.4% of our primary new insurance written in 2006, compared to 11.7% of primary new insurance written in 2005.

We define B/C loans as loans where the borrower's FICO score is below 575. Certain structured transactions that we insure contain a small percentage of B/C loans. We price these structured transactions to

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reflect a higher premium on B/C loans due to the increased default risk associated with these types of loans. B/C loans represented 1.9% of our total primary mortgage risk in force at the end of 2006, compared to 2.7% at the end of 2005, and made up approximately 1.3% of total primary new insurance written during 2006, compared to 3.6% of total primary new insurance written in 2005.

### **5. *Premium Rates (General Mortgage Insurance)***

We cannot change our premium rates after we issue coverage. Accordingly, we determine premium rates in our mortgage insurance business on a risk-adjusted basis that includes borrower, loan and property characteristics. We use proprietary default and prepayment models to project the premiums we should charge, the losses and expenses we should expect to incur and the capital we need to hold in support of our risk. We establish pricing in an amount that we expect will allow a reasonable return on allocated capital.

Premiums for our mortgage insurance may be paid by the lender, which will in turn charge a higher interest rate to the borrower, or directly by the borrower. We price our borrower-paid flow business based on rates that we have filed with the various state insurance departments. We generally price our structured business and some lender-paid business based on the specific characteristics of the insured portfolio, which can vary significantly from portfolio to portfolio depending on a variety of factors, including the quality of the underlying loans, the credit history of the borrowers, the amount of coverage required and the amount, if any, of credit protection in front of our risk exposure.

### **6. *Captive Reinsurance (General Mortgage Insurance)***

We and other companies in the mortgage insurance industry participate in reinsurance arrangements with mortgage lenders commonly referred to as captive reinsurance arrangements. Under captive reinsurance arrangements, a mortgage lender typically establishes a reinsurance company that assumes part of the risk associated with the portfolio of that lender's mortgages insured by us on a flow basis (as compared to mortgages insured in structured transactions, which typically are not eligible for captive reinsurance arrangements). In return for the reinsurance company's assumption of a portion of the risk, we cede a portion of the mortgage insurance premiums paid to us to the reinsurance company. In most cases, the risk assumed by the reinsurance company is an excess layer of aggregate losses that would be penetrated only in a situation of adverse loss development, such as losses brought on by significant national or regional downturns in the real estate market. We also offer quota share captive reinsurance agreements under which the captive reinsurance company assumes a pro rata share of all losses in return for a pro rata share of the premiums collected.

Because of many factors, including the incentives for mortgage lenders to funnel relatively higher-quality loans through their captive reinsurers due to the risk-sharing feature, we continue to evaluate the level of revenue sharing to risk sharing on a customer-by-customer basis as part of our customer profitability analysis. We believe that all of our captive reinsurance arrangements transfer risk to the captive reinsurer at a premium level that is commensurate with the risk. We also believe that captive reinsurance agreements are important in aligning our interests with those of the lenders by providing lenders with an ongoing stake in the outcome of the lending decision.

We and other mortgage insurers have faced private lawsuits alleging, among other things, that our captive reinsurance arrangements constitute unlawful payments to mortgage lenders under the anti-referral fee provisions of the Real Estate Settlement Practices Act of 1974 ( RESPA ). We also have been subject to inquiries from the New York insurance department relating to our captive reinsurance arrangements. For more information, see Regulation Federal Regulation RESPA in this Item 1.

We had approximately 53 active captive reinsurance agreements in place at December 31, 2006, compared to 50 that were in place at December 31, 2005. Premiums ceded to captive reinsurance companies in 2006 were \$96.7 million, representing 11.7% of total mortgage insurance premiums earned, as compared to \$92.9 million,

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or 11.5% in 2005. Primary new insurance written in 2006 that had captive reinsurance associated with it was \$13.2 billion or 32.8% of our total primary new insurance written, as compared to \$12.2 billion, or 28.7% of total primary new insurance written in 2005. These percentages can be volatile as a result of increases or decreases in the volume of structured transactions, which are not typically eligible for captive reinsurance arrangements.

We also have entered into risk/revenue-sharing arrangements with the GSEs whereby the primary insurance coverage amount on certain loans is recast into primary and pool insurance and our overall exposure is reduced in return for a payment made to the GSEs. Ceded premiums written and earned for the year ended December 31, 2006 were \$9.7 million and \$7.1 million, respectively, under these programs.

### **7. Underwriting (General Mortgage Insurance)**

*Delegated Underwriting.* We have a delegated underwriting program with a significant number of our customers. Our delegated underwriting program enables us to meet lenders' demands for immediate insurance coverage by having us commit to insure loans that meet agreed-upon underwriting guidelines. Our delegated underwriting program currently involves only lenders that are approved by our risk management area, and we routinely audit loans submitted under this program. Once we accept a lender into our delegated underwriting program, however, we generally insure all loans submitted to us by that lender even if the lender has, without our knowledge, not followed our specified underwriting guidelines. A lender could commit us to insure a number of loans with unacceptable risk profiles before we discover the problem and terminate that lender's delegated underwriting authority. We mitigate this risk through periodic, on-site reviews of selected delegated lenders by our Portfolio Quality Assurance department. See *Risk Management Mortgage Insurance Portfolio Quality Assurance* in this Item 1. As of December 31, 2006, approximately 36% of our total mortgage insurance in force was originated on a delegated basis, compared to 28% as of December 31, 2005.

*Contract Underwriting.* Our mortgage insurance business also utilizes its underwriting skills to provide an outsourced underwriting service to its customers known as contract underwriting. For a fee, we underwrite our customers' fully documented loan files for secondary market compliance (*i.e.*, for sale to GSEs), while concurrently assessing the file for mortgage insurance, if applicable. Contract underwriting continues to be a popular service to our mortgage insurance customers. During 2006, loans underwritten via contract underwriting accounted for 12.6% of applications, 12.3% of commitments for insurance and 11.4% of insurance certificates issued for flow business.

We give recourse to our customers on loans that we underwrite for compliance. Typically, we agree that if we make a material error in underwriting a loan, we will provide a remedy to the customer by repurchasing or placing additional mortgage insurance on the loan, or by indemnifying the customer against loss. Providing these remedies means we assume some credit risk and interest-rate risk if an error is found during the limited remedy period, which may be up to seven years, but typically is only two years. Rising mortgage interest rates or an economic downturn may expose the mortgage insurance business to an increase in such costs. During 2006, we processed requests for remedies on less than 1% of the loans underwritten and sold a number of loans previously acquired as part of the remedy process. We paid losses for sales and remedies from reserves in 2006 of approximately \$5.9 million, and our reserve for such expenses at December 31, 2006 was \$5.7 million. We closely monitor this risk and negotiate our underwriting fee structure and recourse agreements on a client-by-client basis. We also routinely audit the performance of our contract underwriters to ensure that customers receive quality underwriting services. This audit function is performed by our Portfolio Quality Assurance department. See *Risk Management Mortgage Insurance Portfolio Quality Assurance* in this Item 1 below.

### **B. Financial Guaranty Business (General)**

Our financial guaranty business mainly insures and reinsures credit-based risks through our wholly-owned subsidiary, Radian Asset Assurance Inc. ( *Radian Asset Assurance* ) and through its wholly-owned subsidiary Radian Asset Assurance Limited ( *RAAL* ), located in the United Kingdom.



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Financial guaranty insurance provides an unconditional and irrevocable guaranty to the holder of a financial obligation of full and timely payment of principal and interest when due. Financial guaranty insurance may be issued at inception of an insured obligation or may be issued in the secondary market, to institutional holders. Financial guaranty insurance generally lowers an issuer's cost of borrowing when the insurance premium is less than the value of the spread (commonly referred to as the credit spread) between the yield on the insured obligation (carrying the credit rating of the insurer) and the yield on the obligation if sold on the basis of its uninsured credit rating. Financial guaranty insurance also increases the marketability of obligations issued by infrequent or unknown issuers or obligations with complex structures. Investors generally benefit from financial guaranty insurance through increased liquidity in the secondary market, reduced exposure to price volatility caused by changes in the credit quality of the underlying insured issue, and added protection against loss in the event of the obligor's default on its obligation.

Our financial guaranty business offers the following products:

insurance of public finance obligations, including tax-exempt and taxable indebtedness of states, counties, cities, special service districts and other political subdivisions, and for enterprises such as airports, public and private higher education and health care facilities and private finance initiative assets in sectors such as schools, healthcare and infrastructure projects. The issuers of public finance obligations we insure are typically rated investment grade (BBB-/Baa3 or higher) without the benefit of our insurance;

insurance of structured finance obligations, including collateralized debt obligations (CDOs) and asset-backed securities, consisting of funded and non-funded (synthetic) executions that are payable from or tied to the performance of a specific pool of assets. Examples of the pools of assets that underlie structured finance obligations include residential and commercial mortgages, a variety of consumer loans, corporate loans and bonds, equipment receivables, and real and personal property leases. The structured finance obligations we insure are generally rated investment-grade without the benefit of our insurance;

financial solutions products (which we group as a part of our structured finance business), including guaranties of securities exchanges, excess-Securities Investor Protection Corporation insurance for brokerage firms and excess-Federal Deposit Insurance Corporation insurance for banks; and

reinsurance of domestic and international public finance obligations, including those issued by sovereign and sub-sovereign entities, as well as reinsurance of structured finance, financial solutions and previously, trade credit reinsurance obligations.

In October 2005, we announced that we would be exiting the trade credit reinsurance line of business. Accordingly, this line of business has been placed into run-off and we have ceased initiating new trade credit reinsurance contracts going forward. For 2006, trade credit reinsurance accounted for 1.7% of financial guaranty's net premiums written, down from 15.7% of financial guaranty's net premiums written in 2005 (12.6% excluding the impact of the 2005 recapture of business (referred to herein as the 2005 recapture) by one of the primary insurer customers of our financial guaranty business) as discussed in Note 2 of Notes to Consolidated Financial Statements.

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The following table summarizes the net premiums written and earned by our financial guaranty business's various products for 2006, 2005 and 2004:

	Year Ended December 31		
	2006	2005	2004
	(In thousands)		
Net premiums written:			
Public finance direct	\$ 80,234	\$ 73,117	\$ 52,279
Public finance reinsurance	81,065	77,797	74,777
Structured direct	78,107	71,211	94,423
Structured reinsurance	18,869	20,649	32,112
Trade credit reinsurance	4,599	35,023	59,262
	262,874	277,797	312,853
Impact of recaptures (1)		(54,742)	(96,417)
Total net premiums written	\$ 262,874	\$ 223,055	\$ 216,436
Net premiums earned:			
Public finance direct	\$ 33,017	\$ 32,533	\$ 26,643
Public finance reinsurance	37,765	34,413	41,651
Structured direct	90,295	79,617	78,292
Structured reinsurance	21,278	20,440	33,001
Trade credit reinsurance	21,476	49,309	60,236
	203,831	216,312	239,823
Impact of recaptures (1)		(4,539)	(24,892)
Total net premiums earned	\$ 203,831	\$ 211,773	\$ 214,931

(1) Amounts represent the immediate impact of the 2005 recapture another primary insurer customer in the first quarter of 2004 (referred to herein as the 2004 recapture). See Note 2 of Notes to Consolidated Financial Statements for more information regarding these recaptures. In our financial guaranty business, the issuer of an insured obligation generally pays the premiums for our insurance either, in the case of most public finance transactions, in full at the inception of the policy or, in the case of most structured finance transactions, in regular monthly, quarterly, semi-annual or annual installments from the cash flow of the related collateral. Premiums for synthetic credit protection are generally paid in monthly, quarterly, or in semi-annual or annual installments, but occasionally all or a portion of the premium is paid upfront at the inception of the protection. Unlike our funded structured finance transactions, in synthetic credit protection transactions, payment is due directly from our counterparty and is generally not restricted to the cash flows from the underlying obligation or collateral supporting the obligation. Since we depend on the corporate creditworthiness of our counterparty rather than the cash flows from the insured collateral for payment, we generally have a right to terminate synthetic credit protection without penalty to us if our counterparty fails, or is financially unable to make timely payments to us under the terms of the synthetic credit transaction.

For public finance transactions, premium rates typically are stated as a percentage of debt service, which includes total principal and interest. For structured finance obligations, premium rates are typically stated as a percentage of the total principal. Premiums are generally non-refundable. Premiums paid in full at inception are recorded as revenue earned over the life of the insured obligation (or the coverage period for such obligation if shorter). Premiums paid in installments are generally recorded as revenue in the accounting period in which coverage is provided. The long and relatively predictable premium earnings pattern from our public finance and structured products transactions provides us with a relatively predictable source of future earned revenues.

The establishment of a premium rate for a transaction reflects some or all of the following factors:

issuer-related factors, such as the issuer's credit strength and sources of income;

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servicer-related factors, such as the ability of our counterparty or third-party servicer to manage the underlying collateral and the servicer's credit strength and sources of income;

obligation-related factors, such as the type of issue, the type and amount of collateral pledged, the revenue sources and amounts, the existence of structural features designed to provide additional credit enhancement should collateral performance not meet original expectations, the nature of any restrictive covenants and the length of time until the obligation's stated maturity; and

insurer- and market-related factors, such as rating agency capital charges, competition, if any, from other insurers and the credit spreads in the market available to pay premiums.

### ***1. Public Finance (General Financial Guaranty)***

Financial guaranty of public finance obligations provides credit enhancement of bonds, notes and other evidences of indebtedness issued by states and their political subdivisions (for example, counties, cities or towns), school districts, utility districts, public and private non-profit universities and hospitals, public housing and transportation authorities and other public and quasi-public entities. Municipal bonds can be categorized generally into tax-backed bonds and revenue bonds. Tax-backed bonds, which include general obligation bonds, are backed by the taxing power of the governmental agency that issues them, while revenue bonds are backed by the revenues generated by a specific project such as bridge or highway tolls, or by rents or hospital fees. Insurance provided to the public finance market has been and continues to be a major source of revenue for our financial guaranty business. Public finance direct business represented 30.5% of financial guaranty net premiums written in 2006, compared to 32.8% in 2005 (26.3% excluding the impact of the 2005 recapture). Our public finance business is subject to seasonality. We generally experience a decrease in public finance business written during the first and third quarters.

### ***2. Structured Finance (General Financial Guaranty)***

The structured finance market includes the market for both synthetic and funded asset-backed or mortgage-backed obligations as well as collateralized debt obligations (CDOs), which generally consist of multiple pools of assets, each of which is typically of a different credit quality or possesses different characteristics with respect to interest rates, amortization, and level of subordination. At December 31, 2006, we had \$41.7 billion of notional exposure related to the direct insurance of 140 credit default swaps in structured transactions, compared to \$20.7 billion related to 114 transactions at December 31, 2005. Structured finance direct business represented 29.7% of financial guaranty net premiums written in 2006, compared to 31.9% in 2005 (25.6% excluding the impact of the 2005 recapture). Structured direct net premiums written and earned for 2006 included \$60.1 million and \$71.5 million, respectively, of credit enhancement fees on derivative financial guaranty contracts, compared to \$50.5 million and \$59.1 million, respectively, in 2005 and \$66.1 million and \$50.3 million, respectively, in 2004.

Funded asset-backed obligations usually take the form of a secured interest in a pool of assets, often of uniform credit quality, such as commercial mortgages, credit card or auto loan receivables. Funded asset-backed securities also may be secured by a few specific assets such as utility mortgage bonds and multi-family housing bonds. In low interest rate environments and when credit spreads are tight, as was the case in 2006, our ability to participate in the funded asset-backed market is limited.

Synthetic transactions are tied to the performance of a pool of assets, but are not secured by those assets. Most of the synthetic transactions we insure are CDOs, where we typically assume credit risk on defined portfolios of referenced corporate credits, asset-backed securities, residential and commercial mortgage-backed securities and/or a combination of these asset types. A significant portion of these CDOs consist of synthetic commercial or residential mortgage-backed securities or other synthetic consumer asset-backed securities. The transfer of this type of credit risk typically is done through synthetic credit default swaps.

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With respect to CDOs for which we provide credit protection, we generally are required to make payments to our counterparty upon the occurrence of certain specified credit-related events related to the borrowings or bankruptcy of obligors contained within pools of investment grade corporate obligations or, in the case of pools of mortgage or other asset-backed obligations, upon the occurrence of certain specified credit-related events related to the specific obligations in the pool. Our CDO pools can range in size from 29 to 500 or more obligors or obligations each of which generally is investment grade at the time we begin providing credit protection. Typically, we provide protection up to a specified exposure amount that tends to range from \$20.0 million to \$40.0 million per obligor or obligation (but may be as low as \$10.0 million per obligor or obligation or up to \$60.0 million per obligor or obligation in specific transactions), with an aggregate exposure of \$20.0 million to \$600.0 million per transaction, though the exposure amounts vary significantly on a transaction-by-transaction basis. To manage the amount of risk we incur on these transactions, we have set internal limits as to the aggregate risk per obligor, industry sector and tranche size that we are willing to insure, and we comply with applicable insurance regulations limiting the size and composition of the pools we insure. We also have developed a methodology for aggregating risk across insured pools. See Risk Management Financial Guaranty in this Item 1 for additional information regarding our risk management of our CDO portfolio.

With respect to synthetic credit default swaps covering a specific obligation rather than a pool of debt obligations or reference entities (as in the case of the synthetic CDOs we insure as described above), our payment obligations to our counterparties are generally the same as those we have when insuring the underlying obligations. We agree to pay our counterparty should an underlying security or the issuer of such security suffer a specified credit event, such as nonpayment of scheduled interest or principal, or a reduction of the principal of the security as a result of defaults in the underlying collateral. For example, when providing synthetic credit protection for one or more specified obligations in derivative form, if an event occurred resulting in the acceleration of principal and interest on an underlying obligation, we generally would be responsible for paying these amounts to our counterparty on their regularly scheduled dates, despite the counterparty's not holding the obligation or directly suffering a loss for such amount.

In addition, under corporate CDOs, CDOs of commercial mortgage-backed securities and some other secondary market transactions for which we provide synthetic credit protection, we generally do not have recourse or other rights and remedies against the issuer and/or any related collateral for amounts we may be obligated to pay under the synthetic credit protection. Even when we have recourse or rights and remedies in a synthetic credit protection transaction, they are generally much more limited than the recourse, rights and remedies we generally have in our more traditional financial guaranty transactions.

The same corporate obligor may exist in a number of our structured finance obligations. The five largest corporate obligors, measured by gross nominal exposures, in our direct written book as of December 31, 2006 represented approximately \$9.9 billion of our total nominal exposure. Because each transaction has a distinct subordination requirement, prior credit events would typically have to occur with respect to several obligors in the pool before we would have an obligation to pay in respect of any particular obligor, meaning that our risk adjusted exposure to each corporate obligor in a CDO pool is significantly less than our nominal exposure. If each one of our five largest corporate obligors were to have defaulted at December 31, 2006, we would not have incurred any losses due to the significant subordination in each transaction. We monitor not only the nominal exposure for each obligor for which we provide protection, but also risk-adjusted measures, taking into account, among other factors, our assessment of the relative risk that would be represented by direct exposure to the particular obligor and the remaining subordination in the transactions in which we are exposed to a particular obligor. On occasion, we may have limited exposure to our affiliates, C-BASS and Sherman, under our structured finance transactions, although this exposure generally constitutes a small part of any such transaction and is insignificant in the aggregate. Initial subordination before we are obligated to pay a claim generally ranges from 12.5% to 25.0% of the initial total pool size.

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The following table shows the gross par amounts of structured finance obligations we originated in each of the years presented:

Type	2006	2005 (In millions)	2004
Collateralized debt obligations	\$ 22,362	\$ 11,152	\$ 4,630
Asset-backed obligations	1,305	2,534	2,010
Other structured	1,436	1,197	379
Total structured finance	\$ 25,103	\$ 14,883	\$ 7,019

The following table shows the gross par outstanding on structured finance obligations at the end of each of the years presented:

Type	2006	2005 (In millions)	2004
Collateralized debt obligations	\$ 43,989	\$ 22,736	\$ 13,156
Asset-backed obligations	4,514	6,024	7,927
Other structured	2,721	1,810	912
Total structured finance	\$ 51,224	\$ 30,570	\$ 21,995

The net par originated and outstanding on our structured finance obligations was not materially different from the gross par originated and outstanding at each period because we do not cede a material amount of business to reinsurers.

### 3. Reinsurance (General Financial Guaranty)

We provide reinsurance on direct financial guaranties written by other primary insurers or ceding companies. Reinsurance allows a ceding company to write larger single risks and larger aggregate risks while remaining in compliance with the risk limits and capital requirements of applicable state insurance laws and rating agency guidelines. State insurance regulators allow ceding companies to reduce the liabilities appearing on their balance sheets to the extent of reinsurance coverage obtained from licensed reinsurers or from unlicensed reinsurers meeting certain solvency and other financial criteria. Similarly, the rating agencies permit a reduction in both exposures and liabilities ceded under reinsurance agreements, with the amount of credit permitted dependent on the financial strength rating of the reinsurer.

We have reinsurance agreements with several of the triple-A rated financial guaranty insurers. These reinsurance agreements generally are subject to termination: (1) upon written notice by either party (ranging from 90 to 120 days) before the specified deadline for renewal; (2) at the option of the ceding company if we fail to maintain certain financial, regulatory and rating agency criteria that are equivalent to or more stringent than those that our financial guaranty operating subsidiaries are otherwise required to maintain for their own compliance with the New York insurance law and to maintain a specified financial strength rating for the particular insurance subsidiary; or (3) upon certain changes of control. The merger with MGIC will provide certain of our primary insurer customers with recapture rights. See Risk Factors-We face risks related to our proposed merger with MGIC in Item 1A below. Upon termination under the conditions set forth in (2) and (3) above, we may be required (under some of the reinsurance agreements) to return to the ceding company all unearned premiums, less ceding commissions, attributable to reinsurance ceded pursuant to these agreements. Upon the occurrence of the conditions set forth in (2) above, regardless of whether or not an agreement is terminated, we may be required to obtain a letter of credit or alternative form of security to collateralize our obligation to perform under that agreement, or we may be obligated to increase the level of ceding commissions paid. These and other matters associated with a downgrade in our subsidiaries ratings are discussed in Note 2 of Notes to Consolidated Financial Statements.

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*Treaty and Facultative Arrangements.* The principal forms of reinsurance agreements are treaty and facultative. Under a treaty arrangement, the ceding company is obligated to cede to us, and we are obligated to assume, a specified portion of all risks, within ranges, of transactions deemed eligible for reinsurance by the terms of the treaty. Limitations on transactions deemed eligible for reinsurance typically focus on size, security and ratings of the insured obligation. Each treaty is entered into for a defined term, generally one year, with renewals upon mutual consent and rights to early termination (subject to reinsurance risk extending thereafter for the life of the respective underlying obligations) under certain circumstances. The termination rights described above under *Reinsurance* are typical provisions for the termination of treaty reinsurance arrangements. In treaty reinsurance, there is a risk that the ceding company may select weaker credits or proportionally larger amounts to cede to us. We mitigate this risk by requiring the ceding company to retain a sizable minimum portion of each ceded risk and we include limitations on individual transactions and on aggregate amounts within each type of transaction. Under a facultative agreement, the ceding company has the option to offer to us, and we have the option to accept, a portion of specific risks, usually in connection with particular obligations. Unlike under a treaty agreement, where we generally rely on the ceding company's credit analysis, under a facultative agreement, we often perform our own underwriting and credit analysis to determine whether to accept the particular risk. The majority of our financial guaranty reinsurance is provided under treaty arrangements.

