RADIAN GROUP INC
Form 10-Q
May 06, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2014

OR

o 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

Radian Group Inc.
(Exact name of registrant as specified in its charter)

Delaware	23-2691170
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1601 Market Street, Philadelphia, PA	19103
(Address of principal executive offices)	(Zip Code)

(215) 231-1000
(Registrant's telephone number, including area code)

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 173,171,885 shares of common stock, $0.001 par value per share, outstanding on April 29, 2014.

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Cautionary Note Regarding 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 United States ("U.S.") Private Securities Litigation Reform Act of 1995. In most cases, forward-looking statements may be identified by words such as "anticipate," "may," "will," "could," "should," "would," "expect," "intend," "plan," "goal," "contemplate," "believe," "estimate," "predict," "project," "potential," "continue," "future," "likely" or the negative or other variations on these words and other similar expressions. These statements, which may include, without limitation, projections regarding our future performance and financial condition, 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 statement. These statements speak only as of the date they were made, and we undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. We operate in a changing environment. New risks emerge from time to time and it is not possible for us to predict all risks that may affect us. The forward-looking statements, as well as our prospects as a whole, are subject to risks and uncertainties that could cause actual results to differ materially from those set forth in the forward-looking statements including:

- changes in general economic and political conditions, including unemployment rates, changes in the U.S. housing and mortgage credit markets (including declines in home prices and property values), the performance of the U.S. or global economies, the amount of liquidity in the capital or credit markets, changes or volatility in interest rates or consumer confidence and changes in credit spreads, all of which may be impacted by, among other things, legislative activity or inactivity, actual or threatened downgrades of U.S. government credit ratings, or actual or threatened defaults on U.S. government obligations;
- changes in the way customers, investors, regulators or legislators perceive the strength of private mortgage insurers or financial guaranty providers, in particular in light of the fact that certain of our former competitors have ceased writing new insurance business and have been placed under supervision or receivership by insurance regulators;
- catastrophic events, municipal and sovereign or sub-sovereign bankruptcy filings or other economic changes in geographic regions where our mortgage insurance exposure is more concentrated or where we have financial guaranty exposure;
- our ability to maintain sufficient holding company liquidity to meet our short- and long-term liquidity needs;
- a reduction in, or prolonged period of depressed levels of, home mortgage originations due to reduced liquidity in the lending market, tighter underwriting standards, or general reduced housing demand in the U.S., which may be exacerbated by regulations impacting home mortgage originations, including requirements established under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act");
- our ability to maintain an adequate risk-to-capital position, minimum policyholder position and other surplus requirements for Radian Guaranty Inc. ("Radian Guaranty"), our principal mortgage insurance subsidiary, and an adequate minimum policyholder position and surplus for our insurance subsidiaries that provide reinsurance or capital support to Radian Guaranty;
- our ability to continue to effectively mitigate our mortgage insurance and financial guaranty losses;
- a more rapid than expected decrease in the levels of mortgage insurance rescissions and claim denials, which have reduced our paid losses and resulted in a significant reduction in our loss reserves, including a decrease in net rescissions or denials resulting from an increase in the number of successful challenges to previously rescinded policies or claim denials (including as part of one or more settlements of disputed rescissions or denials), or by Fannie Mae or Freddie Mac (the "Government-Sponsored Enterprises" or the "GSEs") intervening in or otherwise limiting our loss mitigation practices, including settlements of disputes regarding loss mitigation activities;
- the negative impact that our loss mitigation activities may have on our relationships with our customers and potential customers, including the potential loss of current or future business and the heightened risk of disputes and litigation;

