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Conference Call Transcript

RDN - Q1 2006 Radian Group Earnings Conference Call

Event Date/Time: Apr. 20. 2006 / 9:00AM ET

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PRESENTATION

Operator

Welcome to the Radian Group Inc. first-quarter 2006 conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. (OPERATOR INSTRUCTIONS). As a reminder, this conference call is being recorded. I would now like to turn your conference over to your host, Ms. Mona Zeehandelaar. Ma'am, you may begin.

Mona Zeehandelaar - Radian Group - IR

Good morning and thank you for joining us today. With me on the call are S.A. Ibrahim, Chief Executive Officer of Radian; Bob Quint, Chief Financial Officer; Mark Casale, President of our Domestic Mortgage business; Steve Cooke, President of our Financial Guaranty business and Roy Kasmar, President of Strategic Initiatives and International Mortgage.

Today, we will follow our normal format. S.A. will begin, followed by Bob, who will review key quarterly financial metrics and then we will take your question.

For those logged on to the webcast at www.radian.biz, the slides are provided as background and should complement our remarks today. A reconciliation of certain non-GAAP measures that may be discussed on today's call is provided on those slides.

Also, please note that our annual report, which includes S.A.'s letter to stockholders, is now available on our website. In addition, immediately following this call, we intend to post to our website a video interview of S.A. covering key highlights of his stockholders letter, including vision, the intersection of mortgage insurance and financial guaranty and the outlook for growth.

As I do every quarter, let me remind you that today's conference call will contain statements that are forward looking. As you know, these statements are based on current expectations that are subject to risk and uncertainty. And Radian's actual results may differ materially from those expressed or projected in these forward-looking statements. Factors that could cause Radian's actual results to be materially different from those in the forward-looking statements are described in the Safe Harbor statement that is included with our webcast and in item 1a of our annual report on Form 10-K for the 2005 fiscal year.

Now it is my pleasure to introduce you to S.A.

S.A. Ibrahim - Radian Group - CEO

Thank you, Mona. Good morning and thank you for joining us for today's call. In a moment, Bob and I will provide you with details about our first quarter. As you saw from our release, the first quarter was another strong period for Radian. As our net income rose sharply to a record, diluted net income per share increased nearly 60% from a year earlier. Book value and adjusted book value rose 13.9% and 14.8% year-over-year respectively. And return on equity exceeded the Company's targets. You can view our webcast slides for reconciliation of book value to adjusted book value.

This was an excellent performance all around and, as I said, Bob and I will provide additional details on the specifics shortly. But first, I would like to discuss some of our longer-term goals, which we have mentioned previously, but nevertheless are worth repeating because they provide an important context for viewing our first-quarter performance.

As Mona mentioned, we published our 2005 annual report earlier this week. The annual report includes my letter to stockholders and is accompanied by a video interview that will be available on our website right after this call.

I am going to begin my comments this morning by restating a few key messages that I made both in the CEO letter and in the video. First, as I have stated previously, one of our key goals is to import our financial guaranty expertise into Radian's mortgage insurance business.

Let me tell you where we are in this process. I believe we have now successfully completed the task of importing our financial guaranty expertise into mortgage insurance and are now moving on to leveraging the combined expertise to benefit customers that are looking for MI, as well as alternative credit risk solutions. This is an important milestone.

Second, this blending of financial guaranty and mortgage insurance expertise also enables us to more effectively manage and distribute our own credit risk exposure. Our progressively larger Smart Home loan transactions vividly illustrate this point as they allow us to distribute risk, which would have otherwise been retained into the capital markets.

Third, managing capital efficiently remains a key priority as we strive to achieve our target returns on equity of 12% to 15%. We are focused on maintaining the right balance between holding sufficient capital to cover the risk we take in our business and identifying additional ways to profitably deploy our capital.

These are three important points to remember as we look at the first quarter, which was successful for us in several respects. In reaching a record \$163.7 million, our net income reflects important positive trends, both in mortgage insurance and financial guaranty, our two main businesses, as well as another strong quarter for C-BASS and Sherman.

Looking at mortgage insurance specifically, we are optimistic that 2006 presents the mortgage insurance business with a cyclical bounce-back opportunity and we at Radian are encouraged by this opportunity to do more traditional mortgage insurance business in a prudent and profitable manner.

Having been in the same shoes as our customers and enjoying an ongoing open and honest interaction with them, I have heard firsthand that they expect to originate more loans with MI in the near term. When it comes to MI, Radian is seen as a strong partner. We, at Radian, are honored to enjoy strong relationships with our mortgage insurance customers and will continue to focus on competing successfully in delivering traditional MI solutions to our customers when these solutions serve our customers best.