*Proportional or Non-Proportional Reinsurance.* We typically accept reinsurance risk on either a proportional or non-proportional basis. Proportional relationships are those in which we and the ceding company share a proportionate amount of the premiums and the losses of the risk group subject to reinsurance. In addition, we generally pay the ceding company a commission, which typically is related to the ceding company's underwriting and other expenses in connection with obtaining the business being reinsured. Non-proportional relationships are those in which the losses, and consequently, the premiums paid are not shared by the ceding company and us on a proportional basis. Non-proportional reinsurance can be based on an excess-of-loss or first-loss basis. Under excess-of-loss reinsurance agreements, we provide coverage to a ceding company up to a specified dollar limit for losses, if any, incurred by the ceding company in excess of a specified threshold amount. A first-loss reinsurance agreement is a form of structural credit enhancement that provides coverage to the ceding company on a first dollar of loss up to a specified dollar limit for losses. Generally, we do not pay a commission for non-proportional reinsurance (although the factors affecting the payment of a ceding commission in proportional arrangements may be taken into account to determine the proportion of the aggregate premium paid to us). The majority of our financial guaranty reinsurance business is originated on a proportional basis.

#### ***4. European Operations (General Financial Guaranty)***

Through RAAL, we have additional opportunities to write financial guaranty insurance in the United Kingdom and, subject to compliance with the European passporting rules, in other countries in the European Union. In particular, we expect that RAAL will continue to build its structured products business in the United Kingdom and throughout the European Union. RAAL accounted for \$9.2 million of direct premiums written in 2006 (or 5.8% of financial guaranty's 2006 direct premiums written), which is a \$5.7 million increase from the \$3.5 million or 2.4% of direct premiums written in 2005.

In September 2004, the Financial Services Authority (the "FSA") authorized Radian Financial Products Limited ("RFPL"), another subsidiary of Radian Asset Assurance, to transact as a Category A Securities and Futures Firm, which is the highest category of permission in the United Kingdom for an investment firm. In the fourth quarter of 2005, management considered the scope of RFPL's activities and decided that RFPL should focus its core business on arranging credit default swap risk for RAAL and Radian Asset Assurance. For the activity of arranging, or bringing about deals in investments, it is sufficient to have a Category D authorization, which is more cost efficient for the company. The lower category of authorization was granted in August 2006 and limits RFPL to negotiating and arranging transactions in investments, including credit default swaps, with market counterparties located in the United Kingdom or other European countries. Going forward, RFPL's role will be to negotiate credit default swaps between market counterparties and a Bermuda affiliate, Credit Derivatives Limited. The obligations of Credit Derivatives Limited are typically guaranteed by RAAL and, pursuant to a series of reinsurance treaties between RAAL and Radian Asset Assurance, Radian Asset Assurance reinsures at least 90% of RAAL's exposure.

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### **C. Financial Services Business (*General*)**

The financial services segment includes the credit-based businesses conducted through our affiliates, C-BASS and Sherman. We own a 46% interest in C-BASS and an interest in Sherman, consisting of 40.96% of the Class A Common Units of Sherman (Class A Common Units represent 94% of the total equity in Sherman) and 50% of the Preferred Units of Sherman.

C-BASS is a mortgage investment and servicing firm specializing in non-prime, residential mortgage assets and residential mortgage-backed securities. By using sophisticated analytics, C-BASS essentially seeks to take advantage of what it believes to be the mispricing of credit risk for certain of these assets in the marketplace. On February 16, 2007, C-BASS entered into an agreement to acquire Fieldstone Investment Corporation, a mortgage banking company that originates, sells, and invests primarily in non-conforming single-family residential mortgage loans with a current portfolio of over \$5.7 billion, for approximately \$259 million in cash. The transaction, which is expected to occur in the second quarter of 2007, subject to regulatory and other approvals, supports C-BASS's strategy of aligning with companies that have significant investments in mortgage securities, where C-BASS's wholly-owned subsidiary, Litton Loan Servicing, as servicer, can enhance the underlying value of these securities. In addition, if approved, the transaction will provide C-BASS with a platform for loan originations.

Sherman is a consumer asset and servicing firm specializing in charged-off and bankruptcy plan consumer assets that it generally purchases at deep discounts from national financial institutions and major retail corporations and subsequently collects upon these receivables. In addition, Sherman originates non-prime credit card receivables through its subsidiary CreditOne, which Sherman acquired in March 2005.

On June 24, 2005, we entered into agreements to restructure our ownership interest in Sherman. Before the restructuring, Sherman was owned 41.5% by us, 41.5% by MGIC and 17% by an entity controlled by Sherman's management team. As part of the restructuring, we and MGIC each agreed to sell a 6.92% interest in Sherman to a new entity controlled by Sherman's management team, thereby reducing our ownership interest and MGIC's ownership interest to 34.58% for each of us. In connection with the restructuring, we and MGIC each paid \$1 million for each of us to have the right, in the future, to purchase an additional 6.92% interest in Sherman from the new entity controlled by Sherman's management team for a price intended to approximate current fair market value.

On September 14, 2006, we and MGIC each agreed to restructure our respective options. In order to accommodate this restructuring, the equity interests of Sherman were reclassified, effective July 1, 2006, from a single class of equity interests into Class A Common Units and a combination of Preferred Units and Class B Common Units. As part of the reclassification, all of the authorized Class B Common Units were granted to an entity controlled by Sherman's management. The Class B Common Units entitle Sherman's management to 3% of Sherman's earnings above \$200 million (on an annual basis) and a right in liquidation of up to 6% of any amounts after satisfaction of a liquidation preference on the Preferred Units. The actual percentage received by the holders of Class B Common Units upon a liquidation or sale of Sherman will depend on when the sale or liquidation occurs and the value of Sherman at that time.

As restructured, we and MGIC each were granted an identical option to purchase, effective July 1, 2006:

4.17% (8.34% for both of us) of the Class A Common Units outstanding after the reclassification, which represents 3.92% (7.84% for both of us) of the common equity interests in Sherman prior to the reclassification; and

A preferred equity interest that entitles both us and MGIC to:

Three percent (6% in total for both of us) of the first \$200 million of Sherman's annual earnings, which amount shall be allocated to the Preferred Units on a cumulative basis before any amounts are allocated to the Class B Common Units, and 1.5% (3% in total for both of us) of Sherman's annual earnings above \$200 million; and

A preference in the proceeds received upon a liquidation or sale of Sherman equal to the tax basis in the preferred equity.



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On September 22, 2006, we and MGIC each paid \$65.3 million to an entity controlled by Sherman's management team in connection with the exercise of our restructured options. The purchase price consisted of approximately \$44.8 million for the Class A Common Units and approximately \$20.5 million for the Preferred Units.

The following table reconciles our and MGIC's ownership interests in Sherman before its reclassification and the restructuring of the options to our and MGIC's ownership interests after exercise of the restructured options.

Ownership	Before	After	After
		Reclassification/Restructuring	Reclassification/Restructuring
Interests	Reclassification/Restructuring	(Before Exercise of Options)	(After Exercise of Options)
Common Equity	34.58% total equity interest	36.79% of	40.96% of
	(69.16% for both of us)	Class A Common Units	Class A Common Units
		(73.58% for both of us)	(81.92% for both of us)
		0% of Class B Common Units *	0% of Class B Common Units *
Preferred Equity	None Existed	0% of Preferred Units	50% of the Preferred Units (100% for both of us)
Right to Purchase	6.92% total equity interest	4.17% of	No Further
	(13.84% for both of us)	Class A Common Units	Purchase Rights
		(8.34% for both of us) and	
		50% of the Preferred Units	
		(100% for both of us)	

\* Owned entirely by entities controlled by Sherman's management.

### D. Other (General)

Singer Asset Finance Company (Singer), a wholly-owned subsidiary of EFSG, which had been engaged in the purchase, servicing and securitization of assets, including state lottery awards and structured settlement payments, is operating on a run-off basis. Singer's run-off operations consist of servicing and/or disposing of Singer's previously originated assets and servicing its non-consolidated special purpose vehicles. The results of this subsidiary are not material to our financial results.

## II. Risk in Force/Net Par Outstanding

Our business involves taking credit risk in various forms across various asset classes, products and geographies. Credit risk is measured in our mortgage insurance business as risk in force, which represents the maximum exposure that we have at any point in time, and as net par outstanding in our financial guaranty business, which represents our proportionate share of the aggregate outstanding principal on insured obligations. We are also responsible for the timely payment of interest on insured financial guaranty obligations. Our total mortgage insurance risk in force and financial guaranty net par outstanding was \$142.6 billion as of December 31, 2006, compared to \$114.8 billion as of December 31, 2005. Of the \$142.6 billion of total risk in force/net par outstanding as of December 31, 2006, approximately 72.9% consists of financial guaranty risk and 27.1% of mortgage insurance risk.

### A. Mortgage Insurance (Risk in Force/Net Par Outstanding)

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Our primary mortgage insurance risk in force was \$25.3 billion as of December 31, 2006, compared to \$25.7 billion as of December 31, 2005. In recent years, we have faced increased competition for traditional prime mortgage credit enhancement. As a result, we have been insuring non-prime mortgages, as well as unproven products such as interest-only loans and non-traditional products such as second mortgages, credit default swaps and NIMs. We also have been expanding the geographic dispersion of our mortgage insurance products by writing more insurance in non-U.S. markets. We attempt to limit our exposure to such transactions until we can

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perform rigorous risk analytics and generate enough data to assist us in predicting the attendant risks and adjust our pricing accordingly. We analyze our portfolio in a number of ways to identify any concentrations or imbalances in risk dispersion. We believe the performance of our mortgage insurance portfolio is affected significantly by:

the age of the loan insured;

the geographic dispersion of the properties securing the insured loans;

the quality of loan originations; and

the characteristics of the loans insured (including loan-to-value ( LTV ), purpose of the loan, type of loan instrument and type of underlying property securing the loan).

Persistency rates, defined as the percentage of insurance in force that remains on our books after any 12-month period, are a key indicator for the primary mortgage insurance industry. Because most of our insurance premiums are earned over time, higher persistency rates enable us to recover our policy acquisition costs. Therefore, higher persistency rates tend to increase the profitability of a mortgage insurer. At December 31, 2006, the persistency rate of our primary mortgage insurance was 67.3%, compared to 58.2% at December 31, 2005. Both of these figures are slightly lower than historical levels and reflect the high levels of refinancing that have occurred in recent years in the mortgage market.

### 1. Primary Risk in Force by Policy Year (Risk in Force/Net Par Outstanding Mortgage Insurance)

The following table shows the percentage of our primary mortgage insurance risk in force by policy origination year as of December 31, 2006:

2001 and prior	7.6%
2002	5.5
2003	15.0
2004	18.1
2005	25.8
2006	28.0
Total	100.0%

### 2. Geographic Dispersion (Risk in Force/Net Par Outstanding Mortgage Insurance)

The following tables show the percentage of direct primary mortgage insurance risk in force by location of property for the top 10 states and top 15 metropolitan statistical areas ( MSAs ) in the United States as of December 31, 2006 and 2005:

Top Ten States	December 31	
	2006	2005
Florida	9.2%	9.5%
California	7.8	9.4
Texas	6.5	6.1
New York	5.1	5.6
Ohio	4.9	4.2
Georgia	4.8	4.8
Illinois	4.4	4.5

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Michigan	3.8	3.5
Pennsylvania	3.5	3.3
New Jersey	3.4	3.4
Total	53.4%	54.3%

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	December 31	
	2006	2005
<b>Top Fifteen MSAs</b>		
Atlanta, GA	3.5%	3.4%
Chicago, IL	3.2	3.6
New York, NY	2.5	2.1
Phoenix/Mesa, AZ	2.1	2.5
Houston, TX	2.0	1.7
Minneapolis-St. Paul, MN WI	1.6	1.6
Riverside San Bernardino, CA	1.5	1.7
Los Angeles Long Beach, CA	1.4	1.9
Tampa St. Petersburg Clearwater, FL	1.4	1.4
Miami Hialeah, FL	1.3	1.6
Dallas, TX	1.3	1.3
Nassau/Suffolk, NY	1.3	1.5
Washington, DC MD VA	1.3	1.8
Philadelphia, PA	1.3	1.8
Denver, CO	1.2	1.3
Total	26.9%	29.2%

The following table shows the percentage of our international mortgage insurance risk in force by location of property as of December 31, 2006 and 2005:

	December 31	
	2006	2005
<b>International</b>		
Germany	47.9%	50.1%
Denmark	45.9	43.9
Hong Kong	4.0	3.5
Netherlands	1.4	1.3
Australia	0.6	0.4
United Kingdom	0.2	0.8
Total	100.0%	100.0%

### 3. *Lender and Mortgage Characteristics (Risk in Force/Net Par Outstanding Mortgage Insurance)*

Although geographic dispersion is an important component of our overall risk diversification our strategy has been to limit our exposure in the top 10 states and top 15 MSAs we believe the quality of the risk in force should be considered in conjunction with other elements of risk diversification such as product distribution and our risk management and underwriting practices.

One of the most important indicators of claim incidence is the relative amount of a borrower's equity or down payment that exists in a home. Generally, loans with higher LTVs are more likely to result in a claim than lower LTV loans. For example, claim incidence on mortgages with LTVs between 90.01% and 95% ( 95s ) is significantly higher than the expected claim incidence on mortgages with LTVs between 85.01% and 90% ( 90s ). We, along with the rest of the industry, have been insuring loans with LTVs between 95.01% and 97% ( 97s ) since 1995 and loans with an LTV of between 97.01% and 100% ( 100s ) since 2000. These loans are expected to have a higher claim incidence than 95s. We also insure an insignificant amount of loans having an LTV over 100%. We charge a premium for higher LTV loans in an amount that we believe is commensurate with the additional risk and the higher expected frequency and severity of claims.

We believe that the risk of claim on non-prime loans is significantly higher than that on prime loans. Although higher premium rates and surcharges are charged to compensate for the additional risk, non-prime

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products have not been fully tested in adverse economic situations, so we cannot be certain that the premium rates we charge are adequate or that the loss performance will be at, or close to, expected levels. Our claim frequency on insured Adjustable-Rate Mortgages ( ARMs ) has been higher than on fixed-rate loans due to monthly payment increases that occur when interest rates rise. We consider a loan an ARM if the interest rate for that loan will reset at any point during the life of the loan. It has been our experience that loans subject to reset five years or later from origination are less likely to result in a claim than shorter term ARMs, and our premium rates for these longer term reset loans are lower to reflect the lower risk.

In addition, we insure interest-only mortgages, where the borrower pays only the interest charge on a mortgage for a specified period of time, usually five to ten years, after which the loan payment increases to include principal payments. These loans may have a heightened propensity to default because of possible payment shocks after the initial low-payment period expires and because the borrower does not automatically build equity as payments are made. As of December 31, 2006, interest-only mortgages represented approximately 5.8% of our primary mortgage insurance risk in force.

We also insure Option ARMs, a product that has become very popular in the mortgage market. Option ARMs offer a number of different monthly payment options to the borrower. One of these options is a minimum payment that is below the full amortizing payment, which results in principal being added to the loan balance and the loan balance continually increasing. This process is referred to as negative amortization. Additional premiums are charged for these Option ARMs as a result. As of December 31, 2006, Option ARMs represented approximately 4.2% of our primary mortgage insurance risk in force. As of December 31, 2006, approximately 1.0% of our primary mortgage insurance risk in force consists of loans for which interest rates are scheduled to reset during 2007, with most of the Option ARMs and interest-only loans that we insure having first time resets in 2009 or later.

The average size of loans that we insure has been increasing as we continue to insure a larger percentage of non-prime loans, in particular Alt-A loans, which tend to have larger loan balances relative to our other loans, and as a result of a general increase in the size of borrowings during a historically long period of significant home price appreciation. The increase in average loan size has resulted in a corresponding increase in the average size of loans in default, primarily and most significantly, with respect to Alt-A loans. At December 31, 2006, the average size of loans subject to our primary mortgage insurance was \$144,910, compared to \$139,172 at December 31, 2005.

We believe that 15-year mortgages are less risky than 30-year mortgages, mainly as a result of the faster amortization and the more rapid accumulation of borrower equity in the property. Premium rates for 15-year mortgages are lower to reflect the lower risk.

The risk of claim also is affected by the type of property securing the insured loan. Loans on single-family detached housing are less likely to result in a claim than loans on other types of properties. Conversely, we generally consider loans on attached housing types, particularly condominiums and cooperatives, to be a higher risk due to the higher density of these properties. Our more stringent underwriting guidelines on condominiums and cooperatives reflect this higher expected risk.

We believe that the risk of claim on loans to borrowers who are relocating and loans originated by credit unions is low, and we offer lower premium rates on these loans commensurate with the lower risk. We also believe that loans on non-owner-occupied homes purchased for investment purposes are more likely to result in a claim and are subject to greater value declines than loans on either primary or second homes. Accordingly, we underwrite loans on non-owner-occupied investment homes more stringently, and we charge a significantly higher premium rate than the rate charged for insuring loans on owner-occupied homes.

It has been our experience that higher-priced properties experience wider fluctuations in value than moderately priced residences and that the high incomes of many people who buy higher-priced homes are less stable than those of people with moderate incomes. Underwriting guidelines for these higher-priced properties reflect this concern.

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The following table shows the percentage of our direct primary mortgage insurance risk in force (as determined on the basis of information available on the date of mortgage origination) by the categories indicated as of December 31, 2006 and 2005:

	December 31	
	2006	2005
Product Type:		
Primary	89.4%	90.5%
Pool	10.6	9.5
Total	100.0%	100.0%
Direct Primary Risk in Force (dollars in millions)	\$ 25,311	\$ 25,729
Lender Concentration:		
Top 10 lenders (by original applicant)	45.6%	44.6%
Top 20 lenders (by original applicant)	59.6	56.7
LTV:		
95.01% to 100.00%	17.6%	14.0%
90.01% to 95.00%	31.6	33.5
85.01% to 90.00%	35.8	37.1
85.00% and below	15.0	15.4
Total	100.0%	100.0%
Loan Grade:		
Prime	71.9%	69.3%
Alt-A	16.7	17.5
A minus and below	11.4	13.2
Total	100.0%	100.0%
Loan Type:		
Fixed	72.5%	67.7%
ARM (fully indexed) (1)		
Less than 5 years	14.5	21.7
5 years and longer	8.8	8.6
ARM (potential negative amortization) (2)		
Less than 5 years	4.1	2.0
5 years and longer	0.1	
Total	100.0%	100.0%
FICO Score:		
<=619	10.5%	12.3%
620-679	31.7	32.3
680-739	34.2	33.3
>=740	23.6	22.1
Total	100.0%	100.0%
Mortgage Term:		
15 years and under	3.2%	3.2%
Over 15 years	96.8	96.8

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Total	100.0%	100.0%
<b>Property Type:</b>		
Non-condominium (principally single-family detached)	92.7%	93.1%
Condominium or cooperative	7.3	6.9
Total	100.0%	100.0%



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	December 31	
	2006	2005
Occupancy Status:		
Primary residence	92.4%	92.3%
Second home	3.5	3.1
Non-owner-occupied	4.1	4.6
Total	100.0%	100.0%
Mortgage Amount:		
Less than \$300,000	83.9%	85.3%
\$300,000 and over	16.1	14.7
Total	100.0%	100.0%
Loan Purpose:		
Purchase	66.7%	63.4%
Rate and term refinance	15.4	19.6
Cash-out refinance	17.9	17.0
Total	100.0%	100.0%

- (1) Fully Indexed refers to loans where payment adjustments are the same as mortgage interest-rate adjustments.
- (2) Loans with potential negative amortization will not have increasing principal balances unless interest rates increase as contrasted with scheduled negative amortization where an increase in loan balance will occur even if interest rates do not change.

**B. Financial Guaranty (Risk in Force/Net Par Outstanding)**

Our financial guaranty net par outstanding was \$104.0 billion as of December 31, 2006, compared to \$76.7 billion as of December 31, 2005. Although economic factors could affect the performance of the financial guaranty obligations that we insure, we generally consider our financial guaranty risk to be more remote, event-driven risk that is less susceptible to the direct effects of macroeconomic trends. The following table shows the distribution of our financial guaranty net par outstanding by type of issue and as a percentage of total financial guaranty net par outstanding as of December 31, 2006 and 2005:

Type of Obligation	Net Par Outstanding (1)			
	2006		2005	
	Amount	Percent	Amount	Percent
	(\$ in billions)			
Public finance:				
General obligation and other tax-supported	\$ 22.0	21.1%	\$ 19.7	25.7%
Healthcare and long-term care	11.7	11.2	10.0	13.0
Water/sewer/electric/gas and other investor-owned utilities	8.6	8.3	7.4	9.7
Airports/transportation	5.4	5.2	4.7	6.1
Education	4.1	3.9	3.5	4.6
Housing revenue	0.8	0.8	0.7	0.9
AAA Wrap Muni			0.4	0.5
Other municipal (2)	1.2	1.2	0.9	1.2
Total public finance	53.8	51.7	47.3	61.7
Structured finance:				
Collateralized debt obligations	44.0	42.3	22.7	29.6
Asset-backed obligations	3.5	3.4	4.9	6.4
Other structured	2.7	2.6	1.8	2.3

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Total structured finance	50.2	48.3	29.4	38.3
Total	\$ 104.0	100.0%	\$ 76.7	100.0%

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- (1) Represents our proportionate share of the aggregate outstanding principal on insured obligations.
- (2) Represents other types of municipal obligations, none of which individually constitutes a material amount of our financial guaranty net par outstanding.

The following table represents our 10 largest public finance single risks by net par outstanding as of December 31, 2006, along with the credit rating assigned as of that date (in the absence of financial guaranty insurance) to each issuer:

Credit	Credit Rating (1)	Obligation Type	Aggregate
			Net Par Outstanding as of December 31, 2006 (1) (In millions)
New York, NY	AA-	General Obligation	\$ 738
California	A+	General Obligation	611
Port Authority of New York & New Jersey	AA-	Transportation	551
Chicago, IL	AA	General Obligation	464
Washington, G.O	Aa1	General Obligation	371
Massachusetts, G.O	AA	General Obligation	364
New Jersey Economic Development Authority School Facilities	AA-	General Obligation	314
New York City Municipal Water Finance, NY	AA+	General Obligation	313
Long Island Power Authority, NY	A-	Utilities	298
New Jersey Transportation Trust Fund Authority	AA-	Transportation	295

- (1) Indicated ratings reflects the highest rating assigned to the underlying obligation from the three major rating agencies (S&P, Moody's Investor Service (Moody's) and Fitch), or, if no such rating has been assigned, Radian's rating estimate of the obligation utilizing rating agency models and methodologies to the extent available. Radian's rating estimates are subject to revision at any time and may differ from the credit ratings ultimately assigned by the three rating agencies.

The following list of transactions represents our largest structured finance exposures as of December 31, 2006:

One \$600 million transaction representing a Static Synthetic Investment Grade Corporate CDO.

One \$519 million transaction representing a Managed Synthetic Investment Grade Asset-Backed CDO.

25 transactions (\$450 million each) representing Static Synthetic Investment Grade Corporate CDOs.

One \$450 million transaction representing a Second-to-Pay CDO.

One \$450 million transaction representing a Static Investment Grade Asset-Backed CDO.

The above transactions combined total \$13.3 billion, or 12.8% of financial guaranty's net par outstanding as of December 31, 2006. All of the above exposures on CDOs are aggregate exposures whose underlying assets consist of a pool of a large number of corporate names. Our exposure to any individual corporate credit in the pool is typically between \$20 and \$40 million (but may be as low as \$10 million per obligor or up to \$60 million per obligor in specific transactions), and our exposure is subject to significant subordination. Each of these transactions is rated AAA by S&P.