- the need, in the event that we are unsuccessful in defending our loss mitigation activities, to increase our loss reserves for, and reassume risk on, rescinded or cancelled loans or denied claims, and to pay additional claims, including amounts previously curtailed;
- any disruption in the servicing of mortgages covered by our insurance policies, as well as poor servicer performance;
- adverse changes in the severity or frequency of losses associated with certain products that we formerly offered (and which remain a small part of our insured portfolio) that are riskier than traditional mortgage insurance or financial guaranty insurance policies;
- a substantial decrease in the persistency rates of our mortgage insurance policies, which has the effect of reducing our premium income on our monthly premium policies and could decrease the profitability of our mortgage insurance business;
- heightened competition for our mortgage insurance business from others such as the Federal Housing Administration, the U.S. Department of Veterans Affairs and other private mortgage insurers, including with respect to other private mortgage insurers, those that have been assigned higher ratings than we have, that may have access to greater amounts of capital than we do, that are less dependent on capital support from their subsidiaries than we are or that are new entrants to the industry, and therefore, are not burdened by legacy obligations;
- changes in requirements for Radian Guaranty to remain an eligible insurer to the GSEs (which are expected to be released in draft form for public comment as early as the second quarter of 2014, and to become effective following an implementation period), which may include, among other items, more onerous risk-to-capital ratio requirements, capital requirements based on a variety of risk characteristics and measures of credit quality and a limitation on the amount of capital credit available for Radian Guaranty's equity in its subsidiaries, including capital attributable to our financial guaranty business; the form of the new eligibility requirements and the timeframe for their implementation remain uncertain, and we cannot give any assurances as to their potential impact on us;
- changes in the charters or business practices of, or rules or regulations applicable to, the GSEs;
- changes to the current system of housing finance, including the possibility of a new system in which private mortgage insurers are not required or their products are significantly limited in effect or scope;
- the effect of the Dodd-Frank Act on the financial services industry in general, and on our mortgage insurance and financial guaranty businesses in particular, including whether and to what extent loans with private mortgage insurance may be considered "qualified residential mortgages" for purposes of the Dodd-Frank Act securitization provisions;
- the application of existing federal or state laws and regulations, or changes in these laws and regulations or the way they are interpreted, including, without limitation: (i) the resolution of existing, or the possibility of additional, lawsuits or investigations (including in particular investigations and litigation relating to captive reinsurance arrangements under the Real Estate Settlement Procedures Act of 1974); (ii) changes to the Mortgage Guaranty Insurers Model Act (the "Model Act") being considered by the National Association of Insurance Commissioners ("NAIC") that could include more stringent capital and other requirements for Radian Guaranty in states that adopt the new Model Act in the future; and (iii) legislative and regulatory changes (a) impacting the demand for private mortgage insurance, (b) limiting or restricting the products we may offer or increasing the amount of capital we are required to hold, (c) affecting the form in which we execute credit protection, or (d) otherwise impacting our existing businesses or future prospects;
- the amount and timing of potential payments or adjustments associated with federal or other tax examinations, including adjustments proposed by the Internal Revenue Service resulting from the examination of our 2000 through 2007 tax years, which we are currently contesting;
- 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 instruments in determining gains and losses on these instruments;

- volatility in our earnings caused by changes in the fair value of our assets and liabilities carried at fair value, including our derivative instruments, substantially all of our investment portfolio and certain of our long-term incentive compensation awards;
- our ability to realize some or all of the tax benefits associated with our gross deferred tax assets, which will depend, in part, on our ability to generate sufficient sustainable taxable income in future periods;
- changes in accounting principles generally accepted in the United States of America or statutory accounting principles, rules and guidance, or their interpretation;
- legal and other limitations on amounts we may receive from our subsidiaries as dividends or through our tax- and expense-sharing arrangements with our subsidiaries; and
- our pending acquisition of Clayton Holdings LLC (“Clayton”), including: the potential to not fully realize the benefits anticipated from the acquisition, or to not realize such benefits during the anticipated time frame, including as a result of a loss of customers and/or employees; the potential inability to successfully integrate Clayton’s business with our business or the inability to complete such integration during the anticipated time frame; the inability or decision to not complete the acquisition, or to not complete the acquisition on a timely basis; the potential distraction of management time and attention; the risk that we are not able to finance the acquisition as anticipated, or that, if the financing efforts are successful, we are not able to utilize the funds raised efficiently in the event that we do not complete the acquisition.

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 Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, Item 1A of Part II of this Quarterly Report on Form 10-Q and subsequent reports and registration statements filed from time to time with the U.S. Securities and Exchange Commission. We caution you not to place undue reliance on these forward-looking statements, which are current only as of the date on which we issued this report.