However, at the same time, I am also hearing that lenders are feeling increased volume and profitability pressures in an environment of rising rates and fierce competition. These pressures are making lenders more open than ever to creative capital market-based credit risk management solutions, solutions that we, at Radian, can deliver to our customers by uniquely leveraging our blended financial guaranty and mortgage expertise.

Having talked to many lenders, large and small, portfolio-driven as well as secondary market-driven, from all parts of the country, I sense growing respect and appreciation for Radian's ability to bring them the best solution, whether MI or beyond MI. It is our challenge at Radian to build on the opportunity this provides.

Before giving an example that illustrates this point, I would like to note that we are focused on growing our business at the intersection of mortgage insurance and financial guaranty and we're doing it on the same underlying mortgage asset that we have always ensured. Our expertise in deal structuring and our ability to transact in different ways ranging from credit before swaps to traditional mortgage insurance policies, second to pay full policies or a credit enhancement on net interest margin securities provides Radian with an advantage over competitors who may not be able to offer such customized solutions.

Let me illustrate this intersection opportunity with an example. One of our mortgage insurance business channels is called Capital Markets and participates in the credit before swap market. Capital Markets is responsible for writing both mortgage-related guaranties and structuring mortgage insurance and securitizations.

It is important to note that this Capital Markets channel is part of our mortgage business. In the first quarter of 2006, we wrote two credit before swaps on various tranches for an originator we know well to our mortgage insurance business, a triple-A financial guaranty monoline then wrapped over the Radian credit before swaps and issued two triple-A bonds reducing our customer's overall financing costs and improving their execution. This is a triple-A guarantor we know well through our financial guaranty business.

Radian was able to deploy our knowledge and understanding of the customer, the collateral, the structure and the contractual rights of residential mortgage backed securitizations and leverage our existing strong partnership with the primary triple-A financial guarantor to customize a creative solution for our customer and Radian. This is the opportunity and an illustration of how we already are leveraging our combined expertise, as well as our combined relationships for the benefit of our clients.

Before commenting on our performance in the first quarter, I would like to share some views on the external environment and how I see these conditions affecting our business over the next couple of years.

In spite of rising rates and this [slowing] mortgage market, the employment picture remains stable. This employment picture combined with a positive forecast for home purchase demand should help avert a steep decline in home prices. Rather, we may see a gradual easing of home prices. These external signs are encouraging, but the housing slowdown still lies ahead.

Therefore, although we have benefited from lower first-quarter [deports] in claims, we remain cautious about the remainder of 2006 and 2007.

On the financial guaranty side, credit spread got tighter than ever. Hopefully, this is the bottom, but no one can be sure. We are now seeing some of the triple-A guarantors competing in our double-A public finance niche, but we're holding our own due to a long-standing presence in this niche and our reputation for superior execution.

We also are seeing the beginnings of the synthetic market for public finance, similar to the now established and growing synthetic structured market. The structured finance market on the funded side has been growing 25% a year, but has recently been driven by senior subordinated structures requiring little need for typical financial guaranty.

Simultaneously, the synthetic market is growing faster than the funded market providing double-A friendly opportunities for credit enhancement solutions. We are well-positioned to participate in both synthetic markets.

In a moment, Bob will provide you with details on the quarter, but first I will provide some highlights. I am pleased to report that the first quarter was a success for Radian's businesses. In addition to making tangible progress against our strategic objectives, we continue to produce solid earnings and add to book value.

As I stated at the beginning of my remarks, net income in the first quarter was a record \$163.7 million. While our diluted per share net income climbed to \$1.96. We grew book value year-over-year by 13.9% to \$45.43 at March 31, '06 and adjusted book value by 14.8% to \$63.24. You can view our webcast slides for a reconciliation of adjusted book value to the actual GAAP book value.

On return on equity, another important metric we used to run our business, we exceeded our target range of 12% to 15%. In the mortgage insurance segment, primary insurance in force continued to grow, increasing by 4% from the fourth quarter to \$113.9 billion. We are optimistic that this is a reflection of both the emerging cyclical market opportunities, as well as our ability to offer better mortgage risk management solutions to our customers. It is important to note that this growth was achieved with diligent attention to both risk and profitability objectives.

Mortgage credit trends in the first quarter were favorable and Bob will add more color on this. We are pleased with this, but as I indicated earlier, we remain cautious over the near term.