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The following table identifies our net par outstanding as of December 31, 2006 and 2005 by credit ratings:

Credit Rating (1)	As of December 31			
	2006		2005	
	Net Par	Net Par	Net Par	Net Par
	Outstanding	Percent (\$ in billions)	Outstanding	Percent
AAA	\$ 43.2	41.5%	\$ 22.6	29.5%
AA	19.4	18.7	16.4	21.4
A	20.2	19.4	19.3	25.2
BBB	18.3	17.6	15.9	20.7
BIG	1.4	1.4	1.5	1.9
Not rated	1.5	1.4	1.0	1.3
Total	\$ 104.0	100.0%	\$ 76.7	100.0%

The following table shows the distribution of our financial guaranty net par outstanding as of December 31, 2006 and 2005:

State	December 31	
	2006	2005
Domestic Public Finance by State:		
California	5.9%	6.8%
New York	4.9	6.3
Texas	4.0	4.7
Florida	3.1	3.5
Illinois	2.8	3.5
Pennsylvania	2.8	3.8
Massachusetts	2.2	2.8
New Jersey	2.2	2.6
Washington	1.7	2.0
Colorado	1.3	1.5
Other domestic public finance (1)	17.9	22.2
Total Domestic Public Finance	48.8%	59.7%
Domestic Structured Finance	35.8	32.1
International Public and Structured Finance	15.4	8.2
Total Public and Structured Finance	100.0%	100.0%

- (1) Represents all remaining states and the District of Columbia in which obligations insured and reinsured by our financial guaranty business arise, none of which individually constitutes greater than 1.3% and 1.5% of our financial guaranty net par outstanding as of December 31, 2006 or 2005, respectively.

For each of the years ended December 31, 2006, 2005 and 2004, financial guaranty premiums written attributable to foreign countries were approximately 2.1%, 4.2%, and 6.2% of total premiums written and 9.0%, 20.6% (16.5% excluding the 2005 recapture) and 31.1% (21.5% excluding the 2004 recapture) of total financial guaranty premiums written. The decrease from 2004 largely reflects our decision to exit the trade credit reinsurance line of business.

### III. Defaults and Claims

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We establish reserves to provide for losses and the estimated costs of settling claims in both our mortgage insurance and financial guaranty businesses. Setting loss reserves in both businesses involves significant use of

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estimates with regard to the likelihood, magnitude and timing of a loss. We have determined that the establishment of loss reserves in our businesses constitutes a critical accounting policy. Accordingly, a detailed description of our policies is contained in Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Reserve for Losses included in Item 7 below and in Notes 2 and 6 of Notes to Consolidated Financial Statements.

**A. Mortgage Insurance (Defaults and Claims)**

The default and claim cycle in our mortgage insurance business begins with our receipt of a default notice from the insured lender. A default is defined under our master policy as a borrower's failure to make a payment equal to or greater than one monthly regular payment under a loan. Generally, our master policy of insurance requires the insured to notify us of a default within 15 days of (1) the loan's having been in default for three months or (2) the occurrence of an early default in which the borrower fails to make any one of the initial twelve monthly payments under a loan so that an amount equal to two monthly payments has not been paid. For reporting and internal tracking purposes, we do not consider a loan to be in default until the loan has been in default for 60 days.

Defaults can occur due to a variety of factors, including death or illness, unemployment, inability to manage credit or other events reducing the borrower's income, such as divorce or other marital problems. Depending on the type of loan, defaults also may be caused by rising interest rates.

The following table shows the number of primary and pool loans that we have insured, related loans in default and the percentage of loans in default as of the dates indicated:

	2006	December 31 2005	2004
<b>Primary Insurance:</b>			
<u>Prime</u>			
Number of insured loans in force	563,144	567,574	610,480
Number of loans in default (1)	18,441	20,685	19,434
Percentage of loans in default	3.3%	3.6%	3.2%
<u>Alt-A</u>			
Number of insured loans in force	133,633	118,336	128,010
Number of loans in default (1)	7,995	7,510	8,339
Percentage of loans in default	6.0%	6.3%	6.5%
<u>A Minus and below</u>			
Number of insured loans in force	89,037	101,414	104,672
Number of loans in default (1)	16,264	16,015	12,678
Percentage of loans in default	18.3%	15.8%	12.1%
<u>Total Primary Insurance</u>			
Number of insured loans in force	785,814	787,324	843,162
Number of loans in default (1)	42,700	44,210	40,451
Percentage of loans in default	5.4%	5.6%	4.8%
<b>Pool Insurance:</b>			
Number of loans in default (1)	18,681(2)	10,194(2)	6,749

(1) Loans in default exclude loans that are 60 or fewer days past due, in each case as of December 31 of each year.

(2) Includes approximately 13,309 and 3,699 defaults at December 31, 2006 and 2005, respectively, where reserves have not been established because no claim payment is currently anticipated.

The default rate in our mortgage insurance business is subject to seasonality. Historically, our mortgage insurance business experiences a fourth quarter seasonal increase in defaults as a result of higher defaults reported during the winter months.

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Regions of the United States may experience different default rates due to varying economic conditions. The following table shows the primary mortgage insurance default rates by our defined regions as of the dates indicated, including prime and non-prime loans:

	December 31		
	2006	2005	2004
East North Central	7.72%	7.32%	6.59%
New England	6.65	5.12	4.01
East South Central	5.82	7.11	4.88
Mid-Atlantic	5.75	5.72	5.34
West South Central	5.68	7.96	5.13
West North Central	5.53	5.25	4.47
South-Atlantic	5.11	5.45	5.12
Mountain	3.27	3.34	3.77
Pacific	2.81	2.37	2.55

As of December 31, 2006, the two states with the highest primary mortgage insurance default rates were Michigan and Massachusetts, at 10.3% and 8.3%, respectively. Since August 29, 2005, the date that Hurricane Katrina first struck and caused extensive property damage to the U.S. Gulf Coast, we have paid approximately \$16.2 million in claims on mortgage insurance written in areas damaged by Hurricanes Katrina and Rita (as designated by Freddie Mac, the designated areas) as of December 31, 2006, including approximately \$12.7 million for claims received after August 29, 2005.

While we experienced an increase in defaults in mortgage insurance in designated areas in the months following the hurricanes, defaults have been steadily decreasing since then approximately 3,613 defaults remain outstanding as of December 31, 2006, which is down from 6,208 defaults as of December 31, 2005. We remain uncertain as to how many claims we ultimately may have to pay on these defaults. There are many factors that are contributing to the uncertainty surrounding these defaults. The organizations servicing these loans have reported defaults, in some cases, despite the existence of forbearance agreements that permit homeowners to defer mortgage payments on these loans. Limitations also exist in our master policy of insurance that could prevent us from paying all or part of a claim. For example, we are permitted to adjust a claim where the property underlying a mortgage in default is subject to unrestored physical damage.

Mortgage insurance claim volume is influenced by the circumstances surrounding the default. The rate at which defaults cure, and therefore do not go to claim, depends in large part on a borrower's financial resources and circumstances, local housing prices and housing supply (borrowers may cure defaults by selling the property in full satisfaction of all amounts due under the mortgage), interest rates and regional economic conditions. In our first-lien mortgage insurance business, the insured lender is required to complete foreclosure proceedings and obtain title to the property before submitting a claim. It can take anywhere from three months to five years for a lender to acquire title to a property through foreclosure, depending on the state. On average, we are not required to pay a claim until 12 to 18 months following a default on a first-lien mortgage. In our second-lien business, we may be required to pay a claim much earlier, within approximately 150 days of a default.

Claim volume in our mortgage insurance business is not evenly spread throughout the coverage period of our book of business. Historically, most claims under mortgage insurance policies on prime loans occur during the third through fifth year after issuance of the policies, and on non-prime loans during the second through fourth year after issuance of the policies. After those peak years, the number of claims that we receive historically has declined at a gradual rate, although the rate of decline can be affected by macroeconomic factors. Approximately 67.1% of our primary risk in force, including most of our risk in force on non-traditional products, and approximately 41.2% of our pool risk in force at December 31, 2006 had not yet reached its anticipated highest claim frequency years. Because it is difficult to predict both the timing of originating new business and the run-off rate of existing business, it also is difficult to predict, at any given time, the percentage of risk in force that will reach its highest claim frequency years on any future date.



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In addition to claim volume, another significant factor affecting losses is claim severity. The severity of a claim is determined by dividing the claim paid by the original loan amount. The main determinants of the severity of a claim are the size of the loan, the amount of mortgage insurance coverage placed on the loan, and the impact of our loss management activities with respect to the loan. Pre-foreclosure sales, acquisitions and other early workout efforts help to reduce overall claim severity. The average claim severity for loans covered by our primary insurance was 26.4% for 2006, as compared to 25.2% in 2005 and 24.5% in 2004.

The following table shows claims paid information for primary mortgage insurance for the periods indicated:

	<b>Year Ended December 31</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>	
<b>Direct claims paid:</b>		
Prime	\$ 117,471	\$ 121,297
Alt-A	64,018	79,371
A minus and below	93,662	85,980
Seconds	38,204	33,699
<b>Total</b>	<b>\$ 313,355</b>	<b>\$ 320,347</b>
<b>States with highest claims paid:</b>		
Ohio	\$ 30,147	\$ 26,728
Texas	30,130	33,312
Michigan	29,567	22,326
Georgia	26,032	28,548
Colorado	18,382	20,889
<b>Average claim paid:</b>		
Prime	\$ 26.1	\$ 24.1
Alt-A	35.6	36.5
A minus and below	28.3	27.0
Seconds	26.8	22.0
<b>Total</b>	<b>\$ 28.4</b>	<b>\$ 26.9</b>

A much higher level of claims exist in the auto states of Ohio, Michigan and Indiana, as problems with the domestic auto industry and related industries depress economic growth, employment and house prices in these states.

A higher level of claims in Texas resulted, in part, from unemployment levels that were higher than the national average and lower home price appreciation. We believe that claims in the Midwest and Southeast have been rising (and will continue to rise) due to the weak industrial sector of the economy. We also believe that increased claims in Michigan and North Carolina are a result of declining economic conditions in those areas and that in Colorado, increased claims are a result of a significant decline in property values in that area.

A higher incidence of claims in Georgia is directly related to what our risk management department believes to be questionable property values. Several years ago, our risk management department implemented several property valuation checks and balances to mitigate the risk of this issue recurring, and now applies these same techniques to all mortgage insurance transactions. We expect this higher incidence of claims in Georgia to continue until loans originated in Georgia before the implementation of these preventive measures become sufficiently seasoned.

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### **B. Financial Guaranty (*Defaults and Claims*)**

In the event of default, payments under a typical financial guaranty insurance policy that we provide or reinsure may not be accelerated without our or the primary insurer's approval, and without such approval, the policyholder is entitled to receive payments of principal and interest on their regularly scheduled dates as if no default had occurred. The insurer often has remedies against other parties to the transaction, which may be exercised both before and after making payment, if any payment is necessary.

In our direct financial guaranty business, and with respect to some of the mortgage-backed securities insured by our mortgage insurance business, we typically are obligated to pay claims in an amount equal to defaulted payments on insured obligations on their respective due dates. In certain transactions in which we insure mortgage-backed securities, we also are obligated to pay principal when and if due, but only to the extent the outstanding principal balance of the insured obligation exceeds the value of the collateral insuring the bonds at the end of a reporting period (either monthly or quarterly).

In our financial guaranty reinsurance line of business, net claim payments due to the ceding companies are typically deducted from premium amounts due to us. For public finance, asset-backed and other structured products insured by our financial guaranty business, we underwrite to a remote-expected loss standard, which means that under historical economic and operating environments, the assets providing the cash flow to pay the obligations insured by us should perform within the range anticipated at origination and should mature without our having to pay any claims. However, in a stressed or unexpectedly negative economic and operating environment, losses may occur. Accordingly, the patterns of claim payments tend to fluctuate and may be low in frequency and high in severity.

## **IV. Loss Management**

### **A. Mortgage Insurance (*Loss Management*)**

In 2006, we added significant resources to our mortgage insurance loss management team in order to better manage losses in an uncertain housing market. Loss management consists of approximately 55 full-time employees dedicated to avoiding or minimizing losses. These experienced specialists pursue opportunities to mitigate losses both before and after claims are received.

In our traditional mortgage insurance business, upon receipt of a valid claim, we generally have the following three settlement options:

- (1) Pay the maximum liability determined by multiplying the claim amount by the applicable coverage percentage and allow the insured lender to keep title to the property;
- (2) Pay the amount of the claim required to make the lender whole, commonly referred to as the deficiency amount (not to exceed our maximum liability) following an approved sale; or
- (3) Pay the full claim amount and acquire title to the property.

In general, we base our selection of a settlement option on the value of the property. In 2006, we settled 82% of claims by paying the maximum liability (compared to 77% of claims in 2005), 17% by paying the deficiency amount following an approved sale (compared to 22% of claims in 2005) and less than 1% by paying the full claim amount and acquiring title to the property (which was the same in 2005). Flat or declining property values in some regions of the United States during 2006 have made our loss management efforts more challenging. Should property values continue to remain flat or further decline, our ability to mitigate losses would be adversely affected, which would have an adverse effect on our business, financial condition and operating results.

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For pre-claim default situations, our specialists focus on the following activities to reduce losses:

Communication with the insured or the insured's servicer to ensure the timely and accurate reporting of default information;

Prompt and appropriate responses to all loss mitigation opportunities presented by the mortgage servicer; and

Proactive communication with the borrower, realtor or other individuals involved in the loss mitigation process to maximize results and to increase the likelihood of a completed loss mitigation transaction.

After a claim is received and/or paid our specialists focus on:

A review to ensure that program compliance and our master policy requirements have been met;

Analysis and prompt processing to ensure that valid claims are paid in an accurate and timely manner;

Responses to real estate owned (REO) loss mitigation opportunities presented by the insured;

Aggressive management and disposal of acquired real estate; and

Post-claim payment activities to maximize recoveries on various products including, when appropriate, the pursuit of deficiencies through subrogation and/or acquired rights.

Our Special Investigations Unit is responsible for identifying and investigating insured loans involving non-compliance with the terms of our master policy of insurance (or commitment letter for structured transactions) to ensure that claims are ultimately paid for, as agreed, upon valid and insurable risks. Much of our efforts involve the identification, investigation and reporting of mortgage fraud schemes that impact us. We coordinate our activities with legal counsel, law enforcement and fraud prevention organizations, and work to promote mortgage fraud awareness, detection and prevention among our personnel and client lenders.

### **B. Financial Guaranty (*Loss Management*)**

In our financial guaranty business, our surveillance risk management department is responsible for monitoring credit quality or changes in the economic or political environment that could affect the timely payment of debt service on an insured transaction and mitigating losses should they occur. Our surveillance procedures include periodic review of all exposures, focusing principally on those exposures with which we have concerns. The specific procedures vary depending on whether the risk is public finance or structured finance, funded or synthetic, or direct or reinsurance, but the general procedures we follow for surveillance of risks include:

defining the scope and depth of individual transaction review based on the credit profile of the transaction, its size and the specific transaction characteristics;

review of any changes to the ratings for those transactions that have been assigned a public rating by any of the major rating agencies;

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regular review of available news and other information, including subscription services and public sources, regarding the issuer, the specific insured transaction or the related industry;

periodic internal meetings between risk management and the staff of the relevant business line to discuss potential issues related to the applicable risks;

review of financial and other information, including periodic audited financial statements, that we require the relevant issuer to supply, and such other information that becomes publicly or otherwise available regarding the issuer or the specific insured transaction;

the preparation of written reports that provide an internal credit scoring and a report on transaction performance against expectation. We also review compliance with transaction-specific covenants;

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classification of credits as intensified surveillance credits when we determine that continued performance is questionable and, in the absence of a positive change, may result in a claim. A summary of our exposures to credits classified as intensified surveillance credits at December 31, 2006 and 2005 is included below in Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Financial Guaranty Year Ended December 31, 2006 Compared to Year Ended December 31, 2005 Provision for Losses; and

additional scrutiny of transactions over a specified amount or for which a covenant or compliance breach has occurred, including consideration of additional monitoring, discussion with industry experts, investment bankers, and others, and discussions with management and/or site visits.

In our financial guaranty reinsurance business, the primary obligation for the determination and mitigation of claims rests with the primary insurer. As a result, we rely on the primary insurers for loss determination and mitigation. We and the rating agencies conduct extensive reviews of the ceding companies and their procedures for determining and mitigating losses. Moreover, to help align the ceding company's interests with our interests, the ceding company typically is required to retain at least 25% of the exposure on any single risk that we reinsure. As a part of its surveillance for reinsurance transactions, our financial guaranty business periodically re-evaluates the risk underwriting and management of treaty customers and monitors the reinsured portfolio's performance.

As soon as our risk management department detects a problem, it works with the appropriate parties in an attempt to avoid a default. Loss mitigation can consist of restructuring the obligation, enforcing available security arrangements, working with the issuer to solve management or potential political problems and, if appropriate, exercising applicable rights to replace problem parties. Issuers typically are under no obligation to restructure insured transactions to prevent losses, but often do not want to be associated with an obligation that experiences losses. When appropriate, we discuss potential settlement options, either at our behest or that of our counterparties, regarding particular obligations with appropriate parties. On occasion, loss mitigation may include an early termination of our obligations, which could result in payments to or from us. To determine the appropriate loss mitigation approach, we generally consider various factors relevant to such insured transaction, which may include the current and projected performance of the underlying obligation (both on an expected case basis and stressed for more adverse performance and/or market circumstances that we expect), the likelihood that we will pay a claim in light of credit deterioration and reductions in available payment reserves and existing subordination, our total exposure to the obligation, expected future premium payments and the cost to us of pursuing such remedies.

## **V. Risk Management**

We consider effective risk management to be critical to our long-term financial stability. As such, we continuously enhance and integrate the risk management function across our business lines. In 2005, we created the executive position of Chief Risk Officer to enhance our corporate-wide credit processes, to further integrate our credit culture and to establish a single credit risk platform for analysis and valuation. The Chief Risk Officer is responsible for formulating corporate-wide credit policy, maintaining the economic capital methodology, assessing risk analytics and model integrity, maintaining underwriting standards, establishing and monitoring risk limits, and insuring adequate supporting technological and human resources are in place. The respective heads of risk management in the mortgage insurance and financial guaranty businesses report directly to the Chief Risk Officer.

We have implemented a credit committee structure applicable to both our mortgage insurance and financial guaranty businesses. Overseeing this credit committee structure is the Enterprise Risk Committee (the ERC), consisting of members of company-wide senior management. The ERC oversees individual credit committees organized by product line. These product-line committees include representatives of the product line, along with members of our credit policy, finance and legal departments. We believe that this credit committee structure enables us to more fully and consistently utilize the intelligence, knowledge, experience and skills available

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throughout our company to evaluate the risk in each of our subsidiary's insurance in force and in proposed transactions. The credit committee structure also ensures that each transaction is approved by an appropriate group of individuals throughout the company and that no one individual or group of individuals from a single business line or department may commit the company to insure material or extraordinary items.

A committee of independent directors assists our full board of directors to execute its oversight responsibilities as it relates to our credit risk management policies and procedures, including heightening board-level awareness of the impact of developing risk trends on our portfolio and plans. The Chief Risk Officer provides the committee with a quarterly review of all aspects of our credit risk, including notable transactions and a quarterly assessment of the state of our risk management function.

In order to evaluate and review credit risk across the company, we have developed an internal economic capital methodology which allows us to attribute economic capital to each individual credit exposure within our portfolio. Economic capital provides us with a uniform risk measure for analyzing and valuing risk that is consistent across the mortgage insurance and financial guaranty businesses. The ability to measure risk in the same units allows us to set company-wide position limits for our portfolio that take into account both differences in loss probabilities for each credit and also for the correlation in loss probabilities across a portfolio of credit exposures. Economic capital is also the basis for calculating risk-adjusted returns on our capital (RAROC), which allows us to establish criteria for weighing the credit risk relative to the premium received.

Our economic capital methodology relies heavily on our ability to quantify the underlying risks of default and prepayment. We have established a Model Review and Advisory Committee to address the performance of our models. This company-wide committee is made up of representatives of our quantitative modeling groups in each business line with the chairperson reporting directly to the Chief Risk Officer. The results of the committee's model reviews are reported to and approved by the ERC.

In addition to credit risk, we evaluate our risk by reviewing market risk, currency risk, interest-rate risk, operational risk and legal risk across all of our businesses on a regular basis.

### **A. Mortgage Insurance (*Risk Management*)**

Our mortgage insurance business has a comprehensive risk management function that includes individual risk managers aligned with our business channels as well as three distinct functions—Portfolio Management, Mortgage Risk Policy and Portfolio Quality Assurance—that operate across all mortgage insurance business channels. The Mortgage Insurance Risk Management group is focused on mortgage collateral and is responsible for overall credit policy creation and monitoring of compliance, portfolio management, limit setting and reporting, quantitative model creation and maintenance, comprehensive analytics and communication of credit related issues to management and our board of directors. This group reports directly to the Chief Risk Officer.

Risk tolerance policies are established by our Mortgage Risk Policy group to allow each of the mortgage business channels to operate within a predetermined set of acceptable risk parameters. Compliance with these policies is enforced in two ways: first, risk functions within each of the business channels report directly to our risk management group, with indirect reporting to each business channel manager; and second, by direct monitoring and enforcement by our Portfolio Quality Assurance department. Our Portfolio Management and Portfolio Analytics departments provide further surveillance at the portfolio level and coordinate with the business channels, which provide surveillance at the lender and loan level.

#### **1. Portfolio Management and Mortgage Risk Policy (*Risk Management Mortgage Insurance*)**

Portfolio Management oversees the allocation of economic capital within the mortgage insurance and mortgage related financial guaranty business. This group establishes the portfolio limits for product type, loan attributes, geographic concentration and counterparties and also is responsible for distribution of risk using risk transfer mechanisms such as captive reinsurance or the Smart Home arrangements discussed below under Reinsurance Ceded.

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Mortgage Risk Policy is responsible for establishing and maintaining all mortgage related credit risk policy around risk acceptance governance, counterparty, portfolio, operational and structured risks secured by or involving mortgage collateral. Mortgage Risk Policy also is responsible for establishing insurable risk guidelines for product types and loan attributes.

**Portfolio Management Risk Analytics.** Risk Analytics is responsible for all modeling functions in the mortgage insurance business. Risk Analytics estimates, implements and controls our proprietary Prophet Models® used in pricing our flow rate cards and structured transactions. Our proprietary Prophet Models® jointly estimate default and prepayment risk on all of our major product lines. Risk Analytics also reviews and approves all third party models used to approve loans for delegated mortgage insurance. Risk Analytics is also responsible for the economic capital model and RAROC pricing tools, builds and updates the reserve model for the mortgage insurance portfolio and oversees economic research.

**Portfolio Management Portfolio Analytics.** Portfolio Analytics is responsible for analyzing risk in our mortgage portfolio and performing a data and systems management function for the mortgage insurance business. Portfolio analysis involves analyzing risks to the portfolio from the market (e.g., the effects of changes in housing prices and interest rate movements) and analyzing risks from particular lenders, products, and geographic locales.

## **2. Business Channel Risk Management (Risk Management Mortgage Insurance)**

The risk management department has business channel risk managers assigned to each of the mortgage business channels. These channels, which are discussed in more detail below in this Item 1 under Sales and Marketing Mortgage Insurance are Capital Markets, Lender Solutions and International Mortgage. Responsibilities include counterparty and transaction assessment and portfolio management. Business channel risk managers ensure that appropriate due diligence is performed and that any transactions presented to the credit committees for approval include an accurate representation of the risks involved.

**Risk Management Capital Markets.** The Capital Markets function of risk management establishes risk tolerance levels for the Capital Markets business channel and manages both underwriting and the risk profile of the portfolio to established policy and limits, including managing the approval process for any exceptions to policy. The Capital Markets function oversees the allocation of economic capital within the channel and is responsible for surveillance of our non-traditional mortgage insurance portfolio. Further responsibilities in surveillance are the mark-to-market of derivative risk and ongoing assessment of variances in performance for possible changes to underwriting policy. Transactions generated by the business channel that are outside of pre-set delegated parameters or are non-traditional mortgage insurance structures are subject to credit committee approval, and also may require the approval of the ERC.