PART I

Radian Group Inc.
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	March 31, 2014	December 31, 2013
($ in thousands, except share and per share amounts)		
ASSETS		
Investments		
Fixed-maturities held to maturity—at amortized cost (fair value $50 and $351)	$50	$358
Fixed-maturities available for sale—at fair value (amortized cost $212,734 and $120,385)	213,989	120,553
Equity securities available for sale—at fair value (cost $78,106 and $78,106)	137,920	135,168
Trading securities—at fair value	2,728,976	3,117,429
Short-term investments—at fair value	1,649,228	1,429,228
Other invested assets—(including variable interest entity (“VIE”) assets at fair value of $81,635 and $81,000)	128,416	128,421
Total investments	4,858,579	4,931,157
Cash	20,963	23,858
Restricted cash	22,366	22,527
Deferred policy acquisition costs	63,708	66,926
Accrued investment income	27,690	30,264
Accounts and notes receivable	75,072	75,106
Property and equipment, at cost (less accumulated depreciation of $102,436 and $101,625)	12,482	10,516
Derivative assets	14,466	16,642
Deferred income taxes, net	—	17,902
Reinsurance recoverables	31,033	46,846
Other assets (including VIE other assets of $92,594 and $92,023)	402,626	379,947
Total assets	$5,528,985	$5,621,691
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Unearned premiums	$774,788	$768,871
Reserve for losses and loss adjustment expenses (“LAE”)	1,923,711	2,185,421
Long-term debt	938,390	930,072
VIE debt—at fair value	95,580	94,645
Derivative liabilities (including VIE derivative liabilities of $47,769 and $68,457)	257,717	307,185
Other liabilities (including VIE accounts payable of $190 and $254)	392,216	395,852
Total liabilities	4,382,402	4,682,046
Commitments and Contingencies (Note 15)		
Equity component of currently redeemable convertible senior notes (Note 10)	91,016	—
Stockholders’ equity		
Common stock: par value $.001 per share; 485,000,000 shares authorized at March 31, 2014 and December 31, 2013; 190,712,673 and 190,636,972 shares issued at March 31, 2014 and December 31, 2013, respectively; 173,166,892 and 173,099,515 shares outstanding at March 31, 2014 and December 31, 2013, respectively	191	191
Treasury stock, at cost: 17,545,781 and 17,537,457 shares at March 31, 2014 and December 31, 2013, respectively	(892,937)	(892,807)
Additional paid-in capital	2,256,436	2,347,104
Retained deficit	(349,467)	(552,226)

Accumulated other comprehensive income	41,344	37,383
Total stockholders' equity	1,055,567	939,645
Total liabilities and stockholders' equity	$5,528,985	$5,621,691

See Notes to Unaudited Condensed Consolidated Financial Statements.

Radian Group Inc.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended March 31,			
($ in thousands, except per share amounts)	2014		2013	
Revenues:				
Premiums written—insurance:				
Direct	$229,322		$245,467	
Assumed	473		(10,397	)
Ceded	(16,089	)	(27,885	)
Net premiums written	213,706		207,185	
Increase in unearned premiums	(8,041	)	(14,597	)
Net premiums earned—insurance	205,665		192,588	
Net investment income	24,229		26,873	
Net gains (losses) on investments	64,451		(5,505	)
Change in fair value of derivative instruments	50,086		(167,670	)
Net gains (losses) on other financial instruments	698		(5,675	)
Other income	1,127		1,771	
Total revenues	346,256		42,382	
Expenses:				
Provision for losses	54,809		132,059	
Change in premium deficiency reserve (“PDR”)	466		(629	)
Policy acquisition costs	8,614		17,195	
Other operating expenses	59,909		80,100	
Interest expense	19,927		15,881	
Total expenses	143,725		244,606	
Equity in net (loss) income of affiliates	(13	)	1	
Pretax income (loss)	202,518		(202,223	)
Income tax benefit	(241	)	(14,723	)
Net income (loss)	$202,759		$(187,500	)
Basic net income (loss) per share	$1.17		$(1.30	)
Diluted net income (loss) per share	$0.94		$(1.30	)
Weighted-average number of common shares outstanding—basic	173,165		144,355	
Weighted-average number of common and common equivalent shares outstanding—diluted	222,668		144,355	
Dividends per share	$0.0025		$0.0025	

See Notes to Unaudited Condensed Consolidated Financial Statements.