Financial guaranty also had a good first quarter, particularly in the direct structured finance business, notwithstanding the difficult operating environment I described earlier. We continue to originate new deals and demonstrate the viability of our double-A franchise while maintaining our current discipline and focusing on the higher credit business.

Although we are pleased with this quarter's results, we remain committed to our ongoing efforts to improving the performance and position of our financial guaranty business, particularly with respect to enhancing its profitability and working towards the elimination of the credit agency negative outlooks.

In our financial services segment, we again are extremely pleased with the performance of both C-BASS and Sherman, which continues to be strong contributors to Radian's results. Given that both C-BASS and Sherman are privately held, we believe our investors have a unique opportunity to benefit from the continued strong performance of both of these companies.

In closing then, I would like to quickly recap some of the points I believe are most important. First, we have successfully imported our financial guaranty expertise into Radian's mortgage business and are now beginning to leverage this unique blended capability.

Second, this expertise has and will continue to enable us to more effectively manage our own mortgage risk exposure. Third, we continue to remain focused on and committed to active capital management. We are pleased with Radian's performance and prospects. We believe we have the right strategy and the right team for the future.

Bob will now provide additional information on our results for the first quarter. Following his remarks, we will take your questions and have some closing remarks.

Bob Quint - Radian Group - CFO

Good morning. As always, I will be providing some detail and color about our first-quarter financial results. On the MI side, you'll remember that we had an acceleration of earned premium due to cancellations within a large single premium pool policy for the last two quarters. This policy has built up a significant unearned premium, which gets taken directly into earned premium whenever a loan cancels. The acceleration benefit this quarter from the policy was about \$2.4 million compared to \$10 million and \$15 million for the previous two quarters. We believe that this quarter represents a more reasonable run rate for this item.

Excluding this, we expect the increases in primary insurance in force and other risk in force to lead to modest increases in MI earned premium over the balance of the year.

We are pleased to see a continuation and an increase in persistency to 68.7% for the first quarter annualized and to 58.6% for the year. Remember, we had some bulk cancellations in 2005, which still represents about three points on the annual persistency. We expect and are hopeful that this persistency trend will slowly continue.

As S.A. referred to, the amount of business included in structured primary and non-traditional other risk written continues to be substantial as more of our credit protection is written in the less traditional form. You will note the pickup in earned premium related to our non-traditional business to \$29.5 million for the first quarter, including a pickup in international premiums earned to \$3.2 million.

In examining the structured primary transactions written during the quarter, there is a much lower average premium rate than our traditional rate due to our writing policies with deductibles and some policies with a very small coverage percentage.

In turn, the capital associated with new transactions is very low as well commensurate with the more remote risk. While we were happy with the returns on capital that the deals provide this, activity demonstrates that our average premium rates can really move around a lot within the structured transaction product mix.

The provision for losses on the MI side was positively impacted by a decrease in claims paid and a substantial decrease in primary delinquencies, some of which we consider seasoned. Although the remaining delinquencies did migrate to older buckets and therefore require greater reserve per loan.

Hurricanes Katrina and Rita-related delinquencies, and this is per the new Freddie Mac designated area, at year-end, represented 6208 delinquencies with a related loss reserve of \$46.2 million, but are now at March 31 currently down to 5044 delinquencies with a related reserve of \$44 million, including 1799 delinquencies with a reserve of \$16.4 million in heavily damaged areas. We continue to treat the hurricane delinquencies just like any other delinquencies as we still do not have enough information to treat them any differently.

Continuing with what we introduced last quarter, you will see that we have highlighted delinquencies and deals where there is no current loss reserve necessary. These delinquencies currently highlighted are mostly from full insurance transactions written during the last year where there is a deductible in front of our risk position. We have also recently written a substantial amount of primary structured insurance that contains deductibles, so you will likely be seeing more delinquencies on the primary side that contain no reserve and are highlighted as such.

From a loss provision perspective, we calculate what the reserve would have been if there were no deductible and when the existing deductible is enough to cover the reserve, no loss provision will be booked. Losses will only be booked if and when and to the extent that the deductible is smaller than the calculated reserve amount. Only delinquencies with no reserve attached to it will be highlighted. As of March 31, 2006, there were 439 primary delinquencies and 9019 full delinquencies with no reserve.

Claims during the quarter were a little less than we expected. In reviewing our claims inventory and outlook for the rest of the year, we believe that claims will pick up modestly throughout the rest of the year with more of the increase coming toward the end of the year. Our balance sheet loss reserve continues to be at the same point within our modeled range as it was in the fourth quarter of 2005, slightly above our midpoint because of our continued caution about the housing market, particularly in certain overheated markets.