**Risk Management Lender Solutions.** The Lender Solutions function of risk management establishes and maintains risk tolerance levels for the Lender Solutions business channel. This includes counterparty management, underwriting and exception management, as well as managing the risk profile of the traditional mortgage insurance portfolio to established policy and limits. The Lender Solutions function works closely with our field sales team and our service centers to understand, provide solutions for and mitigate market risks. Lender Solutions also oversees the allocation of economic capital within this business channel and performs an ongoing assessment of performance variances for possible changes to underwriting policy.

**Risk Management International Mortgage.** The International Mortgage function of risk management establishes and maintains risk tolerance levels and manages underwriting for the International Mortgage Group. This includes setting insurable risk parameters, counterparty management, exception management and managing the risk profile of our international mortgage portfolio to established policy and limits. In order to better manage local risks, country risk managers are imbedded in the business where significant international mortgage risk exposure exists. Currently, mortgage risk managers are located in the United Kingdom and Australia. These risk

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managers report into the home office based mortgage risk management group. All international mortgage transactions require credit committee approval, and also may require the approval of the ERC.

### ***3. Portfolio Quality Assurance (Risk Management Mortgage Insurance)***

Portfolio Quality Assurance ( PQA ) is responsible for ensuring that credit and related risks that impact the quality of our portfolio of insured loans, the quality of loans underwritten by us or our delegated lenders and the quality of critical data used within our business are assessed, investigated and communicated so that management can make informed decisions about loss prevention, risk mitigation, and appropriate corrective action.

PQA is responsible for ensuring that our underwriting procedures and guidelines (as well as those of lenders and the GSEs) are followed by service center, contract underwriting and corporate operational support personnel through a loan re-underwriting and auditing program. PQA also conducts risk-based reviews of our delegated underwriting business. The results of our reviews are used to improve the quality of the business the lender submits to us for insurance. Issues that are raised in our reports and not resolved within a time period acceptable to us could result in restriction or termination of the lender's delegated underwriting authority.

PQA also is responsible for executing a program of risk-based monitoring to evaluate the level of business channel and operational compliance with critical credit policies established by Mortgage Risk Policy, ensuring enforcement of credit policy and accountability on the part of the business and providing feedback to risk management for continual review and improvement of existing policies.

Recognizing that timely and accurate data are critical to the management of the mortgage insurance business, PQA also includes an information quality assurance function that identifies and recommends solutions for any significant credit-related information that does not meet internal or external customer's expectations for accuracy, consistency, completeness, ease of use, or availability. System or data corrections, development of policies or procedures, standardization of business measures, training in the proper use of data, and the creation of tools to accurately communicate and report information are examples of the corrective actions taken as a result of our information quality efforts.

### ***4. Due Diligence on Structured Transactions (Risk Management Mortgage Insurance)***

We believe that understanding our business partners and customers is a key component of managing the risks posed by potential business transactions. Due diligence is performed by the business channels under policies issued by our Mortgage Risk Policy group. These due diligence reviews are precipitated either by a desire to develop an ongoing relationship with selected lenders, or by the submission of a proposed transaction by a given lender. Due diligence can take two forms: business-level and loan-level.

Our objective in business-level due diligence is to understand the lender's business model in sufficient depth to assess whether the lender would be a viable long-term business partner and customer. Business-level due diligence may be performed on any prospective lender with whom a structured deal is contemplated and with whom we have had no recent business experience.

Loan-level due diligence is conducted on structured transactions (1) to determine whether appropriate underwriting guidelines have been adhered to and whether loans conform to our guidelines, (2) to evaluate data integrity and (3) to detect any fraudulent loans. The results of loan-level due diligence assist our mortgage insurance business in determining whether pending transactions should be consummated and, in the event it is consummated, to provide data that can be used to determine appropriate pricing. The results also provide the mortgage insurance business with a database of information on the quality of a particular lender's underwriting practices for future reference. Automated tools such as fraud detection models and collateral valuation models are often used in this process.



**Table of Contents****5. Reinsurance Ceded (Risk Management Mortgage Insurance)**

Radian Guaranty currently uses reinsurance from affiliated companies to remain in compliance with the insurance regulations of states that require that a mortgage insurer limit its coverage percentage of any single risk to 25%. These transactions have no impact on our Consolidated Financial Statements.

Radian Guaranty and Amerin Guaranty are parties to a cross guaranty agreement. This agreement provides that if either party fails to make a payment to any of its policyholders, then the other party will step in and make the payment. The obligations of both parties under the agreement are unconditional and irrevocable; however, no payments will be made without prior approval by the insurance department of the payor's state of domicile.

In 2004, we developed an approach for reinsuring our non-prime risk. The arrangement, which we refer to as Smart Home, effectively transfers risk from our portfolio to investors in the capital markets. Each transaction begins with the formation of an unaffiliated, offshore reinsurance company. We then enter into an agreement with the Smart Home reinsurer pursuant to which we agree to cede to the reinsurer a portion of the risk (and premium) associated with a portfolio of loans, consisting mostly of non-prime residential mortgages, insured by us. The Smart Home reinsurer is funded in the capital markets through the issuance to investors of a series of separate classes of credit-linked notes. Each class relates to the loss coverage levels on the reinsured portfolio and is assigned a rating by one or more of the three major rating agencies. We typically retain the risk associated with the first-loss coverage levels, and we may retain or sell, in a separate risk transfer agreement, the risk associated with the AAA rated or most remote coverage level. Holders of the Smart Home credit-linked notes bear the risk of loss from losses that would be paid to us under the reinsurance agreement. The Smart Home reinsurer invests the proceeds of the notes in high-quality short-term investments approved by the rating agencies. Income earned on those investments and a portion of the reinsurance premiums that we pay are applied to pay interest on the notes as well as certain of the Smart Home reinsurer's expenses. The rate of principal amortization of the credit-linked notes approximates the rate of principal amortization of the underlying mortgages.

Since August 2004, we have completed four Smart Home arrangements. Details of these transactions (aggregated) as of the initial closing of each transaction and as of December 31, 2006 are as follows:

	As of	
	Initial	December 31, 2006
	(In thousands)	
Pool of mortgages (par value)	\$ 14.7 billion	\$ 10.1 billion
Risk in force (par value)	\$ 3.9 billion	\$ 2.6 billion
Notes sold to investors/risk ceded (principal amount)	\$ 718.6 million	\$ 653.0 million

Smart Home protects us against adverse loss development as we continue to take on higher risk, concentrated positions and unproven products. As a result, we consider Smart Home arrangements to be important to our ability to effectively manage our risk profile, especially in the non-prime market. At December 31, 2006, approximately 10.1% of our primary risk in force was included in Smart Home arrangements, compared to approximately 7.8% at December 31, 2005. In these transactions, we reinsured the middle layer risk positions, while retaining a significant portion of the total risk comprising the first-loss and most remote risk positions. Ceded premiums written and earned related to Smart Home for 2006 were \$12.0 million and \$12.3 million, respectively, compared to \$3.5 million and \$3.0 million, respectively, for 2005. There were no ceded losses in either 2006 or 2005 as a result of the Smart Home transactions.

We and other companies in the mortgage insurance industry also participate in reinsurance arrangements with mortgage lenders commonly referred to as captive reinsurance arrangements. See Mortgage Insurance Business Captive Reinsurance in this Item 1.

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### **B. Financial Guaranty (*Risk Management*)**

We consider effective risk management to be critical to our long-term financial stability and employ a comprehensive risk system. This incorporates the integration of company-wide risk management policies and processes as well as best practices of the financial guaranty industry. All transactions are subject to a thorough underwriting analysis, a comprehensive risk committee decision process, and if a transaction is booked, surveillance by an independent department.

Transaction underwriting includes the analysis of all credit and legal aspects as well as any specific risks that may be inherent in the transaction. Further, the financial guaranty business utilizes our proprietary internal economic capital model for risk analysis, valuation and as the basis for calculating RAROC. All transactions are subject to a credit committee decision process embedded in the business and governed by the ERC. Following documented protocols and voting rules, a transaction must be approved in order to qualify for financial guaranty insurance. For transactions that are approved and booked, responsibility transfers to the surveillance department for monitoring, review, feed back to underwriting and risk mitigation.

#### **1. Underwriting (*Risk Management Financial Guaranty*)**

Our financial guaranty underwriting discipline incorporates a multi-discipline underwriting process for both direct transactions and reinsurance transactions.

*Direct Transactions.* Direct transactions are sourced and screened by the financial guaranty business based upon established criteria and profitability requirements. Transactions that qualify for further analysis are subject to an underwriting process to determine the creditworthiness of the obligor. The underwriting analysis is performed at a transaction level, examining the fundamental ability and willingness of the obligor and/or issuer to meet the specified obligation. This analysis includes all aspects of the obligation ranging from the fundamental financial strength of the obligor to the structure of the transaction, which may dictate the payment structure. All transaction analysis is also subject to legal requirements.

*Reinsurance Transactions.* The same disciplined approach and risk requirements are applied to our reinsurance transactions. As part of our ongoing business, the financial guaranty business assumes transactions from approved reinsurance companies on a treaty or facultative basis. The primary insurance company is subject to a review by us that involves an examination of its operating, underwriting and surveillance procedures, personnel, organization and existing book of business. Additionally, our long-standing relationships with these select companies provide for experience-based analysis and information.

#### **2. Surveillance (*Risk Management Financial Guaranty*)**

Financial guaranty also has a surveillance risk management department that is dedicated to the surveillance of our book of business. See *Loss Management Financial Guaranty* in this Item 1 for information regarding this department.

## **VI. Customers**

### **A. Mortgage Insurance (*Customers*)**

The principal customers of our mortgage insurance business are mortgage originators such as mortgage bankers, mortgage brokers, commercial banks and savings institutions. This is the case even though individual mortgage borrowers generally incur the cost of primary mortgage insurance coverage. We also offer lender-paid mortgage insurance, in which the mortgage lender or loan servicer pays the mortgage insurance premiums. The cost of the mortgage insurance is then passed on to the borrower in the form of higher interest rates. In 2006, approximately 63% of our mortgage insurance was originated on a lender-paid basis, compared to approximately 70% in 2005, much of which resulted from structured transactions. This lender-paid business is highly concentrated among a few large mortgage-lending customers.

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To obtain primary mortgage insurance from us, a mortgage lender must first apply for and receive a master policy. Our approval of a lender as a master policyholder is based, among other factors, on our evaluation of the lender's financial position and demonstrated adherence to sound loan origination practices. Our quality PQA function then monitors the master policyholder based on a number of criteria. See **Risk Management Mortgage Insurance Portfolio Quality Assurance** in this Item 1 for more information.

The number of individual primary mortgage insurance policies in force at December 31, 2006, was 785,814, compared to 787,324 at December 31, 2005, and 843,162 at December 31, 2004.

The top 10 mortgage insurance customers, measured by primary new insurance written, were responsible for 64.7% of our primary new insurance written in 2006, compared to 57.3% in 2005 and 46.7% in 2004. The largest single mortgage insurance customer (including branches and affiliates), measured by primary new insurance written, accounted for 18.6% of new insurance written during 2006, compared to 10.6% in 2005 and 9.6% in 2004. The top three mortgage insurance customers measured by pool new insurance written were responsible for 78.3% of our pool new insurance written for 2006, compared to 87.0% in 2005 and 95.8% in 2004. The largest single mortgage insurance customer (including branches and affiliates) measured by pool new insurance written accounted for 45.0% of pool new insurance written during 2006, compared to 42.6% in 2005 and 65.8% in 2004.

### **B. Financial Guaranty (Customers)**

Our direct financial guaranty insurance customers consist of many of the major global financial institutions that structure, underwrite or trade securities issued in public finance and structured finance obligations. These institutions typically are large commercial or investment banks that focus on high-quality deals in the public finance and structured finance markets.

As a reinsurer of financial guaranty obligations, our financial guaranty business has maintained close and long-standing relationships with most of the primary financial guaranty insurers. We believe that these long-term relationships provide us with a comprehensive understanding of the market and of the financial guaranty insurers' underwriting guidelines and reinsurance needs. Our financial guaranty reinsurance customers consist mainly of the largest primary insurance companies licensed to write financial guaranty insurance and their foreign-based affiliates, including Ambac Assurance Corporation (Ambac), Financial Security Assurance Inc. (FSAI) and Financial Guaranty Insurance Company (FGIC). In 2006, these three primary insurers accounted for \$91.3 million or 34.7% of the financial guaranty segment's gross written premiums. One of these primary insurers accounted for \$43.3 million or 19.3% of the financial guaranty segment's gross written premiums in 2005. Excluding the 2005 recapture, two primary insurers accounted for \$74.9 million or 26.8% of the financial guaranty segment's gross written premiums. No other primary insurer accounted for more than 10% of the financial guaranty segment's gross written premiums in either 2005 or 2006. The largest single customer of our financial guaranty business, measured by gross premiums written, accounted for 13.8% of gross premiums written during 2006, compared to 19.3% in 2005 (15.5% excluding the 2005 recapture) and 21.8% in 2004 (15.2% excluding the 2004 recapture).

## **VII. Sales and Marketing**

### **A. Mortgage Insurance (Sales and Marketing)**

In 2005, in an effort to more appropriately align our mortgage insurance business to meet the needs of a changing business environment resulting from lender consolidation, centralization, and a movement towards a more capital markets risk-based approach, we reorganized our sales and marketing efforts to focus on four separate channels of customers: Business Direct, Strategic Accounts, Capital Markets (which together represent our domestic mortgage insurance business) and International. In 2006, we further consolidated our domestic mortgage insurance business into two business channels: Lender Solutions, which focuses mainly on customers with traditional mortgage insurance needs, and Capital Markets, which focuses on customers that are likely to require our non-traditional product offerings and risk based solutions. Our international mortgage insurance operations continue to be conducted through a separate business channel: the International Mortgage Group.

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Each of our mortgage insurance channels has a business manager with profit and loss responsibility and accountability. In addition, each channel has adopted a specific and focused approach to sustaining profitable growth. There is a priority of maximizing return on capital, enhancing top line and bottom line growth, and an ongoing pursuit of achieving efficiencies through cost reductions and increased productivity.

### ***1. Domestic Mortgage Insurance (Sales and Marketing Mortgage Insurance)***

#### *Lender Solutions*

The Lender Solutions channel focuses on customers with traditional mortgage insurance needs that require fewer solutions from our capital markets product offerings, as well as business from mortgage banking correspondents. Lender Solutions business represented approximately 39% of our total domestic mortgage insurance premiums written and 38% of total domestic mortgage insurance premiums earned in 2006.

#### *Capital Markets*

Our Capital Markets channel focuses on providing credit solutions for non-prime collateral through five main products: structured primary mortgage insurance, pool insurance, second-lien mortgage insurance, financial guaranty of NIMs and credit default swaps. The capital markets team works with investment banks, originators and whole loan aggregators to develop the most cost-effective credit enhancement structure possible. This ensures better access to the capital markets, and in turn, produces a lower cost of capital for our clients. In order to provide the best customer service possible, the capital markets business operates a pricing desk that works in concert with its clients' analysts, as well as transaction managers who shepherd particular deals through closing. The Capital Markets channel also serves many large national accounts that are more likely to require credit enhancement solutions other than traditional mortgage insurance. There are two national account sales managers who are principally responsible for these relationships. Also included within the Capital Markets channel is a strategic account sales manager responsible for relationships and programs implemented with the GSEs. Capital Markets business represented approximately 61% of our total domestic mortgage insurance premiums written and 62% of total domestic mortgage insurance premiums earned in 2006.

#### *Mortgage Insurance Sales Force*

We employ a mortgage insurance field sales force of approximately 48 persons, organized into two regions, that provides local sales representation throughout the United States. Each of the two regions is supervised by a divisional sales manager who is directly responsible for several regional sales managers. The divisional sales managers are responsible for managing the profitability of business in their regions, including premiums, losses and expenses. The six regional sales managers are responsible for managing a sales force in different areas within the region. In addition, there are six account managers that manage specific accounts within a region that are not national accounts, but that need more targeted oversight and attention. Our sales force secures business from small and mid-sized regional customers for our Lender Solutions channel and also provides field support for large national accounts that are serviced by our Capital Markets channel.

Mortgage insurance sales personnel are compensated by salary, account profitability, commissions on new insurance written and a quarterly incentive component based on the achievement of various goals. During 2006, these goals were more focused on profitability and RAROC.

### ***2. International Mortgage Insurance (Sales and Marketing Mortgage Insurance)***

The International Mortgage Group is responsible for the development of mortgage opportunities outside the United States. With personnel located in London, Hong Kong, Philadelphia and Australia, the International Mortgage Group develops and underwrites both mortgage insurance and capital market products. Our primary geographical focus includes locations in Europe and Australia. We also are actively pursuing interests in India and Canada and have been exploring opportunities in other countries as well.

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The International Mortgage Group is comprised of approximately 25 professionals and works with mortgage lenders and originators, investment banks and other market intermediaries to identify market opportunities and credit risk management solutions. We are looking to expand our International Mortgage Group in 2007. In particular, we have been increasing our on-shore presence in Australia.

### **B. Financial Guaranty (*Sales and Marketing*)**

Our financial guaranty business develops its public finance business mainly through relationships with investment banks, commercial banks and financial advisors that provide financial and debt management services to, and intermediate transactions with, public finance borrowers. We, along with many of the financial entities underwriting this business, market directly to these intermediaries. We do not pay or otherwise reimburse these intermediaries for their services. We also have direct relationships with some issuers.

Our financial guaranty business originates its structured finance transaction flow principally by developing and maintaining strong relationships with the financial institutions, both in the United States and abroad, that are actively involved in the structured finance market. Our financial guaranty business develops its structured finance business through three primary business development units: asset-backed securities, CDOs and financial solutions. We have a dedicated structured finance business development team which reports directly to the head of our financial guaranty business's structured products group, for the purpose of developing new clients. In addition, our financial guaranty business has a London-based team of structured finance professionals responsible for sales and marketing for European structured finance obligations that also reports to the head of financial guaranty structured products.

Our financial guaranty reinsurance business markets directly to primary financial guaranty insurers that write credit enhancement business. Our financial guaranty business's goal is to meet the needs of the primary insurers, subject to our internal underwriting and risk management requirements.

## **VIII. Competition**

### **A. Mortgage Insurance (*Competition*)**

We compete directly with six other private mortgage insurers: Genworth Financial Inc., MGIC, PMI Mortgage Insurance Co., Republic Mortgage Insurance Company, Triad Guaranty Insurance Corporation and United Guaranty Corporation—some of which are subsidiaries of well-capitalized companies with stronger financial strength ratings and greater access to capital than we have. We also compete against various federal and state governmental and quasi-governmental agencies, principally the Federal Housing Administration (FHA), the Veterans Administration (VA) and state-sponsored mortgage insurance funds. Legislation is currently pending in the U.S. Congress to reform the FHA, which, if enacted, could provide the FHA with greater flexibility in establishing new products and increase the FHA's competitive position against private mortgage insurers. We do not know whether this proposed legislation, which includes increasing the maximum loan amount that the FHA can insure and allowing the FHA to use risk-based pricing in setting its premiums, will be enacted, and, if enacted, what form the legislation may take. Governmental and quasi-governmental entities typically do not have the same capital requirements that we and other mortgage insurance companies have, and therefore, may have financial flexibility in their pricing and capacity that could put us at a competitive disadvantage. In the event that a government-owned or sponsored entity in one of our markets determines to reduce prices significantly or alter the terms and conditions of its mortgage insurance or other credit enhancement products in furtherance of social or other goals rather than a profit motive, we may be unable to compete in that market effectively, which could have an adverse effect on our financial condition and results of operations.

We compete for flow business with other private mortgage insurance companies on the basis of both service and price. The service-based component includes risk management services, loss mitigation efforts and management and field service organization and expertise. We also provide contract underwriting services and

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participate in arrangements such as captive reinsurance and affordable housing programs. We cede a significant portion of our mortgage insurance business to captive reinsurance companies through captive reinsurance arrangements. Premiums ceded to captive reinsurance companies in 2006 were \$96.7 million, representing 11.7% of our total direct mortgage insurance premiums earned during 2006. Historically, these arrangements have reduced the profitability and return on capital in our mortgage insurance business. There have been a few recent cases in which the captive reinsurer has been required to pay claims.

We also face competition from an increasing number of alternatives to traditional private mortgage insurance, including:

mortgage lenders structuring mortgage originations to avoid private mortgage insurance, mostly through 80-10-10 loans or other forms of simultaneous second loans. The use of simultaneous second loans has increased significantly during recent years and is likely to continue, albeit at a lower level. We expect that the recent passing of legislation making mortgage insurance tax deductible for certain homebuyers will make mortgage insurance more competitive with simultaneous second loans and will further contribute to an increase in the penetration rate of mortgage insurance in the mortgage market;

investors using other forms of credit enhancement such as credit default swaps or securitizations as a partial or complete substitute for private mortgage insurance; and

mortgage lenders and other intermediaries that forego third-party insurance coverage and retain the full risk of loss on their high-LTV loans.

We also compete for structured transactions with other mortgage insurers as well as capital market executions such as senior/subordinated security structures. Competition for this business generally is based both on price and on the percentage of a given pool of loans that we are willing to insure. Our capital markets business also is significantly influenced by credit spreads or the difference between the yield on the obligation if insured by us and the yield on the obligation if sold on an uninsured basis. If the value of the spread resulting from our insurance is not greater than the cost of our insurance, the issuer generally will choose to issue mortgage backed securities without credit enhancement. Accordingly, credit spreads are a significant factor in the issuer's determination of whether to seek credit enhancement. As credit spreads tighten or the cost of our insurance increases vis-à-vis the market benefits of such insurance, the likelihood that issuers will choose to issue mortgage backed securities without credit enhancement increases.

### **B. Financial Guaranty (*Competition*)**

We are subject to competition from companies that specialize in financial guaranty insurance or reinsurance, including MBIA Insurance Corporation, Ambac, FGIC, FSAI, Assured Guaranty Corp., CDC IXIS Financial Guaranty, XL Capital Assurance Inc., XL Financial Assurance Ltd. and RAM Reinsurance Company. In addition, several multiline insurers have increased their participation in financial guaranty reinsurance and have formed strategic alliances with some of the U.S. primary financial guaranty insurers. We believe that competition from multiline reinsurers and new monoline financial guaranty insurers will continue to be limited due to (1) a lack of consistent dedication to the business from multiline insurers with the required financial strength; and (2) barriers to entry for new reinsurers posed by state insurance law and rating agency criteria governing minimum capitalization.

Competition in the financial guaranty reinsurance business is based on many factors, including overall financial strength, financial strength ratings, pricing and service. The rating agencies provide credit to a ceding company's capital requirements and single risk limits for reinsurance that is ceded. The amount of this credit is in part determined by the financial strength rating of the reinsurer. Some of our competitors have greater financial resources than we have and are better capitalized than we are and/or have been assigned higher ratings by one or more of the major rating agencies. In addition, the rating agencies could change the level of credit they will allow a ceding company to take for amounts ceded to us and/or similarly rated reinsurers.

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The majority of insured public finance and structured finance obligations are guaranteed by triple-A rated financial guaranty insurers. As a AA/Aa3-rated company, our financial guaranty business mainly targets distinct niches in the capital markets. There is generally a greater interest cost savings to an issuer by using triple-A rated credit enhancement as compared to our AA/Aa3 rated credit enhancement. However, financial guaranty insurance provided by a double-A provider also can provide significant value over uninsured executions in markets where the triple-A rated financial guaranty insurance is unavailable or uneconomical. In some markets, issuers and other counterparties receive no additional rating agency credit or regulatory relief from triple-A rated enhancement than they do with our AA/Aa3 enhancement, so our enhancement in these markets may be more economical. For example, under the Basel I and Basel II Capital Accords, there is no additional capital relief afforded to those using triple-A rated enhancement rather than our AA/Aa3 enhancement. See Foreign Regulation Basel II Capital Accord below for more information regarding the Basel Accord.