Radian Group Inc.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)

	Three Months Ended March 31,	
(In thousands)	2014	2013
Net income (loss)	$ 202,759	$ (187,500)
Other comprehensive income, net of tax (see Note 11):		
Unrealized gains on investments:		
Unrealized holding gains arising during the period	4,485	7,466
Less: Reclassification adjustment for net gains included in net income (loss)	524	21
Net unrealized gains on investments	3,961	7,445
Other comprehensive income	3,961	7,445
Comprehensive income (loss)	$ 206,720	$ (180,055)

See Notes to Unaudited Condensed Consolidated Financial Statements.

Radian Group Inc.
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN COMMON STOCKHOLDERS' EQUITY (UNAUDITED)

(In thousands)	Common Stock	Treasury Stock	Additional Paid-in Capital	Retained Deficit	Accumulated Other Comprehensive Income	Total
BALANCE, JANUARY 1, 2013	$151	$(892,094)	$1,967,414	$(355,241)	$ 16,095	$736,325
Net loss	—	—	—	(187,500)	—	(187,500)
Net unrealized gain on investments, net of tax	—	—	—	—	7,445	7,445
Issuance of common stock - stock offering	39	—	299,503	—	—	299,542
Issuance of common stock under benefit plans	—	—	271	—	—	271
Issuance of common stock under incentive plans	—	—	62	—	—	62
Amortization of restricted stock	—	—	208	—	—	208
Issuance of convertible debt	—	—	77,026	—	—	77,026
Stock-based compensation expense, net	—	—	(1,999)	—	—	(1,999)
Dividends declared	—	—	(334)	—	—	(334)
BALANCE, MARCH 31, 2013	$190	$(892,094)	$2,342,151	$(542,741)	$ 23,540	$931,046
BALANCE, JANUARY 1, 2014	$191	$(892,807)	$2,347,104	$(552,226)	$ 37,383	$939,645
Net income	—	—	—	202,759	—	202,759
Net unrealized gain on investments, net of tax	—	—	—	—	3,961	3,961
Repurchases of common stock under incentive plans	—	(130)	—	—	—	(130)
Issuance of common stock under benefit plans	—	—	458	—	—	458
Issuance of common stock under incentive plans	—	—	13	—	—	13
Amortization of restricted stock	—	—	459	—	—	459
Stock-based compensation expense, net	—	—	(149)	—	—	(149)
Reclassification to equity component of currently redeemable convertible senior notes	—	—	(91,016)	—	—	(91,016)
Dividends declared	—	—	(433)	—	—	(433)
BALANCE, MARCH 31, 2014	$191	$(892,937)	$2,256,436	$(349,467)	$ 41,344	$1,055,567

See Notes to Unaudited Condensed Consolidated Financial Statements.

Radian Group Inc.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)	Three Months Ended March 31, 2014	2013
Cash flows used in operating activities	$(137,010)	$(165,971)
Cash flows from investing activities:		
Proceeds from sales of fixed-maturity investments available for sale	13,230	1,102
Proceeds from sales of trading securities	444,967	380,030
Proceeds from redemptions of fixed-maturity investments available for sale	1,540	2,035
Proceeds from redemptions of fixed-maturity investments held to maturity	300	255
Purchases of fixed-maturity investments available for sale	(103,506)	—
Purchases of trading securities	—	(232,538)
Purchases of short-term investments, net	(219,943)	(589,799)
Sales of other assets, net	640	2,005
Purchases of property and equipment, net	(2,776)	(362)
Net cash provided by (used in) investing activities	134,452	(437,272)
Cash flows from financing activities:		
Dividends paid	(433)	(334)
Proceeds/payments related to issuance or exchange of debt, net	—	381,165
Redemption of long-term debt	—	(79,372)
Issuance of common stock	—	299,542
Excess tax benefits from stock-based awards	89	50
Net cash (used in) provided by financing activities	(344)	601,051
Effect of exchange rate changes on cash	7	(29)
Decrease in cash	(2,895)	(2,221)
Cash, beginning of period	23,858	31,555
Cash, end of period	$20,963	$29,334
Supplemental disclosures of cash flow information:		
Income taxes paid (received)	$1,508	$(1,983)
Interest paid	$4,520	$3,630

See Notes to Unaudited Condensed Consolidated Financial Statements.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements

1. Condensed Consolidated Financial Statements—Basis of Presentation and Business Overview
Our condensed consolidated financial statements include the accounts of Radian Group Inc. and its subsidiaries. We refer to Radian Group Inc. together with its consolidated subsidiaries as "Radian," the "Company," "we," "us" or "our," unless the context requires otherwise. We generally refer to Radian Group Inc. alone, without its consolidated subsidiaries, as "Radian Group."
Our condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and include the accounts of all wholly-owned subsidiaries. Companies in which we, or one of our subsidiaries, exercise significant influence (generally ownership interests ranging from 20% to 50%), are accounted for in accordance with the equity method of accounting. VIEs for which we are the primary beneficiary are consolidated, as described in Note 5. All intercompany accounts and transactions, and intercompany profits and losses, have been eliminated. We have condensed or omitted certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with GAAP pursuant to the instructions set forth in Article 10 of Regulation S-X of the United States ("U.S.") Securities and Exchange Commission.
The financial information presented for interim periods is unaudited; however, such information reflects all adjustments that are, in the opinion of management, necessary for the fair statement of the financial position, results of operations, comprehensive income and cash flows for the interim periods presented. Such adjustments are of a normal recurring nature. These interim financial statements should be read in conjunction with the audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013 (the "2013 Form 10-K"). The results of operations for interim periods are not necessarily indicative of results to be expected for the full year or for any other period. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP.
The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. While the amounts included in our condensed consolidated financial statements include our best estimates and assumptions, actual results may vary materially.
In July 2013, the Financial Accounting Standards Board ("FASB") issued an update to the accounting standard regarding income taxes. This update provides guidance concerning the balance sheet presentation of an unrecognized tax benefit when a net operating loss carryforward or a tax credit carryforward (the "Carryforwards") is available. This accounting standard requires an entity to net its liability related to unrecognized tax benefits against the related deferred tax assets for the Carryforwards. A gross presentation will be required when the Carryforwards are not available under the tax law of the applicable jurisdiction or when the Carryforwards would not be used by the entity to settle any additional income taxes resulting from disallowance of the uncertain tax position. This update is effective for fiscal years and interim periods within such years beginning after December 15, 2013. We adopted this update in the first quarter of 2014. As a result of our implementation of this new FASB guidance, our March 31, 2014 condensed consolidated balance sheet reflects a full valuation allowance against our deferred tax assets ("DTAs") as our remaining DTA was reduced by the reclassification of our liability for unrecognized tax benefits. The adoption of this update did not affect the recognition or measurement of uncertain tax positions and did not have a significant impact on our consolidated financial statements or disclosures. See Note 12 for additional information.
Business Overview
We are a credit enhancement company with a primary strategic focus on domestic, residential mortgage insurance on first-lien mortgage loans ("first-liens"). We have two operating business segments—mortgage insurance and financial guaranty.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