Although we did not do a new Smart Home transaction during the quarter, it continues to be our goal to use Smart Home this year to cap our downside and much of the subprime risk written recently. As we reported in our 2005 10-K, approximately 13% of our nonprime exposure was covered by Smart Home at year-end.

The expense line for the Company was impacted by a \$1.5 million charge for stock option expense during the first quarter. The total Company expense for stock option for the first quarter was \$3 million. However, half of that was deferred as an acquisition cost and will be amortized along with all the other acquisition costs. We expect that the overall operating expenses of the Company will increase modestly over the balance of the year as we strategically add people in international business and the structured transaction area in both production and risk management.

Financial guaranty had a good quarter of written and earned premium considering the further tightening of an existing tight credit spread environment and the runoff of the trade credit book, which accounts for most of the premium written differential. Revenues should increase modestly over the rest of the year as the book slowly grows and the favorable loss provision and expense activity we experienced this quarter should continue in the current range for the balance of the year.

Financial services again performed exceptionally well this quarter. For C-BASS, the performance was partially due to deal calls, which accelerated some income and some gains on securitization booked as they issued security to tighten spread.

For Sherman, collections on their charged-off portfolios were at greater than anticipated levels. We expect strong second quarters in the similar range for C-BASS and Sherman.

Once again, the change in fair value of derivative line has different components that add up to the overall positive mark for the quarter of \$17.6 million. As we discussed in our 10-K, there is a \$17 million negative mark relating to the settlement we paid on the derivative contracts by paying \$68 million, the previous mark being negative \$51 million.

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In addition, further spread tightening caused a positive movement of about \$20 million in the overall mark and finally our bifurcated convertible securities moved by \$15 million positive due to good performance in the equity market. As we have told you in previous quarters, any mark to market movements will ultimately zero out over the duration of the transaction as long as there is no payment either as a result of a claim or in the sale or settlement of a derivative contract. If we believe a payment is likely and we can estimate the amount or we actually make a payment, it will always be disclosed. You will notice a new separate line after our financial guaranty claims breakout that depicts settlement on derivative contracts.

Of our substantial gain on sale of investment, \$21.4 million of this gain resulted from our sale and our position in Primus Guaranty. Our involvement with Primus helped further our expertise in corporate credit risk and we are very pleased with the gain we realized on this investment in just under four years.

With respect to stock repurchase, we expect that the volume of repurchase activity in the next quarter will approximate the first-quarter activity as we work to fill the current 4 million share repurchase authorization. We would only expect to receive modest dividends from our operating subsidiaries during 2006 and at this point we do not expect to request any kind of special dividend.

Finally, our tax rate this quarter is higher than normal as a result of the lower proportion of tax advantaged income this quarter compared to previous quarters. Future tax rates will be dictated by this proportion. We would now like to turn the call over to questions.

QUESTION AND ANSWER

Operator

(OPERATOR INSTRUCTIONS). Rob Ryan, Merrill Lynch.

Rob Ryan - Merrill Lynch - Analyst

Bob, could you reconcile for us the previous disclosure of 67 hurricane-affected loans and \$58.5 million at year-end '05 to what you're saying now?

Bob Quint - Radian Group - CFO

Yes, Rob. We had previously used a FEMA-designated area and we believe it is more appropriate now to use the Freddie Mac designated area and that includes just Katrina and Rita. Our previous number had included Wilma as well. So now it is a smaller population and the delinquencies did go down in that area nonetheless.

Rob Ryan - Merrill Lynch - Analyst

And getting from that 58.5 because it actually was part of your reserve, however you want to define it, was that a disproportionate part of the loss reserve take-down during the quarter?

Bob Quint - Radian Group - CFO

No, it really wasn't. It really wasn't. I would say it was proportion. A lot of the reserve take-down was throughout the rest of the book.

S.A. Ibrahim - Radian Group - CEO

And that was just a reclassification, Rob. It didn't change how we reserve for anything.

Rob Ryan - Merrill Lynch - Analyst

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And given that historically you have always kept a sequential flat or an increase to your mortgage insurance loss reserve, what was different about this quarter?

Bob Quint - Radian Group - CFO

There was a substantial decrease in primary delinquencies, which in turn drove the model to show us that the reserve required was less than it had been required in the past.

Rob Ryan - Merrill Lynch - Analyst

So on your outlook, do you continue to be at the upper portion of the range?

Bob Quint - Radian Group - CFO

We are above the midpoint. Not significantly above, but above the midpoint.