Our financial guaranty insurance and reinsurance businesses also compete with other forms of credit enhancement, including letters of credit, guaranties and credit default swaps provided, in most cases, by banks and other financial institutions or governmental agencies, some of which have greater financial resources than we do and/or have been assigned the highest credit ratings awarded by one or more of the major rating agencies. Most of these forms of credit enhancement, however, serve to provide ceding companies with increased insurance capacity only for rating agency purposes. Unlike financial guaranty reinsurance, most of these forms of credit do not qualify as capital for state regulatory purposes, nor do they constitute credit against specific liabilities that would allow the ceding company greater single risk capacity. However, the laws applicable to those ceding companies domiciled in New York were amended in 2004 to permit such ceding companies to use certain credit default swaps meeting applicable requirements as collateral to offset statutory single limits, aggregate risk limits, aggregate net liability calculations and contingency reserve requirements. This regulatory change, which makes credit default swaps an alternative to traditional financial guaranty insurance, could result in a reduced demand for traditional monoline financial guaranty reinsurance, although we have not experienced this effect to date.

We also face competition from alternate transaction structures that permit issuers to securitize assets more cost-effectively without the need for other credit enhancement and from cash-rich investors seeking additional yield on their investments by foregoing credit enhancement. As discussed above with respect to our mortgage insurance capital markets business, our financial guaranty business is highly dependent on credit spreads. In a tight credit spread environment, as have existed recently, our financial guaranty insurance may be less attractive to issuers or other intermediaries that use alternative structures.

We also are seeing increased competition in our financial guaranty reinsurance business as a result of captive reinsurance arrangements involving our financial guaranty primary reinsurance customers.

## **IX. Ratings**

S&P, Moody's and Fitch each rate the financial strength of our insurance subsidiaries. The rating agencies mainly focus on the following factors: capital resources; financial strength; commitment of management to, and alignment of stockholder interests with, the insurance business; demonstrated management expertise in our insurance business; credit analysis; systems development; risk management; marketing; capital markets and investment operations, including the ability to raise additional capital; and capital sufficient to meet projected growth and capital adequacy standards. As part of their rating process, S&P, Moody's and Fitch may test our insurance subsidiaries by subjecting them to a stress level scenario in which losses over a stress period are tested against our capital level.

The financial strength rating assigned by the rating agencies to an insurance or reinsurance company is based on factors relevant to policyholders and is not intended to protect that company's equity holders. A financial strength rating is neither a rating of securities nor a recommendation to buy, hold or sell any security. Financial strength ratings are an indication to an insurer's customers of the insurer's present financial strength.

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and its capacity to honor its future claims payment obligations. Therefore, ratings generally are considered critical to an insurer's ability to compete for new insurance business.

We have been assigned a senior debt rating of A+ by Fitch, A by S&P and A2 by Moody's. Our principal insurance subsidiaries have been assigned the following financial strength ratings:

	MOODY'S		S&P		FITCH	
	MOODY'S	OUTLOOK	S&P	OUTLOOK	FITCH	OUTLOOK
Radian Guaranty	Aa3	Stable	AA	Stable	AA	Stable
Radian Insurance	Aa3	Stable	AA	Stable	AA	Stable
Amerin Guaranty	Aa3	Stable	AA	Stable	AA	Stable
Radian Europe Limited			AA	Stable	AA	Stable
Radian Australia Limited						
Radian Asset Assurance	Aa3	Stable	AA	Stable	AA	Negative
Radian Asset Assurance Limited	Aa3	Stable	AA	Stable	AA	Negative

The rating agencies can change or withdraw their financial strength ratings at any time. On June 29, 2006, S&P affirmed the AA financial strength rating, and revised its outlook upward to stable, for Radian Asset Assurance. S&P also affirmed Radian Group Inc.'s A credit rating and revised its outlook for Radian Group upward to stable. Similarly, on July 3, 2006, S&P affirmed the AA financial strength rating and revised its outlook upward to stable for RAAL, and in November 2006, Moody's assigned RAAL a Aa3 financial strength rating with a stable outlook. In 2006, Radian Europe was assigned an initial AA financial strength rating with a stable outlook by both S&P and Fitch, and in February 2007, in connection with the announcement of our agreement to merge with MGIC, Moody's placed under review for possible upgrade the A2 senior debt rating of Radian Group Inc. and the Aa3 insurance financial strength ratings of our mortgage insurance subsidiaries. Also in connection with the announcement of the merger, Fitch affirmed its AA financial strength ratings for Radian Asset Assurance and RAAL and maintained its negative outlook for these insurers.

If the financial strength ratings assigned to any of our mortgage insurance subsidiaries were to fall below Aa3 from Moody's or the AA- level from S&P and Fitch, then national mortgage lenders and a large segment of the mortgage securitization market, including the GSEs, would not likely purchase mortgages or mortgage-backed securities insured by that subsidiary. Any downgrade of the ratings assigned to our financial guaranty subsidiaries would limit the desirability of their respective direct insurance products and would reduce the value of Radian Asset Assurance's reinsurance, even to the point where primary insurers may be unwilling to continue to cede insurance to Radian Asset Assurance at attractive rates. In addition, many of Radian Asset Assurance's reinsurance agreements give the primary insurers the right to recapture business ceded to Radian Asset Assurance under these agreements, and in some cases, the right to increase commissions charged to Radian Asset Assurance if Radian Asset Assurance's insurance financial strength rating is downgraded below specified levels. For example, downgrades that occurred in October 2002 and in May 2004 triggered these recapture rights. See Note 2 of Notes to Consolidated Financial Statements for more information regarding these downgrades and the resulting recapture of business by two of our primary insurer customers. There are no remaining recapture rights with respect to any prior downgrades of our insurance subsidiaries. In addition, the merger with MGIC will provide certain of our primary insurer customers with similar recapture rights. See Note 18 of Notes to Consolidated Financial Statements for more information regarding these recapture rights and the potential impact upon Radian Asset Assurance and the company upon consummation of the merger with MGIC.

## X. Investment Policy and Portfolio

Our income from our investment portfolio is one of our primary sources of cash flow to support our operations and claim payments.



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We follow an investment policy that, at a minimum, requires:

95% of our investment portfolio to consist of cash equivalents and debt securities (including redeemable preferred stock) that, at the date of purchase, were rated investment grade by a nationally recognized rating agency (e.g., BBB or better by S&P); and

At least 50% of our investment portfolio to consist of cash, cash equivalents and debt securities (including redeemable preferred stock) that, at the date of purchase, were rated the highest investment grade by a nationally recognized rating agency (e.g., AAA by S&P). Under our investment policy, which is applied throughout our company on a consolidated risk and asset allocation basis, we are permitted to invest in equity securities (including convertible debt and convertible preferred stock), provided our equity component does not exceed 20% of our total investment portfolio and at least 95% of the portfolio is investment grade. We manage our investment portfolio to minimize exposure to interest rate volatility through active portfolio management and intensive monitoring of investments to ensure a proper mix of the types of securities held and to stagger the maturities of fixed-income securities. Our investment policy focuses on the generation of optimal after-tax returns, stable tax-efficient current returns, and the preservation and growth of capital.

Oversight responsibility of our investment portfolio rests with Radian management allocations are set by periodic asset allocation studies, calibrated by risk and return and after-tax considerations, and are approved by the Investment Committee of our board of directors. Manager selection, monitoring, reporting and accounting (including valuation) of all assets are performed by Radian management. We manage over 70% of the portfolio the portion of the portfolio largely consisting of municipal bonds and short term investments internally, with the remainder managed by eight external managers. External managers are selected by Radian management based primarily upon the allocations approved by Radian's Investment Committee as well as factors such as historical returns and stability of management. Management's selections are presented and approved by the Investment Committee.

We review our investment portfolio on at least a quarterly basis for declines in the fair value of securities below the amortized cost basis of such securities that are considered to be other-than-temporary, and we recognize declines in earnings if the security has not been sold. If the fair value of a security is below the cost basis, and it is judged to be other-than-temporary, the cost basis of the individual security is written down to fair value through earnings as a realized loss and the fair value becomes the new basis. During 2006, we recorded approximately \$10.6 million of charges related to declines in the fair value of securities (primarily small cap value stocks and convertible securities) considered to be other-than-temporary. There were no such charges in 2005. At December 31, 2006 and 2005, there were no other investments held in the portfolio that were determined to be other-than-temporarily impaired.

At December 31, 2006, our investment portfolio had a cost basis of \$5,466.2 million, a carrying value of \$5,745.3 million and a market value of \$5,747.8 million, including \$238.7 million of short-term investments. Our investment portfolio did not include any real estate or mortgage loans. The portfolio included 56 privately placed, investment-grade securities with an aggregate carrying value of \$63.0 million. At December 31, 2006, 97.9% of our investment portfolio (which includes fixed maturities and equity securities) consisted of cash equivalents and debt securities (including redeemable preferred stock) that were rated investment grade.

Our investment policies and strategies are subject to change depending on regulatory, economic and market conditions and our then-existing or anticipated financial condition and operating requirements, including our tax position. The management of the portion of our investments held at our insurance subsidiaries is also subject to insurance regulatory requirements applicable to such insurance subsidiaries.

**Table of Contents****A. Investment Portfolio Diversification (*Investment Policy and Portfolio*)**

The diversification of our investment portfolio (other than short-term investments) at December 31, 2006, is as follows:

	December 31, 2006		
	Amortized		
	Cost	Fair Value (In thousands)	Percent (1)
Fixed maturities held to maturity (2):			
State and municipal obligations	\$ 84,314	\$ 86,817	100.0%
Total	84,314	86,817	100.0%
Fixed maturities available for sale:			
U.S. government securities (3)	105,362	105,840	2.2%
U.S. government-sponsored enterprises	31,102	30,824	0.6
State and municipal obligations	3,709,080	3,848,971	77.0
Corporate obligations	101,775	103,317	2.1
Convertible securities	310,949	319,198	6.4
Asset-backed securities	260,929	258,247	5.4
Redeemable preferred stocks	114,348	123,414	2.4
Private placements	61,032	63,027	1.3
Foreign governments	123,473	122,935	2.6
Total	4,818,050	4,975,773	100.0%
Equity securities	222,444	298,235	
Trading securities	87,009	128,202	
Other invested assets (4)	15,727	20,126	
Total	\$ 5,227,544	\$ 5,509,153	

(1) Percentage of amortized cost.

(2) All security types listed, other than U.S. government securities, consist mostly of investment-grade securities.

(3) Substantially all of these securities are backed by the full faith and credit of the U.S. government.

(4) The fair value of other invested assets is based on carrying value for equity-method investments and cost for cost-method investments.

**Table of Contents****B. Investment Portfolio Scheduled Maturity (*Investment Policy and Portfolio*)**

The weighted average duration of the assets in our investment portfolio as of December 31, 2006, was 5.62 years. The following table shows the scheduled maturities of the securities held in our investment portfolio at December 31, 2006:

	December 31, 2006 Carrying	
	Value (In thousands)	Percent
Short-term investments	\$ 238,677	4.2%
Less than one year (1)	49,852	0.9
One to five years (1)	527,650	9.2
Five to ten years (1)	775,293	13.5
Over ten years (1)	3,325,631	57.9
Asset-backed securities	258,247	4.5
Redeemable preferred stocks (2)	123,414	2.1
Equity securities (2)	298,235	5.2
Trading securities (2)	128,202	2.2
Other invested assets (2)	20,126	0.3
Total	\$ 5,745,327	100.0%

(1) Actual maturities may differ as a result of calls before scheduled maturity.

(2) No stated maturity date.

**C. Investment Portfolio by S&P Rating (*Investment Policy and Portfolio*)**

The following table shows the ratings by S&P of our investment portfolio (other than short-term investments) as of December 31, 2006:

	December 31, 2006 Carrying	
	Value (In thousands)	Percent
<b>Rating (1)</b>		
Fixed maturities:		
U.S. government and agency securities	\$ 136,664	2.5%
AAA	2,983,376	54.2
AA	828,884	15.0
A	526,936	9.6
BBB	347,506	6.3
BB and below and other (2)	13,779	0.3
Not rated (3)	222,942	4.0
Trading securities	128,202	2.3
Equity securities	298,235	5.4
Other invested assets	20,126	0.4
Total	\$ 5,506,650	100.0%

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- (1) As assigned by S&P as of December 31, 2006.
- (2) Securities in this category have been rated non-investment grade by S&P as of December 31, 2006.
- (3) Securities in this category have not been rated by S&P as of December 31, 2006, but have been rated investment grade as of December 31, 2006 by at least one other nationally recognized securities rating agency.

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### **XI. Regulation**

#### **A. State Regulation (*Regulation*)**

We and our insurance subsidiaries are subject to comprehensive, detailed regulation principally designed for the protection of policyholders, rather than for the benefit of investors, by the insurance departments in the various states where our insurance subsidiaries are licensed to transact business. Insurance laws vary from state to state, but generally grant broad supervisory powers to agencies or officials to examine insurance companies and enforce rules or exercise discretion affecting almost every significant aspect of the insurance business.

Insurance regulations address, among other things, the licensing of companies to transact business, claims handling, reinsurance requirements, premium rates and policy forms offered to customers, financial statements, periodic reporting, permissible investments and adherence to financial standards relating to surplus, dividends and other criteria of solvency intended to assure the satisfaction of obligations to policyholders.

Our insurance subsidiaries' premium rates and policy forms are generally subject to regulation in every state in which the insurers are licensed to transact business. These regulations are intended to protect policyholders against the adverse effects of excessive, inadequate or unfairly discriminatory rates and to encourage competition in the insurance marketplace. In most states, premium rates and policy forms must be filed and, in some states approved, before their use. Changes in premium rates may be subject to justification, generally on the basis of the insurer's loss experience, expenses and future trend analysis. The general default experience in the mortgage insurance industry also may be considered with regard to mortgage insurers.

Mortgage insurers in the United States generally are restricted to writing residential mortgage guaranty insurance, and financial guaranty insurers generally are restricted to writing financial guaranty insurance. Our non-insurance businesses, which consist of mortgage insurance-related services, are not generally subject to regulation under state insurance laws.

Radian Guaranty is domiciled and licensed in Pennsylvania as a stock casualty insurance company authorized to carry on the business of mortgage guaranty insurance pursuant to the provisions of the Pennsylvania insurance law and related rules and regulations governing property and casualty insurers. In addition to Pennsylvania, Radian Guaranty is authorized to write mortgage guaranty insurance (or in certain states where there is no specific authorization for mortgage guaranty insurance, the applicable line of insurance under which mortgage guaranty is regulated), in each of the other states, the District of Columbia and Guam. Radian Guaranty must maintain both a reserve for unearned premiums and for incurred losses and a special, formulaically derived contingency reserve to protect policyholders against the impact of excessive losses occurring during adverse economic cycles. The contingency reserve may be drawn on under specified but limited circumstances.

Radian Insurance is domiciled and licensed in the Pennsylvania as a stock casualty insurance company authorized to carry on the business of credit insurance or guaranty insurance pursuant to the provisions of the Pennsylvania insurance law and related rules and regulations governing property and casualty insurers. Radian Insurance must maintain both a reserve for unearned premiums and for incurred losses and a special, formulaically derived contingency reserve to protect policyholders against the impact of excessive losses occurring during adverse economic cycles. The contingency reserve may be drawn on under specified but limited circumstances.

Amerin Guaranty is domiciled and licensed in Illinois as a mortgage guaranty insurer and is subject to the provisions of the Illinois insurance law and related rules and regulations governing property-casualty insurers. In addition to Illinois, Amerin Guaranty is authorized to write mortgage guaranty insurance (or in certain states where there is no specific authorization for mortgage guaranty insurance, the applicable line of insurance under which mortgage guaranty is regulated), in each of the other states except Rhode Island (Amerin operates under an industrial insured exemption in Rhode Island) and the District of Columbia. Amerin Guaranty must maintain

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both a reserve for unearned premiums and for incurred losses and a special, formulaically derived contingency reserve to protect policyholders against the impact of excessive losses occurring during adverse economic cycles. The contingency reserve may be drawn on under specified but limited circumstances.

Radian Asset Assurance is domiciled and licensed in New York as a financial guaranty insurer and is subject to all other provisions of the New York insurance law and related rules and regulations governing property-casualty insurers to the extent these provisions are not inconsistent with the New York financial guaranty insurance statute. Radian Asset Assurance is also licensed under the New York insurance law to write surety insurance and credit insurance. In addition to New York, Radian Asset Assurance is authorized to write financial guaranty and surety insurance (or in one state where there is no specific authorization for financial guaranty insurance, credit insurance) in each of the other states, the District of Columbia, Guam and the United States Virgin Islands. Radian Asset Assurance must maintain both a reserve for unearned premiums and for incurred losses and a special, formulaically derived contingency reserve to protect policyholders against the impact of excessive losses occurring during adverse economic cycles. The contingency reserve may be drawn on under specified but limited circumstances with approval of the Commissioner of the New York Insurance Department.

Each insurance subsidiary is required by its state of domicile and each other jurisdiction in which it is licensed to transact business to make various filings with those jurisdictions and with the National Association of Insurance Commissioners, including quarterly and annual financial statements prepared in accordance with statutory accounting practices. In addition, our insurance subsidiaries are subject to examination by the insurance departments of each of the states in which they are licensed to transact business.

### ***1. Insurance Holding Company Regulation (Regulation State Regulation)***

We are an insurance holding company and our insurance subsidiaries belong to an insurance holding company system. All states have enacted legislation regulating insurance companies in an insurance holding company system. These laws generally require the insurance holding company to register with the insurance regulatory authority of each state in which its insurance subsidiaries are domiciled as well as its state of domicile and to furnish to this regulator financial and other information concerning the holding company and its affiliated companies within the system that may materially affect the operations, management or financial condition of insurers within the system.

Because we are an insurance holding company, and because Radian Guaranty and Radian Insurance are Pennsylvania insurance companies, Amerin Guaranty is an Illinois insurance company, and Radian Asset Assurance is a New York insurance company, the Pennsylvania, Illinois and New York insurance laws regulate, among other things, certain transactions in our common stock and certain transactions between us, our insurance subsidiaries and other parties affiliated with us. Specifically, no person may, directly or indirectly, offer to acquire or acquire control of us or our insurance subsidiaries, unless that person files a statement and other documents with the Commissioner of Insurance of the state in which such target company is domiciled and obtains the Commissioner's prior approval. The Commissioner may hold a public hearing on the matter. In addition, material transactions between us, our insurance subsidiaries and our affiliates are subject to certain conditions, including that they be fair and reasonable. These restrictions generally apply to all persons controlling or who are under common control with us or our insurance subsidiaries. Certain transactions between us, our insurance subsidiaries or our affiliates may not be entered into unless the applicable Commissioner of Insurance is given 30 days prior notification and does not disapprove the transaction during that 30-day period.

### ***2. Dividends (Regulation State Regulation)***

Radian Guaranty's and Radian Insurance's ability to pay dividends on their common stock is restricted by certain provisions of the insurance laws of Pennsylvania. Under Pennsylvania's insurance laws, dividends and other distributions may only be paid out of an insurer's unassigned surplus unless the Pennsylvania Insurance Commissioner approves additional dividends. Radian Guaranty and Radian Insurance had positive unassigned

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surpluses at December 31, 2006 of \$302.5 million and \$92.2 million, respectively. In addition, without the prior approval of the Pennsylvania Insurance Commissioner, an insurer only may pay dividends during any 12-month period in an amount equal to the greater of (i) 10% of the preceding year-end statutory policyholders' surplus, or (ii) the preceding year's statutory net income. In accordance with this test, \$384.7 million and \$62.8 million would be available for dividends from Radian Guaranty and Radian Insurance, respectively, in 2007. Radian Insurance has not paid any dividends to Radian Guaranty, its immediate parent company. Radian Guaranty paid \$150 million in dividends to us in 2006.

Amerin Guaranty's ability to pay dividends on its common stock is restricted by certain provisions of the insurance laws of Illinois. The insurance laws of Illinois establish a test limiting the maximum amount of dividends that may be paid from unassigned surplus by an insurer without prior approval by the Illinois Insurance Commissioner. Under this test, Amerin Guaranty may pay dividends during any 12-month period in an amount equal to the greater of (i) 10% of the preceding year-end statutory policyholders' surplus, or (ii) the preceding year's statutory net income. In accordance with this test, \$20.2 million would be available for dividends in 2007 without prior regulatory approval.

Radian Asset Assurance's ability to pay dividends is restricted by certain provisions of the insurance laws of New York. Under the New York insurance laws, Radian Asset Assurance may only declare or distribute dividends from earned surplus. Unless the company has prior approval from the New York Superintendent of Insurance, the company can only pay a dividend, which when totaled with all other dividends declared or distributed by it during the preceding twelve months, is the lesser of 10% of its surplus to policyholders as shown by its last statement on file with the Superintendent of Insurance, or 100% of adjusted net investment income. At December 31, 2006, Radian Asset Assurance had \$100.1 million available for dividends that could be paid in 2007 without prior approval.

### **3. *Risk-to-Capital (Regulation State Regulation)***

A number of states limit a private mortgage insurer's risk in force to 25 times the total of the insurer's policyholders' surplus, plus the statutory contingency reserve. This is commonly known as the risk-to-capital requirement. As of December 31, 2006, the consolidated risk-to-capital ratio for our mortgage insurance business was 10.4 to 1 compared to 11.6 to 1 as of December 31, 2005.

### **4. *Reserves (Regulation State Regulation)***

For statutory reporting, mortgage insurance companies are required annually to provide for additions to their contingency reserve in an amount equal to 50% of earned premiums. Such amounts cannot be withdrawn for a period of 10 years except under certain circumstances. The contingency reserve, designed to be a reserve against catastrophic losses, essentially restricts dividends and other distributions by mortgage insurance companies. We classify the contingency reserve as a statutory liability. At December 31, 2006, Radian Guaranty had statutory policyholders' surplus of \$496.1 million and a contingency reserve of \$2.7 billion, Amerin Guaranty had statutory policyholders' surplus of \$202.1 million and Radian Insurance had statutory policyholders' surplus of \$627.9 million and a contingency reserve of \$117.4 million.

Our financial guaranty business must establish a contingency reserve in an amount equal to the greater of 50% of premiums written or a stated percentage of the principal guaranteed, ratably over 15 to 20 years depending on the category of obligation insured in accordance with the most stringent state requirements. Reinsurers are required to establish a contingency reserve equal to their proportionate share of the reserve established by the ceding company. At December 31, 2006, Radian Asset Assurance had statutory policyholders' surplus of \$1,001.3 million and a contingency reserve of \$336.7 million.

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### **5. *Reinsurance (Regulation State Regulation)***

Restrictions apply under the laws of several states to any licensed company ceding business to an unlicensed reinsurer. Under those laws, if a reinsurer is not admitted, authorized or approved in such state, the company ceding business to the reinsurer cannot take credit in its statutory financial statements for the risk ceded to the reinsurer without compliance with certain reinsurance security requirements. Several states limit the amount of risk a mortgage insurer may retain with respect to coverage on an insured loan to 25% of the insured's claim amount. Coverage in excess of 25% (*i.e.*, deep coverage) must be reinsured.