Mortgage Insurance
Our mortgage insurance segment provides credit-related insurance coverage, principally through private mortgage insurance, and risk management services to mortgage lending institutions. We provide these products and services mainly through our wholly-owned subsidiary, Radian Guaranty Inc. (“Radian Guaranty”). Private mortgage insurance protects mortgage lenders from all or a portion of default-related losses on residential mortgage loans made to home buyers who generally 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 Freddie Mac and Fannie Mae. We refer to Freddie Mac and Fannie Mae together as “Government-Sponsored Enterprises” or “GSEs.”
Our mortgage insurance segment offers primary mortgage insurance coverage on residential first-liens. At March 31, 2014, primary insurance on first-liens comprised approximately 96.0% of our $42.1 billion total direct risk in force (“RIF”). In the past, we also wrote pool insurance, which at March 31, 2014, comprised approximately 3.8% of our total direct RIF. Additionally, we offered other forms of credit enhancement on residential mortgage assets. These products included mortgage insurance on second-lien mortgages (“second-lien”), credit enhancement on net interest margin securities (“NIMS”), and primary mortgage insurance on international mortgages (collectively, we refer to the risk associated with these transactions as “non-traditional”). Our non-traditional RIF was $93.0 million as of March 31, 2014, representing less than 1% of our total direct RIF.
Financial Guaranty
Our financial guaranty segment has provided direct insurance and reinsurance on credit-based risks through Radian Asset Assurance Inc. (“Radian Asset Assurance”), our principal financial guaranty subsidiary. Radian Asset Assurance is a wholly-owned subsidiary of Radian Guaranty, which has allowed our financial guaranty business to serve as an important source of capital for Radian Guaranty and our mortgage insurance business. We have provided financial guaranty credit protection in several forms, including through the issuance of financial guaranty policies, by insuring the obligations under one or more credit default swaps (“CDS”) and through the reinsurance of both types of obligations. While we discontinued writing new financial guaranty business in 2008, we continue to provide financial guaranty insurance on our existing portfolio consisting primarily of public finance and structured finance insured transactions. We have continued to reduce our financial guaranty exposures in order to mitigate uncertainty, maximize the ultimate capital and liquidity available for our mortgage insurance business and accelerate access to that capital and liquidity through transactions such as risk commutations, ceded reinsurance, discounted insured bond purchases and transaction settlements and terminations.
Business Conditions
As a seller of credit protection, our results are subject to macroeconomic conditions and specific events that impact the origination environment and the credit performance of our underlying insured assets. The financial crisis and the downturn in the housing and related credit markets that began in 2007 has had a significant negative impact on the operating environment and results of operations for both of our business segments. This was characterized by a decrease in mortgage originations, a broad decline in home prices, mortgage servicing and foreclosure delays, and ongoing deterioration in the credit performance of mortgage and other assets originated prior to 2009, together with macroeconomic factors such as high unemployment, limited employment growth, limited economic growth and a lack of meaningful liquidity in many sectors of the capital markets. More recently, we have experienced a period of economic recovery and the operating environment for our businesses has improved. Our results of operations have continued to improve as the negative impact from losses on the mortgage insurance we wrote during the poor underwriting years of 2005 through 2008 (we refer to this portion of our mortgage insurance portfolio, together with business written prior to 2005, as our “legacy portfolio”) has been reduced and we continue to write insurance on higher credit quality loans. As of March 31, 2014, our legacy portfolio had been reduced to approximately 38% of our total primary RIF, while insurance on loans written after 2008 constituted approximately 62% of our primary RIF.

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Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

Although the U.S. economy and certain housing markets remain weak compared to historical standards, home prices have been appreciating on a broad basis throughout the U.S., foreclosure activity has declined and the credit quality of recent mortgage market originations continues to be significantly better than the credit quality of our legacy portfolio. In addition, although the economic recovery has been sluggish, there are signs of a broader recovery in the U.S. economy, including importantly, a reduction in unemployment rates. As a consequence of these and other factors, in the first quarter of 2014 we have experienced improvement in our results of operations, driven primarily by a significant reduction in our incurred losses as a result of an 18.4% decline in new primary mortgage insurance defaults compared to the first quarter of 2013 and by other positive default and claim developments.

Currently, our business strategy is primarily focused on: (1) growing our mortgage insurance business by writing insurance on high-quality mortgages in the U.S.; (2) pursuing other potential alternatives for providing credit-related services to the mortgage finance market, such as expanding our presence in the mortgage finance market through our agreement to acquire Clayton Holdings, LLC ("Clayton") referred to below; (3) continuing to manage losses in our legacy mortgage insurance and financial guaranty portfolios; (4) continuing to reduce our legacy mortgage insurance and financial guaranty exposures; and (5) continuing to effectively manage our capital and liquidity positions.

Our businesses also are significantly impacted by, and our future success may be dependent upon, legislative and regulatory developments impacting the housing finance industry. The Federal Housing Administration ("FHA") remains our primary competitor outside of the private mortgage insurance industry. The GSEs' current federal charters generally prohibit them from purchasing any mortgage with a loan amount that exceeds 80% of a home's value, unless that mortgage is insured by a qualified mortgage 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 loan-to-value ("LTV") mortgages purchased by the GSEs generally are insured with private mortgage insurance. Changes in the charters or business practices of the GSEs, including the introduction of alternatives to private mortgage insurance as a condition to purchasing high-LTV loans, could reduce the number of mortgages they purchase that are insured by us and consequently diminish our franchise value.