Rob Ryan - Merrill Lynch - Analyst

On a different topic, could you comment on the nature of the bulk transactions that you saw during the quarter given the substantial volume that you actually booked?

Mark Casale - Radian Group - President, Domestic Mortgage

This is Mark. I will take that question. We did see a substantial volume in the first quarter, but really to break it down -- we had to break it down into two areas. We wrote the production both within our Capital Market segment, which is more of the nonprime and it is subprime lower -- bigger premium and obviously higher risk and the other part was in our strategic accounts channel, which was done with deductibles. As Bob had stated earlier, which is a much lower risk and therefore a much lower premium.

The key reason we wrote so much is a lot of that business was awarded in the fourth quarter, especially in the Capital Market side when the whole loan market was highly volatile. Both MI and our NIM wraps offered consistency and greater certainty for the issuer's execution. So we awarded the business in December, but booked it in January and February and as the whole loan market has bounced back through the end of the first quarter with a very aggressive pricing, our business in that area has slowed considerably.

On the dynamics on the strategic accounts side are different though. The bulks in this area that are written more as a risk transfer with the GSEs or other very large customers and are much less dependent on spread in the capital markets.

Operator

Geoff Dunn, KBW.

Geoff Dunn - KBW - Analyst

I think Rob just hit on a couple of my specific questions, but I wanted to follow up on the buyback in the quarter. It looked like you got almost or approximately \$68 million of dividends from C-BASS and Sherman. Is that what funded the buyback activity in the quarter or is that what is going to lead to a similar repurchase in the second?

Bob Quint - Radian Group - CFO

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Some of that certainly funded it, Geoff, and again, we think that next quarter is going to approximate the first quarter and with regard to dividends from our subs, we do expect that they will be pretty modest this year.

Geoff Dunn - KBW - Analyst

And then in the financial guaranty business, it looked like you might have had some positive development on your Canseco exposure. Can you talk about that a little bit?

Bob Quint - Radian Group - CFO

Yes. It was really -- there were some reimbursements that we get after we make the claim payments and originally it was thought that those would have to be paid out ultimately, but it was determined that they wouldn't have to be. So I wouldn't expect it to continue. This is kind of a onetime thing that reflects that, but you will notice that there has been a major slowdown in the amounts paid out. So from a cash-flow standpoint, it's really been better than we anticipated.

Geoff Dunn - KBW - Analyst

And then S.A., in the financial guaranty segment, expenses as well as capital have been a major focus of yours and you did touch on that. Can you give us a little bit more color as far as how much progress has been made in rightsizing both those items?

S.A. Ibrahim - Radian Group - CEO

Well, as you know, we have been peeling off businesses that strategically we believe do not fit with us going forward such as the [create] credit business. We have taken other actions on the expenses, but we have also invested in some of the new business opportunities. So there is a changing picture as we go through this and also you have got to remember as we exit some of these businesses that there is a lag effect related to severance and the expenses not going away.

Let me ask Steve Cooke to add a little bit more color on where we are in terms of positioning the business to be much stronger going forward and in particular, while answering your question on expenses, I'd also like you to focus on what we have done in terms of positioning to be a much stronger player, particularly in the direct synthetic structured market.

Steve Cooke - Radian Group - President, Financial Guaranty

What we have done as a general matter is to focus on those areas where on participation in the double-A niche as a double-A player makes the most sense. What we have done as an overall matter in addition to holding the line on expenses and focusing on through the expense reduction is target those areas where we think there are reasonable opportunities for revenue growth, as well as focusing on the rating agency negative outlooks because that clearly will have we think a long-term favorable impact on our ability to write business -- additional business in certain sectors.

What we have done with respect to and this is a continuation of the overall trend in direction is that more of a focus on our direct versus our reinsurance business -- if you look at it on a quarter-over-quarter basis, our direct business now represents about 47% of our total net fars outstanding versus about 43.5% a year ago. And continuing our focus with respect to the reinsurance business, we are focusing more on facultative versus treaty business.

Geoff Dunn - KBW - Analyst

Are you able to give us any idea on time frame for a potential shift upward to a double-digit of return?

Steve Cooke - Radian Group - President, Financial Guaranty

I think what we have looked at and what our goal is is to within a three-year period to achieve ROEs in the 10% to 12% range.

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S.A. Ibrahim - Radian Group - CEO

Again, Geoff, just remember that this is going to be slower progress than you would normally expect because we're still dealing with a very, very tight spread environment. Should that spread environment change, then we would see more positive results.

Operator

Bruce Harting, Lehman Brothers.