### **6. *Accreditation (Regulation State Regulation)***

The National Association of Insurance Commissioners instituted the Financial Regulatory Accreditation Standards Program, known as FRASP, in response to federal initiatives to regulate the business of insurance. FRASP provides standards intended to establish effective state regulation of the financial condition of insurance companies. FRASP requires states to adopt certain laws and regulations, institute required regulatory practices and procedures, and have adequate personnel to enforce these items in order to become accredited. In accordance with the National Association of Insurance Commissioners' Model Law on Examinations, accredited states are not permitted to accept certain financial examination reports of insurers prepared solely by the insurance regulatory agencies of non-accredited states. Although the State of New York is not accredited, no state where Radian Asset Assurance is licensed has refused to accept the New York Insurance Department's Reports on Examination for Radian Asset Assurance. We cannot be certain that, if the New York Insurance Department remains unaccredited, other states that are accredited will continue to accept financial examination reports prepared solely by the New York Insurance Department. We do not believe that the refusal by an accredited state to continue accepting financial examination reports prepared by the New York Insurance Department would have a material adverse impact on our insurance businesses.

## **B. *Federal Regulation (Regulation)***

### **1. *Mortgage Insurance Tax Deductibility (Regulation Federal Regulation)***

On December 20, 2006, federal legislation was enacted making mortgage insurance premiums tax deductible. The legislation allows borrowers with adjusted gross incomes of \$100,000 or less (\$50,000 in the case of a married individual filing a separate return) to deduct the full amount of their mortgage insurance premiums paid in 2007. Borrowers making between \$100,000 and \$110,000 will be eligible to write off a portion of the premiums paid in 2007. The new legislation applies to loans closing on or after January 1, 2007 and to both purchase and refinance transactions. Unless extended, the new legislation expires December 31, 2007. We believe this legislation, which remains subject to interpretation by the Internal Revenue Service, will make our mortgage insurance products more competitive with 80-10-10 loans and other forms of simultaneous second loans, which were often viewed by homebuyers and others as more favorable than loans with mortgage insurance because of the tax deductibility associated with the first and second mortgage payments.

### **2. *RESPA (Regulation Federal Regulation)***

The origination or refinance of a federally regulated mortgage loan is a settlement service, and therefore, subject to RESPA. In December 1992, regulations were issued stating that mortgage insurance also is a settlement service. As a result, mortgage insurers are subject to the anti-referral provisions of Section 8(a) of RESPA, which provide, in essence, that mortgage insurers are prohibited from paying anything of value to a mortgage lender in consideration of the lender's referral of business to the mortgage insurer. Although many states prohibit mortgage insurers from giving rebates, RESPA has been interpreted to cover many non-fee services as well. The U.S. Department of Housing and Urban Development's (HUD) interest in pursuing violations of RESPA has increased the awareness of both mortgage insurers and their customers of the possible sanctions resulting from a violation of RESPA. HUD, as well as the insurance commissioner or an attorney general of any state, may conduct investigations, levy fines and other sanctions or enjoin future violations of



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RESPA. We and other mortgage insurers have faced private lawsuits alleging, among other things, that our captive reinsurance arrangements, as well as pool insurance and contract underwriting services, constitute unlawful payments to mortgage lenders under RESPA. Although to date we have successfully defended against all such lawsuits on the basis that the plaintiffs lacked standing, we cannot be certain that we will have continued success defending against similar lawsuits.

The insurance law provisions of many states, including New York, also prohibit paying for the referral of insurance business and provide various mechanisms to enforce this provision. In February 1999, the New York Insurance Department issued Circular Letter No. 2 that discusses its position concerning various transactions between mortgage guaranty insurance companies licensed in New York and mortgage lenders. The letter confirms that captive reinsurance transactions are permissible if they constitute a legitimate transfer of risk and are fair and equitable to the parties. The letter also states that supernotes/performance notes, dollar pool insurance, and un-captive captives violate New York insurance law. In May 2005, we received a letter from the New York Insurance Department seeking information related to all of the captive mortgage reinsurance arrangements that we entered into since January 1, 2000, a list of the lenders associated with each captive along with each captive's state of domicile and capital/surplus requirements. The letter also included a request for a description of any other arrangements through which we provide any payment or consideration to a lender in connection with mortgage insurance. We submitted our response and affirmed it as true under penalties of perjury to the New York insurance department on June 8, 2005. We are aware that other mortgage insurers have received similar requests from the New York insurance department.

In February 2006, we and other mortgage insurers received a second letter from the New York insurance department seeking documentation and a description of the due diligence that we perform in selecting reinsurers for our mortgage insurance risk. The letter indicates that the New York insurance department is seeking evidence from us to rebut the assertion that the premiums we pay under our captive reinsurance arrangements constitute an inducement or compensation to lenders for doing business with us and to bolster a claim that it is difficult or impossible to obtain mortgage reinsurance from non-captive reinsurers. We submitted a response to the New York insurance department for Radian Guaranty in March 2006 and for Amerin in May 2006, as requested. We have had no further inquiries from the insurance department about either company.

In addition to the New York inquiry, other mortgage insurers have received subpoenas from the Minnesota Insurance Commissioner relating to their captive reinsurer arrangements, and public reports have indicated that both the Colorado and North Carolina Insurance Commissioners were considering investigating or reviewing captive mortgage reinsurance arrangements. Insurance departments or other officials in other states may also conduct such investigations or reviews. Although we believe that all of our captive reinsurance arrangements transfer risk to the captive reinsurer at a premium rate that is commensurate with the risk, we cannot be certain that we will be able to successfully defend against any alleged violations of RESPA or other laws.

HUD proposed a rule under RESPA to create an exemption from Section 8(a) of RESPA. The proposed rule would have made the exemption available to lenders that, at the time a borrower submits a loan application, give the borrower a firm, guaranteed price for all the settlement services associated with the loan, commonly referred to as bundling. In 2004, HUD indicated its intention to abandon the proposed rule and to submit a revised proposed rule to the U.S. Congress. HUD began looking at the reform process again in 2005 and there may be a new proposed rule as early as 2007. If bundling is exempted from RESPA, mortgage lenders may have increased leverage over us and the premiums we are able to charge for mortgage insurance could be negatively affected.

### **3. Home Mortgage Disclosure Act of 1975 (HMDA) (Regulation Federal Regulation)**

Most originators of mortgage loans are required to collect and report data relating to a mortgage loan applicant's race, nationality, gender, marital status and census tract to HUD or the Federal Reserve under the HMDA. The purpose of the HMDA is to detect possible discrimination in home lending and, through disclosure, to

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discourage this discrimination. Mortgage insurers are not required pursuant to any law or regulation to report HMDA data, although under the laws of several states, mortgage insurers are currently prohibited from discriminating on the basis of certain classifications.

Several mortgage insurers, through their trade association, Mortgage Insurance Companies of America ( MICA ), entered into an agreement with the Federal Financial Institutions Examinations Council ( FFIEC ) to report the same data on loans submitted for insurance as is required for most mortgage lenders under HMDA. Reports of HMDA-type data for the mortgage insurance industry have been submitted by several mortgage insurers through MICA to the FFIEC since 1993. We are not aware of any pending or expected actions by governmental agencies in response to the reports submitted by MICA to the FFIEC. Since January 2004, we have been independently reporting HMDA data to the FFIEC, due to our withdrawal from MICA.

### ***4. Mortgage Insurance Cancellation (Regulation Federal Regulation)***

The Homeowners Protection Act of 1998 (the HPA ) was signed into law on July 29, 1998. The HPA imposes certain cancellation and termination requirements for borrower-paid private mortgage insurance and requires certain disclosures to borrowers regarding their rights under the law. The HPA also requires certain disclosures for loans covered by lender-paid private mortgage insurance. Specifically, the HPA provides that private mortgage insurance on most loans originated on or after July 29, 1999, may be canceled at the request of the borrower once the LTV reaches 80%, provided that certain conditions are satisfied. Private mortgage insurance must be canceled automatically once the LTV reaches 78% (or, if the loan is not current on that date, on the date that the loan becomes current). The HPA establishes special rules for the termination of private mortgage insurance in connection with loans that are high risk. The HPA does not define high risk loans but leaves that determination to Fannie Mae and Freddie Mac for loans up to the conforming loan limit and to the mortgagee for any other loan. For high risk loans above the conforming loan limit, private mortgage insurance must be terminated on the date that the LTV is first scheduled to reach 77%. In no case, however, may private mortgage insurance be required beyond the midpoint of the amortization period of the loan if the mortgagor is current on the payments required by the terms of the mortgage. We do not believe that the HPA has had a material impact on the persistency rate of our insured loans or on our financial results.

### ***5. Freddie Mac and Fannie Mae (Regulation Federal Regulation)***

As the largest purchasers and sellers of conventional mortgage loans, and therefore beneficiaries of private mortgage insurance, Freddie Mac and Fannie Mae impose requirements on private mortgage insurers so that they may be eligible to insure loans sold to Freddie Mac and Fannie Mae. Freddie Mac's current eligibility requirements impose limitations on the type of risk insured, standards for the geographic and customer diversification of risk, procedures for claims handling, standards for acceptable underwriting practices, standards for certain reinsurance cessions and financial requirements that generally mirror state insurance regulatory requirements. These requirements are subject to change from time to time. Fannie Mae also has eligibility requirements, although those requirements are not published. Radian Guaranty is an approved first-lien mortgage insurer for both Freddie Mac and Fannie Mae.

Fannie Mae and Freddie Mac have programs that allow for lower levels of required mortgage insurance coverage for certain low-down-payment 30-year fixed-rate loans approved through their automated underwriting systems. Under these programs the GSEs replace a portion of their standard mortgage insurance coverage with a reduced layer of coverage.

The Office of Federal Housing Enterprise Oversight issued new risk-based capital regulations for Freddie Mac and Fannie Mae, which took effect September 13, 2002. The most relevant provision to us is a distinction between AAA rated insurers and AA rated insurers. The new regulations impose a lesser credit reduction for Fannie Mae and Freddie Mac for exposure ceded by them to AAA rated insurers (only one mortgage insurer currently is rated AAA), as compared to AA rated insurers. As a result, there may be an incentive for the GSEs to

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prefer private mortgage insurance provided by the AAA rated insurer, although this has not occurred to this point. The provisions of the new regulations are to be phased in over a 10-year period commencing on the effective date of the regulation.

Fannie Mae and Freddie Mac require that we participate in affordable housing programs that they maintain to provide for loans to low- and moderate-income borrowers. These programs usually include 95s, 97s and 100s, and may require the liberalization of certain underwriting guidelines to achieve the programs' objectives. Our default experience on loans that we insure through these programs has been worse than on non-affordable housing loans, but our participation in these programs does not constitute a material amount of our risk in force.

### **6. Indirect Regulation (Regulation Federal Regulation)**

We also are indirectly, but significantly, impacted by regulations affecting originators and purchasers of mortgage loans, such as Freddie Mac and Fannie Mae, and regulations affecting governmental insurers such as the FHA and the VA. We and other private mortgage insurers may be significantly impacted by federal housing legislation and other laws and regulations that affect the demand for private mortgage insurance and the housing market generally. For example, legislation that increases the number of persons eligible for FHA or VA mortgages could have a material adverse effect on our ability to compete with the FHA or VA.

The FHA single-family loan limits were raised effective January 1, 2006. The 2006 limits range from \$200,160 in low-cost areas to \$362,790 in high-cost areas. The limits did not change effective January 1, 2007. We do not believe that demand for private mortgage insurance has been or will be materially adversely affected by this change.

In October 2006, the federal banking regulators (Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA)) issued joint interagency guidance on non-traditional mortgage loans. The guidance was developed to address what the regulators identified as the risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. While the guidance does not have legally binding effect on lenders, the provisions are used by federal bank examiners to determine whether regulated institutions are in compliance with recommended underwriting and risk management practices. As a result, lenders often are influenced to adjust their business practices in order to conform with currently prevailing guidance. The guidance includes a focus on tightening underwriting and credit standards for non-traditional loans. Simultaneous second lien loans (which typically are utilized in lieu of mortgage insurance) are among the factors cited in the guidance as a risk factor when used in conjunction with non-traditional loan features. The guidance cites the use of mortgage insurance as a mitigating factor for lenders to reduce risk in non-traditional loan products.

### **C. Foreign Regulation (Regulation)**

We also are subject to certain regulation in various foreign countries, namely the United Kingdom, Hong Kong and Bermuda, as a result of our operations in those jurisdictions.

In the United Kingdom, we are subject to regulation by the FSA. The FSA periodically performs a formal risk assessment of insurance companies or groups carrying on business in the United Kingdom. After each risk assessment, the FSA will inform the insurer of its views on the insurer's risk profile. This will include details of any remedial action that the FSA requires. The FSA also supervises the management of insurance companies through the approved persons regime, by which any appointment of persons to perform certain specified controlled functions within a regulated entity, must be approved by the FSA.

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In addition, the FSA recently began to supervise the sale of general insurance, including payment protection insurance and mortgage insurance. Under FSA rules, persons who are involved in the sale of general insurance (including insurers and distributors) are prohibited from offering or accepting any inducement in connection with the sale of general insurance that is likely to conflict materially with their duties to insureds. Although the rules do not generally require disclosure of broker compensation, the insurer or distributor must disclose broker compensation at the insured's request.

The FSA has extensive powers to intervene in the affairs of an insurance company or authorized person and has the power, among other things, to enforce, and take disciplinary measures in respect of, breaches of its rules. Under FSA rules, insurance companies must maintain a margin of solvency at all times, the calculation of which in any particular case depends on the type and amount of insurance business a company writes.

Our United Kingdom subsidiaries are prohibited from declaring a dividend to their shareholders unless they have profits available for distribution. The determination of whether a company has profits available for distribution is based on its accumulated realized profits less its accumulated realized losses.

The acquisition of control of any United Kingdom insurance company will require FSA approval. For these purposes, a party that controls a United Kingdom insurance company includes any company or individual that (together with its or his associates) directly or indirectly acquires 10% or more of the shares in a United Kingdom authorized insurance company or its parent company, or is entitled to exercise or control the exercise of 10% or more of the voting power in such authorized insurance company or its parent company. In considering whether to approve an application for approval, the FSA must be satisfied that the acquirer is both a fit and proper person to have such control and that the interests of consumers would not be threatened by such acquisition of control. Failure to make the relevant prior application could result in action being taken against our United Kingdom subsidiaries by the FSA.

By reason of Radian Insurance's authorization, in September 2006, to conduct insurance business through a branch in Hong Kong, we also are subject to regulation by the Hong Kong Insurance Authority (HKIA). The HKIA's principal purpose is to supervise and regulate the insurance industry, primarily for the protection of policy holders and the stability of the industry. Hong Kong insurers are required by the Insurance Companies Ordinance to maintain minimum capital as well as an excess of assets over liabilities of not less than a required solvency margin, which is determined on the basis of a statutory formula. Foreign-owned insurers are also required to maintain assets in Hong Kong in an amount sufficient to ensure that assets will be available in Hong Kong to meet the claims of Hong Kong policy holders if the insurer should become insolvent. The HKIA also reviews the backgrounds and qualifications of insurance companies' directors and key local management to ensure that these controllers are fit and proper to hold their positions, and has the authority to approve or disapprove key appointments.

### **D. Basel II Capital Accord (*Regulation*)**

The Basel II Capital Accord represents a proposal by the Basel Committee on Banking Supervision (BCBS), consisting of bank supervisors and central bankers from 13 countries, to revise the international standards for measuring the adequacy of a bank's capital. The implementation of the Basel II Capital Accord proposal will promote a more forward-looking approach to capital supervision and ensure greater consistency in the way banks and banking regulators approach risk management around the world. The implementation of the Basel II Capital Accord may affect the demand for and capital treatment provided to mortgage insurance and the capital available to large domestic and internationally active banking institutions for their mortgage origination and securitization activities.

Our primary mortgage insurance business and opportunities may be significantly impacted by the implementation of the Basel II Capital Accord in the U.S, the European Union, Hong Kong and Australia, due to adoption of jurisdiction specific prudential standards, that may lead to change in demand for and acceptance of mortgage insurance by large domestic and internationally active banking institutions. The implementation of the

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Basel II Capital Accord and adoption of standards is subject to the views and discretion of the local banking supervisors and its implementation is expected to vary across national jurisdictions. We are continuously assessing the impact of Basel II Capital Accord implementation in the countries where we have significant operations.

Currently, European banking supervisors do not explicitly recognize mortgage insurance as a risk mitigant for bank capital requirements. In October 2005, the European Union adopted new legislation, the Capital Requirements Directive ( CRD ), which provides a revised framework for EU member nation banking supervisors to implement new Basel II Capital Accord risk-based capital guidelines starting in 2007. The CRD prescribes standard criteria for credit risk mitigation instruments eligible to provide banks with risk relief. We believe the CRD facilitates recognition of mortgage insurance benefits for European banks under certain circumstances. The CRD is subject to further clarification by the European Commission and incorporation into the regulatory framework of European Union member countries.

Under the Basel II Capital Accord, the regulatory capital relief provided to an affected bank is the same whether the provider of the relief is rated AAA or AA (such as Radian Asset Assurance or Radian Insurance). As a result, price should be a more significant factor in our bank customers making their selection of credit protection providers among the AAA and AA providers. Due to our lower cost of capital as a AA insurer relative to AAA providers, we believe we can compete effectively on price to provide this relief to our customers.

## **XII. Employees**

At December 31, 2006, we had 1,027 employees, of which 187 work mainly for Radian Group Inc., while 673 and 167 are employed in our mortgage insurance and financial guaranty businesses, respectively. Approximately 290 of our employees are contract underwriters that are hired on an as-needed basis. The number of contract underwriters can vary substantially from period to period, mainly as a result of changes in the demand for these services. Our employees are not unionized and management considers employee relations to be good.

### **Item 1A. Risk Factors. Risks Affecting Our Company**

***Deterioration in general economic factors may increase our loss experience and decrease demand for mortgage insurance and financial guaranties.***

Our business tends to be cyclical and tends to track general economic and market conditions. Our loss experience on the mortgage and financial guaranty insurance we write is subject to general or regional economic factors that are beyond our control, many of which we cannot anticipate, including extended national economic recessions, interest-rate changes or volatility, business failures, the impact of terrorist attacks or acts of war, or changes in investor perceptions regarding the strength of private mortgage insurers or financial guaranty providers and the policies or guaranties they offer. Deterioration of general economic conditions, such as increasing unemployment rates, negatively affects our mortgage insurance business by increasing the likelihood that borrowers will not pay their mortgages. Personal factors affecting individual borrowers, such as divorce or illness, also impact the ability of borrowers to continue to pay their mortgages. Depreciation of home prices also could be a leading indication of an increase in our future losses. Our financial guaranty business also is impacted by adverse economic conditions due to the impact or perceived impact these conditions may have on the credit quality of municipalities and corporations. A deterioration in general or regional economic factors also could lead to a decrease in the overall volume of mortgage originations and financial obligations that are available for insurance, which would likely result in decreased demand for mortgage insurance or financial guaranties and a corresponding increase in the competition that we face. An increase in our loss experience or a decrease in demand for our products due to adverse economic factors could have a material adverse effect on our business, financial condition and operating results.

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### ***Deterioration in regional economic factors could increase our losses or reduce demand for our insurance.***

We could be affected by weakening economic conditions, catastrophic events, or acts of terrorism in specific regions of the United States or in foreign countries where our business is concentrated. A majority of our primary mortgage insurance in force is concentrated in 10 states, with the highest percentage being in Florida, California, Texas and New York. A large percentage of our second-lien mortgage insurance in force is concentrated in California and Florida. Approximately 11% of our primary mortgage risk in force at December 31, 2006 was concentrated in the Midwestern states of Michigan, Indiana and Ohio. As a result of declining economic conditions in the Midwest, this region experienced higher default rates in 2006 than any other region of the U.S. Our financial guaranty business also has a significant portion of its insurance in force concentrated in a small number of states, principally including California, New York, Texas, Florida and Pennsylvania. A continued and prolonged weakening of economic conditions, declines in property valuations, or catastrophic events or acts of terrorism in the states where our business is concentrated could have an adverse effect on our business, financial condition and operating results.

### ***A tightening of credit spreads may decrease demand for our credit enhancement and reduce opportunities for us to write profitable business.***

Our financial guaranty business, our financial services affiliates (C-BASS in particular), and an increasing percentage of our mortgage insurance business is significantly influenced by credit spreads that are set by market factors, over which we have little or no control. Our insurance generally provides value by lowering an issuer's cost of borrowing, by providing capital relief to an issuer or by improving on the market execution of an insured security. The difference or credit spread between the actual or anticipated benefit of credit enhancement, which may be influenced by a number of factors such as credit performance, market liquidity and an investor's willingness to take on risk, and the cost of credit enhancement is a significant factor in an issuer's determination of whether to seek credit enhancement. As credit spreads tighten or the cost of our insurance increases vis-à-vis the perceived market benefits of such insurance the likelihood that issuers will choose to forego credit enhancement increases. As a result, in a tight credit spread environment, as has existed recently, we experience fewer opportunities to write profitable business in both our financial guaranty business and in the Capital Markets channel of our mortgage insurance business along with increased competition among insurers for the limited opportunities that are available to us. If tight credit spreads continue to persist or if spreads further tighten, we may experience limited or no opportunities to write profitable business in these businesses, which would have an adverse affect on our business, financial condition and operating results.

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***Downgrade or potential downgrade of our credit ratings or the insurance financial strength ratings assigned to any of our operating subsidiaries could weaken our competitive position and affect our financial condition.***

The insurance financial strength ratings assigned to our subsidiaries may be downgraded by one or more of S&P, Moody's or Fitch if they believe that we or the applicable subsidiary has experienced adverse developments in our business, financial condition or operating results. These ratings are important to our ability to market our products and to maintain our competitive position and customer confidence in our products. A downgrade in these ratings, or the announcement of a potential for a downgrade or any other concern relating to the on-going financial strength of our insurance subsidiaries, could have a material adverse effect on our business, financial condition and operating results. Our principal operating subsidiaries had been assigned the following ratings as of the date of this report:

	MOODY'S		S&P		FITCH	
	MOODY'S	OUTLOOK	S&P	OUTLOOK	FITCH	OUTLOOK
Radian Guaranty	Aa3	Stable	AA	Stable	AA	Stable
Radian Insurance	Aa3	Stable	AA	Stable	AA	Stable
Amerin Guaranty	Aa3	Stable	AA	Stable	AA	Stable
Radian Europe Limited			AA	Stable	AA	Stable
Radian Australia Limited						
Radian Asset Assurance	Aa3	Stable	AA	Stable	AA	Negative
Radian Asset Assurance Limited	Aa3	Stable	AA	Stable	AA	Negative

If the financial strength ratings assigned to any of our mortgage insurance subsidiaries were to fall below Aa3 from Moody's or the AA- level from S&P and Fitch, or in the case of those mortgage insurance subsidiaries not rated by one or more of such rating agencies, such subsidiary being assigned an initial rating below those currently held by our mortgage subsidiaries with such ratings, then national mortgage lenders and a large segment of the mortgage securitization market, including Fannie Mae and Freddie Mac, generally would not purchase mortgages or mortgage-backed securities insured by that subsidiary. Any downgrade of the ratings assigned to our financial guaranty subsidiaries would limit the desirability of their respective direct insurance products and would reduce the value of Radian Asset Assurance's reinsurance, even to the point where primary insurers may be unwilling to continue to cede insurance to Radian Asset Assurance at attractive rates. In addition, many of Radian Asset Assurance's reinsurance agreements give the primary insurers the right to recapture business ceded to Radian Asset Assurance under these agreements, and in some cases, the right to increase commissions charged to Radian Asset Assurance if Radian Asset Assurance's insurance financial strength rating is downgraded below specified levels. Accordingly, Radian Asset Assurance's competitive position and prospects for future financial guaranty reinsurance opportunities would be damaged by a downgrade in its ratings. For example, downgrades that occurred in October 2002 and in May 2004 triggered these recapture rights. See Note 2 of Notes to Consolidated Financial Statements for more information regarding these downgrades. We cannot be certain that the impact on our business of any future downgrades would not be worse than the impact resulting from these prior downgrades.