The GSEs are in the process of revising their eligibility requirements for mortgage insurers. We expect the GSEs to release the new requirements for public comment as early as the second quarter of 2014 and for these new requirements to become effective following an implementation period. Among other changes, the new GSE eligibility requirements are expected to contain new capital adequacy standards for private mortgage insurers that are more onerous than the capital requirements that are currently in effect, including potentially: (i) a risk-to-capital ratio (defined below) below Radian Guaranty's 19.2 to 1 risk-to-capital ratio as of March 31, 2014; (ii) capital requirements based on a variety of risk characteristics and measures of credit quality; and (iii) a limitation on the amount of capital credit available for subsidiary capital (including Radian Guaranty's capital that is attributable to its ownership of Radian Asset Assurance). The form of the new eligibility requirements and the timeframe for their implementation remain uncertain. If the new GSE eligibility requirements include more onerous capital requirements, including any one or more of the potential requirements referenced above, we may need to provide additional capital support to, or arrange additional capital relief for, Radian Guaranty, including potentially, entering into new reinsurance arrangements, increasing the amount of capital contributions from our available holding company funds or seeking to raise funds in private or public capital transactions.

Under state insurance regulations, Radian Guaranty is required to maintain minimum surplus levels and, in certain states, a minimum ratio of statutory capital relative to the level of net RIF, or "risk-to-capital." Sixteen states (the "RBC States") currently impose a statutory or regulatory risk-based capital requirement (the "Statutory RBC Requirement"). The most common Statutory RBC Requirement is that a mortgage insurer's risk-to-capital ratio may not exceed 25 to 1. In certain of the RBC States there is a Statutory RBC Requirement that the mortgage insurer must maintain a minimum policyholder position, which is calculated based on both risk and surplus levels (the "MPP Requirement"). The statutory capital requirements for the non-RBC States are de minimis (ranging from $1 million to $5 million); however, the insurance laws of these states generally grant broad supervisory powers to state agencies or officials to enforce rules or exercise discretion affecting almost every significant aspect of the insurance business, including the power to revoke or restrict an insurance company's ability to write new business. Unless an RBC State grants a waiver or other form of relief, if a mortgage insurer is not in compliance with the Statutory RBC Requirement of such state, that mortgage insurer may be prohibited from writing new mortgage insurance business in that state. Radian Guaranty's domiciliary state, Pennsylvania, is not one of the RBC States. As of March 31, 2014, Radian Guaranty was in compliance with all applicable Statutory RBC Requirements.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

Capital and Liquidity

Since the financial crisis that began in 2007, we have engaged in a number of strategic actions and initiatives in response to the negative economic and market conditions impacting our businesses. These actions include the following:

- We significantly tightened our mortgage insurance underwriting standards to focus primarily on insuring high credit quality first-liens originated in the U.S. and we ceased writing mortgage insurance on non-traditional and other inherently riskier products.
- We expanded our claims management and loss mitigation efforts to better manage losses in the weak housing market and high default and claim environment.
- We discontinued writing new financial guaranty business and Radian Group contributed its ownership interest in Radian Asset Assurance to Radian Guaranty. Although this structure makes the capital adequacy of our mortgage insurance business dependent, to a significant degree, on the successful run-off of our financial guaranty business, the structure has provided Radian Guaranty with substantial regulatory capital and, through dividends from Radian Asset Assurance, has increased liquidity at Radian Guaranty.
- We reduced our legacy mortgage insurance portfolio, non-traditional mortgage insurance RIF and our financial guaranty portfolio through risk commutations, discounted security purchases, ceded reinsurance, discounted insured bond purchases and transaction settlements and terminations.

Additionally, consistent with our strategy, we are currently pursuing the following initiative:

- Since Radian Asset Assurance ceased writing new business in June 2008, Radian Asset Assurance has reduced its aggregate net par exposure by approximately 80% to $22.7 billion as of March 31, 2014. This reduction included large declines in many of the riskier segments of Radian Asset Assurance’s insured portfolio. In light of this risk reduction and the significant level of capital, including $1.2 billion of statutory surplus remaining at Radian Asset Assurance, Radian Asset Assurance submitted a request to the New York State Department of Financial Services (“NYSDFS”) seeking permission to pay an extraordinary dividend to Radian Guaranty. The NYSDFS currently is considering this request and there can be no assurance if and when such request will be granted in whole or in part, and if granted, that it will not be subject to material conditions.