Bruce Harting - Lehman Brothers - Analyst

Can you talk about cure rates and the differences between your various product classes on page 8 -- I'm sorry -- on page -- well, what kind of a cure rate are you experiencing or do you expect to experience if the economy -- if housing gets a little worse on the A- and some of the other areas where you have double-digit default rates? Thanks.

S.A. Ibrahim - Radian Group - CEO

Bob, do you want to take that?

Bruce Harting - Lehman Brothers - Analyst

Sorry, I didn't pick up [there].

Bob Quint - Radian Group - CFO

Bruce, a lot of the improvement was really throughout the book. So cure rates were good really throughout the book. Now it is going to vary by product a little bit, but it was a real consistent decrease in delinquencies. And then I guess the Alt A -- the prime really cured the best during the quarter. The subprime I think had a pretty good quarter and the Alt A was probably on the lower end of the cure rate.

Bruce Harting - Lehman Brothers - Analyst

But what is the math on the A- and Alt A where we are seeing percentage of loans in default of 7%, 12%, 13%? Can you just talk about how that migrates through from a default to actual claim and how you see severity developing or any changes from previous quarters? Thanks.

Bob Quint - Radian Group - CFO

It's no different from any of the other products. What we have said in the past and I think it is true is that on the A- or the nonprime, your delinquencies are going to appear sooner and they are going to -- the foreclosure process depends on state and the severities really move around a lot. It depends on loan size. A lot depends obviously on loss mitigation and where the loan is.

S.A. Ibrahim - Radian Group - CEO

Bruce, I hope that answers your question.

Bruce Harting - Lehman Brothers - Analyst

I'll follow up with you guys. Thanks.

Operator

(OPERATOR INSTRUCTIONS). Paul Miller, FBR.

Paul Miller - FBR - Analyst

I wonder if you guys can -- one of your competitors last week talked about how they are seeing a switch from piggyback loans into MI loans on the flow side because I guess the pricing for the consumer is almost a neutral to them and also we are seeing that the appetite for home equity lines, especially piggyback loans, are waning in the secondary markets. Can you touch on that a little bit?

S.A. Ibrahim - Radian Group - CEO

As I mentioned Paul, I've been talking to a lot of customers and we constantly talk to customers and their expectation among the lenders is that logically it makes sense that the seconds get more expensive given the shape of the yield curve, as well as the rising rates that a larger first should be more attractive to borrowers.

Our own math shows that too, so we expect that cyclical bounce-back will continue. However, keep in mind though, it is a very practical issue here. We are dealing with intermediaries like brokers and salespeople, many of whom have been in the business for five years or less and they don't really have memories related to MI. So they also are going to have to work in educating them. So the math is certainly beginning to work. That doesn't mean it will directly translate into proportional increase in the MI volume or MI penetration, but we are optimistic and the industry in general seems to be optimistic that there should be a cyclical bounce-back. I think we in the industry need to do a lot more work in educating these new intermediaries and salespeople on the math that is in the best interest of the borrowers.

Paul Miller - FBR - Analyst

The other question is -- if you can go back to what you were talking about earlier about the synthetic CDO market and you talked about that it is one of the fastest-growing parts of the CDO market, the non-cash side, but it doesn't need financial guaranty, but you think on the double-A it does. I was a little confused by that.

S.A. Ibrahim - Radian Group - CEO

Yes. Let us add more color to that. What we were distinguishing between is the funded synthetic and then public finance versus structured and maybe we should discuss this a little bit more slowly. So I will turn to Steve Cooke to respond to that question.

Steve Cooke - Radian Group - President, Financial Guaranty

What we were sort of distinguishing is sort of the traditional cash funded market where the financial guaranty insurance participation is typically in the form of the use of financial guaranty insurance policy where the holder of the policy often is the owner of the underlying obligation versus a synthetic execution where the protection is provided by means of a credit default swap with respect to a reference obligation for the underlying corporate debt or another corporate obligation, but where there is no requirement that the buyer protection actually own the underlying reference obligation. So that's the primary difference.

I think S.A.'s comments were in terms of the growth in the market and the impact on the senior substructures was primarily with respect to the talking about the cash funded market and our primary participation is in the synthetic CDO market and at least for this quarter, one of the heartening developments was that notwithstanding very, very tight spread environments, we had a particularly strong quarter on our structured finance direct business with our net premiums written and net premiums earned both up by significant margins.

Paul Miller - FBR - Analyst

But you're basically saying in the cash market there is really not a lot of need for the financial guaranty because of the tightness of the spreads, but in the non-cash and the synthetic market, there is a lot of opportunity to grow?