In addition to the financial strength ratings assigned to our subsidiaries, we have been assigned a senior debt rating of A+ by Fitch, A by S&P and A2 by Moody's. Our credit ratings generally impact the interest rates that we pay on money that we borrow. A downgrade in our credit ratings could increase our cost of borrowing, which could have an adverse effect on our liquidity, financial condition and operating results.

***An increase in our subsidiaries' risk-to-capital or leverage ratios may prevent them from writing new insurance.***

Rating agencies and state insurance regulators impose capital requirements on our subsidiaries. These capital requirements include risk-to-capital ratios, leverage ratios and surplus requirements that limit the amount of insurance that these subsidiaries may write. For example, Moody's and S&P have entered into an agreement

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with Radian Guaranty that obligates Radian Guaranty to maintain specified levels of capital in Radian Insurance as a condition of the issuance and maintenance of Radian Insurance's ratings. A material reduction in the statutory capital and surplus of any of our insurance subsidiaries, whether resulting from underwriting or investment losses or otherwise, or a disproportionate increase in risk in force, could increase that subsidiary's risk-to-capital ratio or leverage ratio. This in turn could limit that subsidiary's ability to write new business or require that subsidiary to lower its ratios by obtaining capital contributions from us or another of our insurance subsidiaries or by reinsuring existing business, which could have a material adverse effect on our business, financial condition and operating results.

*If the estimates we use in establishing loss reserves for our mortgage insurance or financial guaranty business are incorrect, we may be required to take unexpected charges to income and our ratings may be downgraded.*

We establish loss reserves in both our mortgage insurance and financial guaranty businesses to provide for the estimated cost of claims. However, because our reserves represent an estimate, these reserves may be inadequate to protect us from the full amount of claims we ultimately may have to pay. Setting our loss reserves involves significant reliance on estimates of the likelihood, magnitude and timing of anticipated losses. The models and estimates we use to establish loss reserves may prove to be inaccurate, especially during an extended economic downturn. Further, if our estimates are inadequate, we may be forced by insurance and other regulators or rating agencies to increase our reserves, which could result in a downgrade of the insurance financial strength ratings assigned to our operating subsidiaries. Failure to establish adequate reserves or a requirement that we increase our reserves could have a material adverse effect on our business, financial condition and operating results.

In our mortgage insurance business, in accordance with accounting principles generally accepted in the United States of America (GAAP), we generally do not establish reserves until we are notified that a borrower has failed to make at least two payments when due. Upon notification that two payments have been missed, we establish a loss reserve by using historical models based on a variety of loan characteristics, including the status of the loan as reported by the servicer of the loan, economic conditions, the estimated amount recoverable by foreclosure and the estimated foreclosure period in the area where a default exists. These reserves are therefore based on a number of assumptions and estimates that may prove to be inaccurate.

It also is difficult to estimate appropriate loss reserves for our financial guaranty business because of the nature of potential losses in that business, which are largely influenced by the particular circumstances surrounding each troubled credit, including the availability of loss mitigation, and therefore, are less capable of being evaluated based on historical assumptions or precedent. We establish both case and non-specific reserves for losses. Case reserves occur when we determine that a default has occurred. We also establish non-specific reserves to reflect general deterioration of our insured credits for which we have not provided case reserves.

In January and February 2005, we discussed with the SEC staff, both separately and together with other members of the financial guaranty industry, the differences in loss reserve practices followed by different financial guaranty industry participants. On June 8, 2005, the Financial Accounting Standards Board (FASB) added a project to its agenda to consider the accounting by insurers for financial guaranty insurance. The FASB's objective is to provide guidance with respect to the timing of claim liability recognition, premium recognition and the related amortization of deferred policy acquisition costs, specifically for financial guaranty contracts issued by insurance companies that are not accounted for as derivative contracts under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133), and as amended by Statement of Financial Accounting Standard (SFAS) No. 149. The goal is to reduce diversity in accounting by financial guaranty insurers, thereby enabling users to better understand and more readily compare the insurers' financial statements. The FASB is also expected to examine the appropriate accounting model for other insurance products with similar characteristics, such as mortgage guaranty contracts and trade credit insurance. Proposed and final guidance from the FASB regarding accounting for financial guaranty insurance is expected to be issued in 2007. When and if the FASB or the SEC reaches a conclusion on these issues, we and the rest of the financial



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guaranty and mortgage insurance industries may be required to change some aspects of our accounting policies. If the FASB or the SEC were to determine that we should account for our financial guaranty contracts differently, for example by requiring them to be treated solely as one or the other of short-duration or long-duration contracts under SFAS No. 60, this determination could impact our accounting for loss reserves, premium revenue and deferred acquisition costs, all of which are covered by SFAS No. 60. Management is unable to estimate what impact, if any, the ultimate resolution of this issue will have on our business, financial condition or operating results.

### ***Our success depends on our ability to assess and manage our underwriting risks.***

Our mortgage insurance and financial guaranty premium rates may not adequately cover future losses. Our mortgage insurance premiums are based upon our expected risk of claims on insured loans, and take into account, among other factors, each loan's LTV, type (e.g., prime vs. non-prime or fixed vs. variable payments), term, coverage percentage or the existence of a deductible in front of our loss position. Similarly, our financial guaranty premiums are based upon our expected risk of claim on the insured obligation, and take into account, among other factors, the rating and creditworthiness of the issuer and of the insured obligations, the type of insured obligation, the policy term and the structure of the transaction being insured. In addition, our premium rates take into account expected cancellation rates, operating expenses and reinsurance costs, as well as profit and capital needs and the prices that we expect our competitors to offer.

We generally cannot cancel or elect not to renew the mortgage insurance or financial guaranty insurance coverage we provide, and because we generally fix premium rates for the life of a policy when issued, we cannot adjust renewal premiums or otherwise adjust premiums over the life of a policy. If the risk underlying a particular mortgage insurance or financial guaranty coverage develops more adversely than we anticipate, or if national and regional economies undergo unanticipated stress, we generally cannot increase premium rates on in-force business, cancel coverage or elect not to renew coverage to mitigate the effects of these adverse developments. Our premiums earned and the associated investment income on those premiums may ultimately prove to be inadequate to compensate for the losses that we may incur. An increase in the amount or frequency of claims beyond the levels contemplated by our pricing assumptions could have a material adverse effect on our business, financial condition and operating results.

### ***Our success depends, in part, on our ability to manage risks in our investment portfolio.***

Our income from our investment portfolio is one of our primary sources of cash flow to support our operations and claim payments. If we underestimate our policy liabilities, or if we improperly structure our investments to meet those liabilities, we could have unexpected losses, including losses resulting from forced liquidation of investments before their maturity. Our investments and investment policies and those of our subsidiaries are subject to state insurance laws. We may be forced to change our investments or investment policies depending upon regulatory, economic and market conditions and the existing or anticipated financial condition and operating requirements, including the tax position, of our business segments.

Our investment objectives may not be achieved. Although our portfolio consists mostly of highly-rated investments and complies with applicable regulatory requirements, the success of our investment activity is affected by general economic conditions, which may adversely affect the markets for interest-rate-sensitive securities, including the extent and timing of investor participation in these markets, the level and volatility of interest rates and, consequently, the value of our fixed-income securities. Volatility or illiquidity in the markets in which we directly or indirectly hold positions could have a material adverse effect on our business, financial condition and operating results.

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*As a holding company, we depend on our subsidiaries' ability to transfer funds to us to pay dividends and to meet our obligations.*

We act principally as a holding company for our insurance subsidiaries and do not have any significant operations of our own. Dividends from our subsidiaries, which include amounts received by our subsidiaries from our affiliates (C-BASS and Sherman), and permitted payments to us under our expense- and tax-sharing arrangements with our subsidiaries, along with income from our investment portfolio, are our principal sources of cash to pay stockholder dividends and to meet our obligations. These obligations include our operating expenses and interest and principal payments on long-term debt. The payment of dividends and other distributions to us by our insurance subsidiaries is regulated by insurance laws and regulations. In general, dividends in excess of prescribed limits are deemed extraordinary and require insurance regulatory approval. In addition, our insurance subsidiaries' ability to pay dividends to us, and our ability to pay dividends to our stockholders, is subject to various conditions imposed by the rating agencies for us to maintain our ratings. If the cash we receive from our subsidiaries pursuant to dividend payment and expense- and tax-sharing arrangements is insufficient for us to fund our obligations, we may be required to seek capital by incurring additional debt, by issuing additional equity or by selling assets, which we may be unable to do on favorable terms, if at all. The need to raise additional capital or the failure to make timely payments on our obligations could have a material adverse effect on our business, financial condition and operating results.

*Our reported earnings are subject to fluctuations based on changes in our credit derivatives that require us to adjust their fair market value as reflected on our income statement.*

Our business includes the provision of credit enhancement in the form of derivative contracts. The gains and losses on these derivative contracts are derived from internally generated models, which may differ from models used by our counterparties or others in the industry. We estimate fair value amounts using market information, to the extent available, and valuation methodologies that we deem appropriate. The gains and losses on assumed derivative contracts are provided by the primary insurance companies. Considerable judgment is required to interpret available market data to develop the estimates of fair value. Accordingly, our estimates are not necessarily indicative of amounts we could realize in a current market exchange, due to, among other factors, the lack of a liquid market. Temporary market changes as well as actual credit improvement or deterioration in these contracts are reflected in mark-to-market gains and losses. Because these adjustments are reflected on our income statement, they affect our reported earnings and create earnings volatility even though they might not have a cash flow effect.

*The performance of our strategic investments could harm our financial results.*

Part of our business involves strategic investments in other companies, and we generally do not have control over the way that these companies run their day-to-day operations. In particular, our financial services segment consists of our strategic interests in C-BASS and Sherman. At December 31, 2006, we had investments in affiliates of \$618.8 million. Our ability to engage in additional strategic investments is subject to the availability of capital and maintenance of the insurance financial strength ratings of our insurance subsidiaries. The performance of our strategic investments could be harmed by:

the performance of our strategic affiliates;

changes in the financial markets generally and in the industries in which our strategic affiliates operate, including increased competition from new entrants in these industries such as large investment and commercial banks;

significant litigation involving the companies in which we hold a strategic interest or other significant costs incurred by such companies in complying with regulatory or other applicable laws;

changes in interest rates or other macroeconomic factors that might diminish the profitability of these businesses; or

the ability of our strategic affiliates to obtain or renew financing upon reasonable terms.

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C-BASS is particularly exposed to mortgage credit risk as a result of its investing in and servicing non-prime, residential mortgage assets, which bear a high risk of default. As a result, the same macroeconomic factors that negatively affect losses in our mortgage insurance business (*e.g.*, deterioration of general economic conditions such as increasing unemployment rates) also would likely negatively affect C-BASS's results of operations. Similarly, a prolonged period of declining home price appreciation is likely to increase C-BASS's credit losses.

C-BASS's results could vary significantly from period to period. As part of its business, C-BASS securitizes non-conforming mortgages into mortgage-backed securities. As a result, a portion of C-BASS's income depends on its ability to sell different tranches of its securities in the capital markets, which can be volatile, depending on interest rates, credit spreads and liquidity. In addition, C-BASS also owns mortgage-backed securities, some of which can be called for redemption, particularly in low interest-rate environments. Redemptions can result in volatility in C-BASS's quarterly results as can the application of accounting rules that require C-BASS to mark many components of its balance sheet to market. Although there has been growth in the volume of non-conforming mortgage originations in recent years, growth in this industry may not continue if interest rates continue to rise or competition in the industry continues to increase. If C-BASS is unable to continue to successfully grow its portfolio of non-conforming mortgages, its income could be negatively affected. C-BASS is also dependent on its ability to obtain or renew financing on satisfactory terms.

Sherman's results could be adversely impacted by increased pricing competition for the pools of consumer assets it purchases, as well as a reduction in the success of its collection efforts due to macroeconomic or other factors. In addition, results of its credit card origination business are sensitive to interest-rate changes, charge-off losses and the success of its collection efforts.

As a result of their significant amount of collection efforts, there is a risk that either C-BASS or Sherman could be subject to consumer related lawsuits and other investigations related to fair debt collection practices, which could have an adverse effect on C-BASS's or Sherman's income, reputation and future ability to conduct business.

### ***Our international operations subject us to numerous risks.***

We have committed and may in the future commit additional significant resources to expand our international operations, particularly in the United Kingdom and Australia. Accordingly, we are subject to a number of risks associated with our international business activities, including:

dependence on regulatory and third-party approvals;

changes in ratings or outlooks assigned to our foreign insurance subsidiaries by rating agencies;

challenges in attracting and retaining key foreign-based employees, customers and business partners in international markets;

foreign governments' monetary policies and regulatory requirements;

economic downturns in targeted foreign mortgage origination markets;

interest-rate volatility in a variety of countries;

our lack of significant institutional experience (compared to the domestic U.S. market) with foreign mortgage credit risks and foreclosure proceedings and customs;

political risk and risks of war, terrorism, civil disturbances or other events that may limit or disrupt markets;

the burdens of complying with a wide variety of foreign regulations and laws, some of which are materially different than the regulatory and statutory requirements we face in our domestic business, and which may change unexpectedly;

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potentially adverse tax consequences;

restrictions on the repatriation of earnings;

foreign currency exchange rate fluctuations; and

the need to develop and market products appropriate to the various foreign markets.

Any one or more of the risks listed above could limit or prohibit us from developing our international operations profitably. In addition, we may not be able to effectively manage new operations or successfully integrate them into our existing operations, which could have a material adverse effect on our business, financial condition or operating results.

### ***Our business may suffer if we are unable to meet our customers' technological demands.***

Participants in the mortgage insurance and financial guaranty industries rely on e-commerce and other technologies to provide and expand their products and services. Our customers generally require that we provide aspects of our products and services electronically, and the percentage of our new insurance written and claims processing that we deliver electronically has continued to increase. We expect this trend to continue and, accordingly, we may be unable to satisfy our customers' requirements if we fail to invest sufficient resources or otherwise are unable to maintain and upgrade our technological capabilities. This may result in a decrease in the business we receive, which could impact our profitability.

### ***Our information technology systems may not be configured to process information regarding new and emerging products.***

Many of our information technology systems have been in place for a number of years, and many of them originally were designed to process information regarding traditional products. As new products such as reduced documentation or interest-only mortgages with new features emerge, or when we insure structured transactions with unique features, our systems may require modification in order to recognize these features to allow us to price or bill for our insurance of these products appropriately. Our systems also may not be capable of recording, or may incorrectly record, information about these products that may be important to our risk management and other functions. In addition, our customers may encounter similar technological issues that prevent them from sending us complete information about the products or transactions that we insure. Making appropriate modifications to our systems involves inherent time lags and may require us to incur significant expenses. The inability to make necessary modifications to our systems in a timely and cost-effective manner may have adverse effects on our business, financial condition and operating results.

### ***We face risks related to our proposed merger with MGIC.***

There are significant risks and uncertainties associated with our proposed merger with MGIC. For example, the merger may not be consummated, or may not be consummated in the fourth quarter of 2007 as currently anticipated, as a result of a number of factors, including, without limitation, the inability to obtain governmental approvals of the merger on the proposed terms or the failure of either company to receive stockholder approval for the merger. In addition, the combined company may fail to realize the revenue enhancements and cost savings anticipated to be derived from the merger. If the combined company is not able to combine successfully the businesses of Radian and MGIC, the anticipated benefits from the merger may not be realized fully or at all or may take longer to realize than expected. For example, it is possible that the integration process could result in the loss of key employees, complications in combining Radian's and MGIC's operations, or that the disruption of ongoing business from the merger could adversely affect each company's ability to maintain relationships with customers.

Upon completion of the merger, certain of our reinsurance customers will have the right to recapture reinsurance business previously assumed by Radian Asset Assurance. At December 31, 2006, Radian Asset

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Assurance had assumed an aggregate of approximately \$10 billion par in force and approximately \$70 million of unearned premium reserves (a small portion of which is not subject to recapture) from these customers. If all these customers were to recapture all of their reinsurance business assumed by Radian Asset Assurance, Radian Asset Assurance would experience an estimated reduction of approximately \$88 million of written premiums, as well as immediate reductions of approximately \$18 million of earned premiums, \$12 million in acquisition costs, and \$6.0 million in incurred losses, which would result in a pretax gain of approximately \$0.5 million. If all this reinsurance business were recaptured, we estimate that Radian Asset Assurance would have to disburse \$55 million in cash to settle the recaptures. We cannot be certain as to whether the merger will be consummated, and if so whether any or which of these customers will recapture all or any portion of this business upon consummation of the merger or the exact impact of the actual recapture, if any.

### **Risks Particular to Our Mortgage Insurance Business**

*A decrease in the volume of high-LTV home mortgage originations or an increase in the volume of cancellations or non-renewals of our existing policies could have a significant effect on our revenues.*

We generally provide private mortgage insurance on high-LTV home mortgages. Factors that could lead to a decrease in the volume of high-LTV home mortgage originations, and consequently, reduce the demand for our mortgage insurance products, include:

a decline in economic conditions generally or in conditions in regional and local economies such as have existed recently in the Midwestern United States;

the level of home mortgage interest rates;

adverse population trends, lower homeownership rates and the rate of household formation; and

changes in government housing policies encouraging loans to first-time homebuyers.

Most of our mortgage insurance premiums earned each month are derived from the monthly renewal of policies that we previously have written. As a result, a decrease in the length of time that our mortgage insurance policies remain in force reduces our revenues and could have a material adverse effect on our business, financial condition and operating results. Fannie Mae and Freddie Mac generally permit homeowners to cancel their mortgage insurance when the principal amount of a mortgage falls below 80% of the home's value. Factors that are likely to increase the number of cancellations or non-renewals of our mortgage insurance policies include:

falling mortgage interest rates (which tends to lead to increased refinancings and associated cancellations of mortgage insurance);

appreciating home values; and

changes in the mortgage insurance cancellation requirements applicable to mortgage lenders and homeowners.

*Because our mortgage insurance business is concentrated among relatively few major customers, our revenues could decline if we lose any significant customer.*

Our mortgage insurance business depends to a significant degree on a small number of customers. Our top ten mortgage insurance customers are generally responsible for half of both our primary new insurance written in a given year and our direct primary risk in force. This concentration of business may increase as a result of mergers of those customers or other factors. Our master policies and related lender agreements do not, and by law cannot, require our mortgage insurance customers to do business with us. The loss of business from even one of our major customers could have a material adverse effect on our business franchise and operating results.



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***A large portion of our mortgage insurance risk in force consists of loans with high-LTV ratios and loans that are non-prime, or both, which generally result in more and larger claims than loans with lower-LTV ratios and prime loans.***

We generally provide private mortgage insurance on mortgage products that have more risk than those mortgage products that meet the GSE's classification of conforming loans. A large portion of our mortgage insurance in force consists of insurance on mortgage loans with LTVs at origination of more than 90%. Mortgage loans with LTVs greater than 90% are expected to default substantially more often than those with lower LTVs. In addition, when we are required to pay a claim on a higher LTV loan, it is generally more difficult to recover our costs from the underlying property, especially in areas with declining property values.

Due to competition for prime loan business from lenders offering alternative arrangements, such as simultaneous second mortgages, a large percentage of the mortgage insurance that we write and, consequently, our mortgage insurance in force, is on non-prime loans. In 2006, non-prime business accounted for \$17.5 billion or 43.7% of our new primary mortgage insurance written (80.2% of which was Alt-A), compared to \$17.8 billion or 41.7% in 2005 (63.3% of which was Alt-A). At December 31, 2006, non-prime mortgage insurance in force was \$37.0 billion or 32.5% of total primary insurance in force, compared to \$34.7 billion or 31.7% of primary insurance in force at December 31, 2005. Although we historically have limited the insurance of these non-prime loans to those made by lenders with good results and servicing experience in this area, because of the lack of data regarding the performance of non-prime loans, in particular in an uncertain housing market, and our relative inexperience in insuring these loans, we may fail to estimate default rates properly and may incur larger losses than we anticipate, which could have a material adverse effect on our business, financial condition and operating results. In general, non-prime loans are more likely to go into default and require us to pay claims than prime loans. In addition, some of our non-prime business, in particular Alt-A loans, tends to have larger loan balances relative to our other loans. We cannot be certain that the increased premiums that we charge for mortgage insurance on non-prime loans will be adequate to compensate us for the losses we incur on these products.

We use Smart Home reinsurance arrangements as a way of managing our exposure to unproven products and non-prime risk. Under these arrangements, we cede a portion of the risk associated with a portfolio of mostly non-prime residential mortgage loans insured by us to an unaffiliated reinsurance company. The reinsurance company in turn issues credit-linked notes to investors in the capital markets. As a consequence of these arrangements, we are able to effectively transfer a portion of the risk associated with non-prime and unproven products that we would otherwise hold to investors that are willing to hold the risk in exchange for payments of interest and principal on the credit-linked notes. By ceding risk in this manner, we are able to continue to take on more non-prime risk and exposure to unproven products and the higher premiums associated with insuring these types of products. As a result, we consider Smart Home arrangements to be very important to our ability to effectively manage our risk profile and to remain competitive in these markets. Because the Smart Home arrangement ultimately depends on the willingness of investors to invest in Smart Home securities, we cannot be certain that Smart Home will always be available to us or will be available on terms that are acceptable to us. If we are unable to continue to use Smart Home arrangements, our ability to participate in the non-prime mortgage market could be limited, which could have an adverse effect on our operating results.

***Some of our mortgage insurance products are riskier than traditional mortgage insurance.***

We offer pool mortgage insurance, which exposes us to different risks than the risks applicable to primary mortgage insurance. Our pool mortgage insurance products generally cover all losses in a pool of loans up to our aggregate exposure limit, which generally is between 1% and 10% of the initial aggregate loan balance of the entire pool of loans. Under pool insurance, we could be required to pay the full amount of every loan in the pool within our exposure limits that is in default and upon which a claim is made until the aggregate limit is reached, rather than a percentage of the loan amount, as is the case with traditional primary mortgage insurance. At December 31, 2006, \$3.0 billion of our mortgage insurance risk in force was attributable to pool insurance.



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At December 31, 2006, approximately 28% of our mortgage insurance risk in force consists of ARMs (19% of our mortgage insurance in force relates to ARMs with resets of less than five years from origination), including loans with negative amortization features, such as pay option ARMs. We consider a loan an ARM if the interest rate for that loan will reset at any point during the life of the loan. It has been our experience that ARMs with resets of less than five years from origination are more likely to result in a claim than longer-term ARMs. Our claim frequency on ARMs has been higher than on fixed-rate loans due to monthly payment increases that occur when interest rates rise or when the teaser rate (an initial interest rate that does not fully reflect the index which determines subsequent rates) expires. We believe that claims on ARMs will continue to be substantially higher than for fixed-rate loans during prolonged periods of rising interest rates, although the performance of ARMs has not been fully tested in such an environment. In addition, at December 31, 2006, approximately 5.8% of our primary mortgage insurance risk in force consists of interest-only mortgages, where the borrower pays only the interest charge on a mortgage for a specified period of time, usually five to ten years, after which the loan payment increases to include principal payments. These loans may have a heightened propensity to default because of possible payment shocks after the initial low-payment period expires and because the borrower does not automatically build equity as payments are made. As of December 31, 2006, approximately 1% of our primary mortgage insurance risk in force consists of loans for which interest rates are scheduled to reset during 2007, with most of our option ARMs and interest only loans having first time resets in 2009 or later.