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Steve Cooke - Radian Group - President, Financial Guaranty

Right.

Paul Miller - FBR - Analyst

Is that basically what you are saying? Okay. And that is growing at -- you said 25 -- I know we're hearing on this anecdotal evidence that the synthetic markets are growing very, very fast.

Steve Cooke - Radian Group - President, Financial Guaranty

I just think that for our direct business on the structured finance side, which is primarily consisting of the synthetic CDOs that we operate in, that our direct net premiums written were up a little over 20% and our net earned premiums were up by 18%.

Paul Miller - FBR - Analyst

Thank you very much.

S.A. Ibrahim - Radian Group - CEO

And again, remember that when it comes to the synthetic CDO market, there is no inherent disadvantage we as a double-A have to triple-A financial guarantors because most of the counterparties we are dealing with are at best double-As.

Steve Cooke - Radian Group - President, Financial Guaranty

I mean the other advantage that we have had notwithstanding the tight spread environment is that we have been able to do this business at high-quality levels. Our attachment points on these transactions have steadily increased and increased significantly for example from 2004 to 2005 and this first quarter of 2006.

Paul Miller - FBR - Analyst

Is there any marketshare data that you can say how much of a marketshare you're getting of it and how much part of the whole financial guaranty businesses could be down the road?

Steve Cooke - Radian Group - President, Financial Guaranty

I think it is difficult to quantify the actual portion of the -- particularly with respect to the insured portion portion of that market on the synthetic side since so much of it is not really -- or not public transaction. But as we have seen the synthetic market grow, I think those -- our direct experience is that we've seen our opportunities for participation in that market growing.

Paul Miller - FBR - Analyst

How much of the business is it right now in the financial guaranty?

Steve Cooke - Radian Group - President, Financial Guaranty

Of the total financial guaranty market?

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Paul Miller - FBR - Analyst

No, of your total.

Steve Cooke - Radian Group - President, Financial Guaranty

Right. I would say that of our total, we have approximately \$28 billion of our total CDO exposure, most of which is primary business and I would say our total net our outstanding in all structured finance is --

Operator

David Hochstim, Bear Stearns.

David Hochstim - Bear Stearns - Analyst

I think Steve was still answering the other question.

Steve Cooke - Radian Group - President, Financial Guaranty

I am just saying that our total structured finance exposure, both direct and reinsurance and nets far outstanding, is about \$34 billion, most of which -- of that, our CDO exposure is about \$28 billion of that.

S.A. Ibrahim - Radian Group - CEO

Paul, if you look at page 6 of our supplement, there is a detailed breakdown.

Steve Cooke - Radian Group - President, Financial Guaranty

Right, which shows net far outstanding by product.

S.A. Ibrahim - Radian Group - CEO

So we have a total of 83.3 and then it is broken down between public finance (indiscernible), public finance reinsurance structured direct and structured reinsurance.

David Hochstim - Bear Stearns - Analyst

Can I ask my question now?

Mona Zeehandelaar - Radian Group - IR

Go ahead, David.

David Hochstim - Bear Stearns - Analyst

Thanks. I wonder if Bob or Steve could elaborate on the reference to the new disclosure on page 5 that claims paid under derivative contracts, that \$66.6 million and sort of what that relates to and how do we think about that?

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Bob Quint - Radian Group - CFO

Well, that -- as we disclosed in our 10-K, that is a payment made on the settlement of the derivative contract. It is not a claim, but it was a settlement made to essentially make derivative contract -- the risk go away. So we determined that it was a proper disclosure to put it in with the claims paid on financial guaranty, but obviously in our 10-K we described it in greater detail.

David Hochstim - Bear Stearns - Analyst

And that is a one-time or it's recurring and it happens -- sort of a settlement each quarter?

Bob Quint - Radian Group - CFO

No, that was clearly one time. However, if it ever happens, it will be disclosed in this way.

Operator

Jim Shanahan, Wachovia Securities.

Jim Shanahan - Wachovia Securities - Analyst

-- a significant portion of that came from the bulk channel --

S.A. Ibrahim - Radian Group - CEO

We missed the beginning of your question.

Bob Quint - Radian Group - CFO

Start over, Jim, please.

Jim Shanahan - Wachovia Securities - Analyst

Okay. I'm sorry. I was comparing your NIW this quarter versus the year-ago period and it was twice the level with significant contribution from bulk and I guess with that bulk business came some somewhat alarming statistics where ARMs have increased as a significant percentage to total, 60% this year versus 36% a year ago. It is substantially more of a nonprime after the business much more all day than a year ago and it seems like it reflects all this bulk business, but is the right way to really think about this to really focus more on the net change in risk in force and said differently, does risk in force really capture the impact of deductibles, protection from Smart Home executions, all those things and is that really more of what you'd prefer that analysts at investors focus on?

S.A. Ibrahim - Radian Group - CEO

Let's have Mark address your point.

Mark Casale - Radian Group - President, Domestic Mortgage

I think -- risk in force is the best way to look at it because deductibles does take -- the risk in force does take into account the deductibles that we have on our larger transactions.

Jim Shanahan - Wachovia Securities - Analyst

Does it also take into consideration the attachment points of captives and Smart Home executions?

Mark Casale - Radian Group - President, Domestic Mortgage

It does not take into account the captives and Smart Home executions.

Jim Shanahan - Wachovia Securities - Analyst

The risk in force versus a year ago, the year-over-year change in risk in force, the only real meaningful change here appears to be in the A-segment of a 10% increase relative to basically flattish for the prime risk in force and just kind of curious what you are thinking about the subprime space there? Are you feeling that you are more equipped to compete in subprime today because of your ability to execute Smart Home type of executions because one of your peers commented that they weren't really see much opportunity in bulk this quarter and obviously you did?

Mark Casale - Radian Group - President, Domestic Mortgage

As I stated earlier, I think we saw a lot of the opportunity in the fourth quarter. The fourth quarter in the nonprime market was very dicey in terms of the liquidity. Whole loan prices -- then we saw that also with C-BASS where C-BASS had a lot of activity in the fourth quarter. They tend to do very well when people are scared in the market. We were also able to agree or come to terms on a few large bulk transactions in the fourth quarter that didn't get executed until the first quarter. So as the whole loan market has picked up significantly in the first quarter, liquidity has come back into the market. Spreads have tightened considerably. In the secondary -- in the capital markets, we have seen our pipeline in that area decrease drastically.

In terms of how comfortable we are with the business, I would say over the last 12 to 18 months, we continue to get more comfortable and it is twofold. One is previously to this position I ran the Capital Markets group and I spent a lot of time over the last year filling that group not only with structuring talent, but also with folks who understand the business very well. So a lot of folks have come into Radian that have worked as originators in that space. So when you think about the subprime business, it is more than just structuring transactions; it is understanding the counterparty from an origination standpoint, from a servicing standpoint, from a financial standpoint. It is understanding how to underwrite the loans and it is also managing the losses on the back end. So that is one way that we've gotten a lot more comfortable with the business.

The second way quite frankly is Smart Home where we're now going out and reinsuring excessive loss above what our models say and again when we do that, although it doesn't show up in risk in force, it really does show up in our economic capital and in our rating agency capital where we get significant relief.

Jim Shanahan - Wachovia Securities - Analyst

I guess one more, just a point of clarification. If you don't assume a Smart Home execution reduces your potential risk in force, is that effectively saying that your expectation for losses in that subprime business that has been protected with the Smart Home execution would in fact reach a peak or a cumulative peak, cumulative loss experience that is in line with your expectations therefore you wouldn't expect Smart Home to attach?

Bob Quint - Radian Group - CFO

Even when we do Smart Home execution, we take expected losses. So we have the risk of expected losses. The Smart Home execution protects us against adverse development, so it is higher than expected loss. So in a normal situation, we are going to absorb all of the losses associated with this business. However, if we are wrong and losses are significantly higher then all of that risk is going to be absorbed by the Smart Home reinsurance transaction. So that is why it makes us feel better about originating subprime risk because we have this protection, but remember the protection is an adverse protection. It is not an expected level of loss.

Mark Casale - Radian Group - President, Domestic Mortgage

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The reason it doesn't impact risk in force as much as you would think is that we keep the first layer of risk, which is the risk in force. We sell off above that expected loss, but we keep a lion's share of the double-A and triple-A part of the structure. So it really comes back in the risk in force. Although it is much more remote, it still counts in the line item. Where we think above the expected loss is really -- which is the unexpected loss is where you get the capital relief.

Jim Shanahan - Wachovia Securities - Analyst

Understood. Thank you.

Operator

I am showing no further questions in the queue. I would like to turn your conference back over to Ms. Mona Zeehandelaar.

Mona Zeehandelaar - Radian Group - IR

Thank you very much for joining us. We look forward to talking to you next quarter.

Operator

Ladies and gentlemen, this concludes today's program. You may all disconnect.

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