We also write credit insurance on non-traditional, mortgage-related assets such as second mortgages, home equity loans and mortgages with LTVs above 100%, provide credit enhancement to mortgage-related capital market transactions such as net interest margin securities and credit default swaps, and have in the past and may again write credit insurance on manufactured housing loans. These types of insurance generally have higher claim payouts than traditional mortgage insurance products. We have less experience writing these types of insurance and less performance data on this business, which could lead to greater losses than we anticipate. Greater than anticipated losses could have a material adverse effect on our business, financial condition and operating results.

***An increasing concentration of servicers in the mortgage lending industry could lead to disruptions in the servicing of mortgage loans that we insure, resulting in increased delinquencies.***

We depend on reliable, consistent third-party servicing of the loans that we insure. A recent trend in the mortgage lending and mortgage loan servicing industry has been towards consolidation of loan servicers. This reduction in the number of servicers could lead to disruptions in the servicing of mortgage loans covered by our insurance policies. This, in turn, could contribute to a rise in delinquencies among those loans and could have a material adverse effect on our business, financial condition and operating results.

***We face the possibility of higher claims as our mortgage insurance policies age.***

Historically, most claims under private mortgage insurance policies on prime loans occur during the third through fifth year after issuance of the policies, and under policies on non-prime loans during the second through fourth year after issuance of the policies. Low mortgage interest-rate environments tend to lead to increased refinancing of mortgage loans and to lower the average age of our mortgage insurance policies. On the other hand, increased interest rates tend to reduce mortgage refinancings and cause a greater percentage of our mortgage insurance risk in force to reach its anticipated highest claim frequency years. In addition, periods of growth in our business tend to reduce the average age of our policies. For example, the relatively recent growth of our non-prime mortgage insurance business means that a significant percentage of our insurance in force on non-prime loans has not yet reached its anticipated highest claim frequency years. If the growth of our new business were to slow or decline, a greater percentage of our total mortgage insurance in force could reach its anticipated highest claim frequency years. A resulting increase in claims could have a material adverse effect on our business, financial condition and operating results.

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### ***Our delegated underwriting program may subject our mortgage insurance business to unanticipated claims.***

In our mortgage insurance business, we enter into agreements with our mortgage lender customers that commit us to insure loans using pre-established underwriting guidelines. Once we accept a lender into our delegated underwriting program, we generally insure a loan originated by that lender even if the lender does not follow our specified underwriting guidelines. Under this program, a lender could commit us to insure a material number of loans with unacceptable risk profiles before we discover the problem and terminate that lender's delegated underwriting authority. Even if we terminate a lender's underwriting authority, we remain at risk for any loans previously insured on our behalf by the lender before that termination. The performance of loans insured through programs of delegated underwriting has not been tested over a period of extended adverse economic conditions, meaning that the program could lead to greater losses than we anticipate. Greater than anticipated losses could have a material adverse effect on our business, financial condition and operating results.

### ***We face risks associated with our contract underwriting business.***

As part of our mortgage insurance business, we provide contract underwriting services to some of our mortgage lender customers, even with respect to loans for which we are not providing mortgage insurance. Under the terms of our contract underwriting agreements, we agree that if we make mistakes in connection with these underwriting services, the mortgage lender may, subject to certain conditions, require us to purchase the loans or issue mortgage insurance on the loans, or to indemnify the lender against future loss associated with the loans. Accordingly, we assume some credit risk and interest-rate risk in connection with providing these services. In a rising interest-rate environment, the value of loans that we are required to repurchase could decrease, and consequently, our costs of those repurchases could increase. In 2006, we underwrote \$3.0 billion in principal amount of loans through contract underwriting. Depending on market conditions, a significant amount of our underwriting services may be performed by independent contractors hired by us on a temporary basis. If these independent contractors make more mistakes than we anticipate, the resulting need to provide greater than anticipated recourse to mortgage lenders could have a material adverse effect on our business, financial condition and operating results.

### ***If housing values fail to appreciate or begin to decline, we may be less able to recover amounts paid on defaulted mortgages.***

The amount of loss we suffer, if any, depends in part on whether the home of a borrower who has defaulted on a mortgage can be sold for an amount that will cover unpaid principal and interest on the mortgage and expenses from the sale. If a borrower defaults under our standard mortgage insurance policy, generally we have the option of paying the entire loss amount and taking title to a mortgaged property or paying our coverage percentage in full satisfaction of our obligations under the policy. In the recent past, we have been able to take title to the properties underlying certain defaulted loans and to sell the properties quickly at prices that have allowed us to recover some of our losses. In the current housing market, in which housing values have failed to appreciate or have begun to decline in certain regions, our ability to mitigate our losses in such manner has been reduced. If housing values fail to appreciate or begin to decline on a more significant and larger geographic basis, the frequency of loans going to claim could increase and our ability to mitigate our losses on defaulted mortgages may be significantly reduced, which could have a material adverse effect on our business, financial condition and operating results.

### ***Our mortgage insurance business faces intense competition from other mortgage insurance providers and from alternative products.***

The United States mortgage insurance industry is highly dynamic and intensely competitive. Our competitors include:

other private mortgage insurers, some of which are subsidiaries of well-capitalized companies with stronger insurance financial strength ratings and greater access to capital than we have;

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federal and state governmental and quasi-governmental agencies, principally the VA and the FHA, which has increased its competitive position in areas with higher home prices by streamlining its down-payment formula and reducing the premiums it charges; and

mortgage lenders that demand increased participation in revenue-sharing arrangements such as captive reinsurance arrangements. Governmental and quasi-governmental entities typically do not have the same capital requirements that we and other mortgage insurance companies have, and therefore, may have financial flexibility in their pricing and capacity that could put us at a competitive disadvantage. In the event that a government-owned or sponsored entity in one of our markets decides to reduce prices significantly or alter the terms and conditions of its mortgage insurance or other credit enhancement products in furtherance of social or other goals rather than a profit motive, we may be unable to compete in that market effectively, which could have an adverse effect on our business, financial condition and operating results.

In addition, there are an increasing number of alternatives to traditional private mortgage insurance, and new alternatives may develop, which could reduce the demand for our mortgage insurance. Existing alternatives include:

mortgage lenders structuring mortgage originations to avoid private mortgage insurance, mostly through 80-10-10 loans or other forms of simultaneous second loans. The use of simultaneous second loans has increased significantly during recent years and is likely to continue to be a competitive alternative to private mortgage insurance, particularly in light of (1) the potential lower monthly cost of simultaneous second loans compared to the cost of mortgage insurance in a low-interest-rate environment and (2) possible negative borrower, broker and realtor perceptions about mortgage insurance;

investors using other forms of credit enhancement such as credit default swaps or securitizations as a partial or complete substitute for private mortgage insurance; and

mortgage lenders and other intermediaries that forego third-party insurance coverage and retain the full risk of loss on their high-LTV loans.

Much of the competition described above is directed at prime loans, which has led us to shift more of our business to insuring riskier, non-prime loans. In addition, the intense competition we face in the mortgage insurance industry requires that we dedicate time and energy to the development and introduction of competitive new products and programs. Our inability to compete with other providers and the various alternatives to traditional mortgage insurance, including the timely introduction of profitable new products and programs, or our incurring increased losses as a result of insuring more non-prime loans could have a material adverse effect on our business, financial condition and operating results.

***Because many of the mortgage loans that we insure are sold to Fannie Mae and Freddie Mac, changes in their charters or business practices could significantly impact our mortgage insurance business.***

Fannie Mae's and Freddie Mac's charters generally prohibit them from purchasing any mortgage with a loan amount that exceeds 80% of the home's value, unless that mortgage is insured by a qualified insurer or the mortgage seller retains at least a 10% participation in the loan or agrees to repurchase the loan in the event of a default. As a result, high-LTV mortgages purchased by Fannie Mae or Freddie Mac generally are insured with private mortgage insurance. Fannie Mae and Freddie Mac are the beneficiaries of the majority of our mortgage insurance policies.

Changes in the charters or business practices of Fannie Mae or Freddie Mac could reduce the number of mortgages they purchase that are insured by us and consequently reduce our revenues. Some of Fannie Mae's and Freddie Mac's more recent programs require less insurance coverage than they historically have required, and they have the ability to further reduce coverage requirements, which could reduce demand for mortgage

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insurance and have a material adverse effect on our business, financial condition and operating results. Fannie Mae and Freddie Mac also have the ability to implement new eligibility requirements for mortgage insurers and to alter or liberalize underwriting standards on low-down-payment mortgages they purchase. We cannot predict the extent to which any new requirements may be implemented or how they may affect the operations of our mortgage insurance business, our capital requirements and our products.

Fannie Mae's and Freddie Mac's business practices may be impacted by legislative or regulatory changes governing their operations and the operations of other government-sponsored enterprises. Fannie Mae and Freddie Mac currently are subject to ongoing investigations regarding their accounting practices, disclosures and other matters, and legislation proposing increased regulatory oversight over them is currently under consideration in the U.S. Congress. The proposed legislation encompasses substantially all of the operations of Fannie Mae and Freddie Mac and is intended to be a comprehensive overhaul of the existing regulatory structure. Although we cannot predict whether, or in what form, this legislation will be enacted, the proposed legislation could limit the growth of Fannie Mae and Freddie Mac, which could reduce the size of the mortgage insurance market and consequently have an adverse effect on our business, financial condition and operating results.

### ***Legislation and regulatory changes and interpretations could harm our mortgage insurance business.***

Our business and legal liabilities may be affected by the application of federal or state consumer lending and insurance laws and regulations, or by unfavorable changes in these laws and regulations. For example, legislation is currently pending in the U.S. Congress to reform the FHA, which, if enacted, could provide the FHA with greater flexibility in establishing new products and increase the FHA's competitive position against private mortgage insurers. We do not know whether this proposed legislation, which includes increasing the maximum loan amount that the FHA can insure and allowing the FHA to use risk-based pricing in setting its premiums, will be enacted, and, if enacted, what form the legislation may take. Any increase in the competition we face from the FHA or any other government sponsored entities could harm our business, financial condition and operating results.

We and other mortgage insurers have faced private lawsuits alleging, among other things, that our captive reinsurance arrangements constitute unlawful payments to mortgage lenders under the anti-referral fee provisions of RESPA. In addition, we and other mortgage insurers have been subject to inquiries from the New York Insurance Department (NYID) relating to our captive reinsurance arrangements. We cannot predict whether the NYID's inquiry will lead to further inquiries, or investigations, of our captive arrangements, or the scope, timing or outcome of the present inquiry or any other inquiry or action by the NYID or other regulators. Although we believe that all of our captive reinsurance arrangements comply with applicable legal requirements, we cannot be certain that we will be able to successfully defend against any alleged violations of RESPA or other laws.

Proposed changes to the application of RESPA could harm our competitive position. HUD proposed an exemption under RESPA for lenders that, at the time a borrower submits a loan application, give the borrower a firm, guaranteed price for all the settlement services associated with the loan, commonly referred to as "bundling." In 2004, HUD indicated its intention to abandon the proposed rule and to submit a revised proposed rule to the U.S. Congress. HUD began looking at the reform process again in 2005 and there may be a new proposed rule as early as 2007. We do not know what form, if any, the rule will take or whether it will be approved. If bundling is exempted from RESPA, mortgage lenders may have increased leverage over us, and the premiums we are able to charge for mortgage insurance could be negatively affected.

### **Risks Particular to Our Financial Guaranty Business**

***Our financial guaranty business may subject us to significant risks from the failure of a single company, municipality or other entity whose obligations we have insured.***

The breadth of our financial guaranty business exposes us to potential losses in a variety of our products as a result of credit problems with one counterparty. For example, we could be exposed to an individual corporate credit risk in multiple transactions if the credit is contained in multiple portfolios of collateralized debt

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obligations that we have insured, or if one counterparty (or its affiliates) acts as the originator or servicer of the underlying assets or loans backing any of the structured securities that we have insured. Although we track our aggregate exposure to single counterparties in our various lines of business and have established underwriting criteria to manage aggregate risk from a single counterparty, we cannot be certain that our ultimate exposure to a single counterparty will not exceed our underwriting guidelines, due to merger or otherwise, or that an event with respect to a single counterparty will not cause a significant loss in one or more of the transactions in which we face risk to such counterparty. In addition, because we insure and reinsure municipal obligations, we can have significant exposures to individual municipal entities, directly or indirectly through explicit or implicit support of related entities. Even though we believe that the risk of a complete loss on some municipal obligations generally is lower than for corporate credits because some municipal bonds are backed by taxes or other pledged revenues, a single default by a municipality could have a significant impact on our liquidity or could result in a large or even complete loss that could have a material adverse effect on our business, financial condition and operating results.

***Our financial guaranty business is concentrated among relatively few significant customers, meaning that our revenues could decline if we lose any significant customer.***

Our financial guaranty business derives a significant percentage of its annual gross premiums from a small number of customers. A loss of business from even one of our significant customers could have a material adverse effect on our business, financial condition and operating results. Our largest single customer in terms of premiums written for our financial guaranty business accounted for over 13% of the premiums written by our financial guaranty business in 2006.

***Some of our financial guaranty products are riskier than traditional guaranties of public finance obligations.***

In addition to the traditional guaranties of public finance bonds, we write guaranties involving structured finance obligations that expose us to a variety of complex credit risks and indirectly to market, political and other risks beyond those that generally apply to financial guaranties of public finance obligations. We issue financial guaranties connected with certain asset-backed transactions and securitizations secured by one or a few classes of assets, such as residential mortgages, auto loans and leases, credit card receivables and other consumer assets, obligations under credit default swaps, both funded and synthetic, and in the past have issued financial guaranties covering utility mortgage bonds and multi-family housing bonds. We also have exposure to trade credit reinsurance (which is currently in run-off), which protects sellers of goods under certain circumstances against nonpayment of their accounts receivable. These guaranties expose us to the risk of buyer nonpayment, which could be triggered by many factors, including the failure of a buyer's business. These guaranties may cover receivables where the buyer and seller are in the same country as well as cross-border receivables. In the case of cross-border transactions, we sometimes grant coverage that effectively provides coverage of losses that could result from political risks, such as foreign currency controls and expropriation, which could interfere with the payment from the buyer. Losses associated with these non-public finance financial guaranty products are difficult to predict accurately, and a failure to properly anticipate those losses could have a material adverse effect on our business, financial condition and operating results.

***We may be forced to reinsure greater risks than we desire due to adverse selection by ceding companies.***

A portion of our financial guaranty reinsurance business is written under treaties that generally give the ceding company some ability to select the risks that they cede to us within the terms of the treaty. There is a risk under these treaties that the ceding companies will decide to cede to us exposures that have higher rating agency capital charges or that the ceding companies expect to be less profitable, which could have a material adverse effect on our business, financial condition and operating results. We attempt to mitigate this risk in a number of ways, including requiring ceding companies to retain a specified minimum percentage on a pro-rata basis of the ceded business, but we cannot be certain that our mitigation attempts will succeed.

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### ***Our financial guaranty business faces intense competition.***

The financial guaranty industry is highly competitive. The principal sources of direct and indirect competition are:

other financial guaranty insurance companies;

multiline insurers that have increased their participation in financial guaranty reinsurance, some of which have formed strategic alliances with some of the U.S. primary financial guaranty insurers;

other forms of credit enhancement, including letters of credit, guaranties and credit default swaps provided in most cases by foreign and domestic banks and other financial institutions, some of which are governmental enterprises, that have been assigned the highest ratings awarded by one or more of the major rating agencies or have agreed to post collateral to support their risk position;

alternate transaction structures that permit issuers to securitize assets more cost-effectively without the need for credit enhancement of the types we provide; and

cash-rich investors seeking additional yield on their investments by foregoing credit enhancement.

Competition in the financial guaranty reinsurance business is based on many factors, including overall financial strength, financial strength ratings, pricing and service. The rating agencies allow credit to a ceding company's capital requirements and single risk limits for reinsurance that is ceded. The amount of this credit is in part determined by the financial strength rating of the reinsurer. Some of our competitors have greater financial resources than we have and are better capitalized than we are and/or have been assigned higher ratings by one or more of the major rating agencies. In addition, the rating agencies could change the level of credit they will allow a ceding company to take for amounts ceded to us and/or similarly rated reinsurers.

In 2004, the laws applicable to New York-domiciled monoline financial guarantors were amended to permit them to use certain default swaps meeting applicable requirements as statutory collateral (*i.e.*, to offset their statutory single risk limits, aggregate risk limits, aggregate net liability calculations and contingency reserve requirements). This regulatory change, which makes credit default swaps a more attractive alternative to traditional financial guaranty reinsurance, could result in a reduced demand for traditional monoline financial guaranty reinsurance in the future. An inability to compete for desirable financial guaranty business could have a material adverse effect on our business, financial condition and operating results.

### ***Legislation and regulatory changes and interpretations could harm our financial guaranty business.***

The laws and regulations affecting the municipal, asset-backed and trade credit debt markets, as well as other governmental regulations, could be changed in ways that subject us to additional legal liability or affect the demand for the primary financial guaranty insurance and reinsurance that we provide. Any such change could have a material adverse effect on our business, financial condition and operating results.

### ***Changes in tax laws could reduce the demand for or profitability of financial guaranty insurance, which could harm our business.***

Any material change in the U.S. tax treatment of municipal securities, or the imposition of a flat tax or a national sales tax in lieu of the current federal income tax structure in the United States, could adversely affect the market for municipal obligations and, consequently, reduce the demand for related financial guaranty insurance and reinsurance. For example, the Jobs and Growth Tax Relief Reconciliation Act of 2003, enacted in May 2003, significantly reduced the federal income tax rate for individuals on dividends and long-term capital gains. This tax change may reduce demand for municipal obligations and, in turn, may reduce the demand for financial guaranty insurance and reinsurance of these obligations by increasing the comparative yield on dividend-paying equity securities. Future potential changes in U.S. tax laws, including current efforts to eliminate the federal income tax on dividends, might also affect demand for municipal obligations and for financial guaranty insurance and reinsurance of those obligations.



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*We may be unable to develop or sustain our financial guaranty business if it cannot obtain reinsurance or other forms of capital.*

In order to comply with regulatory, rating agency and internal capital and single risk retention limits as our financial guaranty business grows, we need access to sufficient reinsurance or other capital capacity to underwrite transactions. The market for reinsurance recently has become more concentrated because several participants have exited the industry. If we are unable to obtain sufficient reinsurance or other forms of capital, we may be unable to issue new policies and grow our financial guaranty business. This could have a material adverse effect on our business, financial condition and operating results.

### **Item 1B. Unresolved Staff Comments.**

None.

### **Item 2. Properties.**

At our corporate headquarters in Philadelphia, Pennsylvania, we lease approximately 152,500 square feet of office space under a lease that expires in August 2017. In addition, we also lease the following:

Approximately 22,000 square feet of office space for our mortgage insurance regional offices, service centers and on-site offices throughout the United States. The leases for this space expire between 2007 and 2012;

Approximately 121,000 square feet of office space (approximately 63,000 square feet of which we sublease to others) for our financial guaranty operations in New York City. The lease for this space expires in 2015;

Approximately 6,600 square feet of office space for our international mortgage insurance and financial guaranty operations in London. The lease for this space expires in 2012;

Approximately 500 square feet of office space for our mortgage insurance operations in Hong Kong. The lease for this space expires September 30, 2007;

Approximately 500 square feet of office space for our Australian operations in Sydney, Australia. The lease for this space expires in March 2007; and

Approximately 16,400 and 27,000 square feet of office space for our data centers in Philadelphia, Pennsylvania and Dayton, Ohio, respectively. The leases for these offices expire in September 2012 (Philadelphia) and August 2015 (Dayton). The lease for our Dayton, Ohio data center has an early termination option that may be executed by us anytime after May 2007.

With respect to all of our facilities, we believe we will be able to obtain satisfactory lease renewal terms. We believe our existing properties are well utilized, suitable and adequate for our present circumstances.

Our two data centers (Dayton and Philadelphia) serve as one another's disaster recovery sites and support all of our businesses. We have verified that these data centers and disaster recovery sites work properly. We have established hot site recovery plans for London, New York and Philadelphia from a business continuity standpoint.





**Table of Contents****Part II****Item 3. Legal Proceedings.**

We are involved in litigation that has arisen in the normal course of our business. We are contesting the allegations in each such pending action and believe, based on current knowledge and after consultation with counsel, that the outcome of such litigation will not have a material adverse effect on our consolidated financial position and results of operations.

**Item 4. Submission of Matters to a Vote of Security Holders.**

None.

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Our common stock is listed on the New York Stock Exchange ( NYSE ) under the symbol RDN. At February 26, 2007, there were 79,934,586 shares outstanding and approximately 110 holders of record. The following table shows the high and low sales prices of our common stock on the NYSE for the financial quarters indicated:

	2006		2005	
	High	Low	High	Low
1st Quarter	\$ 61.41	\$ 54.53	\$ 53.36	\$ 46.15
2nd Quarter	65.80	57.68	48.08	42.90
3rd Quarter	65.18	57.95	54.58	47.00
4th Quarter	62.08	51.61	60.38	47.40

We declared cash dividends on our common stock equal to \$0.02 per share in each quarter of 2006 and 2005. As a holding company, we depend mainly upon our subsidiaries' ability to transfer funds to us in order to pay dividends. The payment of dividends and other distributions to us by our insurance subsidiaries is regulated by insurance rules and regulations. For more information on our ability to pay dividends, see

Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources in Item 7 and Note 10 of Notes to Consolidated Financial Statements.

The following table provides information about repurchases by us during the quarter ended December 31, 2006, of equity securities that are registered by us pursuant to Section 12 of the Exchange Act.

**Issuer Purchases of Equity Securities**

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of	Maximum Number of
			Shares Purchased	Shares that May Yet
			as Part of Publicly	Be Purchased Under
			Announced Plans	the Plans or
	Shares Purchased	per Share	or Programs (1)	Programs (2)
10/01/06 to 10/31/06	690,000	\$ 54.62	690,000	310,000
11/01/06 to 11/30/06	367,200	53.23	367,200	1,942,800
12/01/06 to 12/31/06	442,800	53.79	442,800	1,500,000

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Total	1,500,000	\$	54.03	1,500,000
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- (1) On February 8, 2006, we announced that our board of directors had authorized the repurchase of up to 4.0 million shares of our common stock on the open market under a new repurchase plan. On November 9, 2006, we announced that our board of directors had authorized the purchase of an additional 2.0 million shares as part of an expansion of the existing stock repurchase program. Stock purchases under this program are funded from available working capital and are made from time to time, depending on market conditions, stock price and other factors. The board did not set an expiration date for this program.
- (2) Amounts shown in this column reflect the number of shares remaining under the 4.0 million share authorization and, effective November 9, 2006, the additional 2.0 million share authorization referenced in Note 1 above.

**Table of Contents****Item 6. Selected Financial Data.**

The following table sets forth our selected financial data. This information should be read in conjunction with our Consolidated Financial Statements, related notes included in Item 8 of this report and the information included in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

	2006	2005	2004	2003	2002
	(In millions, except per-share amounts and ratios)				
Condensed Consolidated Statements of Income					
Net premiums written	\$ 1,112.0	\$ 1,100.7	\$ 1,082.5	\$ 1,110.5	\$ 954.9
Net premiums earned	\$ 1,015.8	\$ 1,018.7	\$ 1,029.5	\$ 1,008.2	\$ 847.1
Net investment income	234.3	208.4	204.3	186.2	178.8
Net gains on securities	40.8	36.6	50.8	17.4	10.5
Change in fair value of derivative instruments	16.1	9.2	47.1	4.1	(13.0)
Other income	20.9	25.2	32.3	63.3	44.4
Total revenues	1,327.9	1,298.1	1,364.0	1,279.2	1,067.8
Provision for losses	369.3	390.6	456.8	476.1	243.4
Policy acquisition costs	111.6	115.9	121.8	128.5	100.8
Other operating expenses	242.6	226.0	205.7	211.1	175.3
Interest expense	48.1	43.0			