On May 6, 2014, Radian Group entered into a Unit Purchase Agreement (the “Purchase Agreement”) to purchase all of the outstanding equity interests in Clayton for aggregate cash consideration of $305 million. In connection with the acquisition, we plan to raise the aggregate cash consideration by seeking financing through the issuance of debt and equity. See Note 17 for additional information.

Radian Group currently has immediately available, either directly or through an unregulated subsidiary, unrestricted cash and liquid investments of approximately $615 million. This amount excludes certain additional cash and liquid investments that have been advanced from our subsidiaries for corporate expenses and interest payments. Substantially all of Radian Group’s obligations to pay corporate expenses and interest payments on outstanding debt are reimbursed to Radian Group through the expense-sharing arrangements currently in place with its subsidiaries.

Currently, we expect to maintain Radian Guaranty’s risk-to-capital ratio at or below 20 to 1. However, we expect this target level may change upon the modification of GSE eligibility requirements or future changes in applicable regulatory requirements.

2. Segment Reporting

Our mortgage insurance and financial guaranty segments are strategic business units that are managed separately. We allocate corporate income and expenses to our mortgage insurance and financial guaranty segments based on either an allocated percentage of time spent on each segment or internally allocated capital, which is based on the relative GAAP equity of each segment. We allocate corporate cash and investments to our segments based on internally allocated capital. The results for each segment for each reporting period can cause significant volatility in internally allocated capital based on relative GAAP equity, which can impact the allocations of income and expenses to our segments.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

Adjusted Pretax Operating Income (Loss)

Our senior management, including our Chief Executive Officer (our chief operating decision maker), uses adjusted pretax operating income (loss) as our primary measure to facilitate evaluation of the fundamental financial performance of the Company's business segments and to allocate resources to the segments. Adjusted pretax operating income (loss) is defined as pretax income (loss) excluding the effects of net gains (losses) on investments and other financial instruments and net impairment losses recognized in earnings. It also excludes gains and losses related to changes in fair value estimates on insured credit derivatives and includes the impact of changes in the present value of insurance claims and recoveries on insured credit derivatives, based on our ongoing insurance loss monitoring, as well as premiums earned on insured credit derivatives. Management's use of this measure as its primary measure to evaluate segment performance began with the quarter ended March 31, 2014. Accordingly, for comparison purposes, we also present the applicable measures from the corresponding period of 2013 on a basis consistent with the current year presentation.

Although adjusted pretax operating income (loss) excludes certain items that have occurred in the past and are expected to occur in the future, the excluded items represent those that are: (1) not viewed as part of the operating performance of our primary activities; or (2) not expected to result in an economic impact equal to the amount reflected in pretax income (loss). These adjustments, along with the reasons for their treatment, are described below.

(1) Change in fair value of derivative instruments. Gains and losses related to changes in the fair value of insured credit derivatives are subject to significant fluctuation based on changes in interest rates, credit spreads (of both the underlying collateral as well as our credit spread), credit ratings and other market, asset-class and transaction-specific conditions and factors that may be unrelated or only indirectly related to our obligation to pay future claims. With the exception of the estimated present value of net credit (losses) recoveries incurred and net premiums earned on derivatives, discussed in items 2 and 3 below, we believe these gains and losses will reverse over time and consequently these changes are not expected to result in economic gains or losses. Therefore, these gains and losses are excluded from our calculation of adjusted pretax operating income (loss).

(2) Estimated present value of net credit (losses) recoveries incurred. The change in present value of insurance claims we expect to pay or recover on insured credit derivatives represents the amount of the change in credit derivatives from item 1 above, that we expect to result in an economic loss or recovery based on our ongoing loss monitoring analytics. Therefore, this item is expected to have an economic impact and is included in our calculation of adjusted pretax operating income (loss). Also included in this item is the expected recovery of miscellaneous operating expenses associated with our consolidated VIEs.

(3) Net premiums earned on derivatives. The net premiums earned on insured credit derivatives are classified as part of the change in fair value of derivative instruments discussed in item 1 above. However, since net premiums earned on derivatives are considered part of our fundamental operating activities, these premiums are included in our calculation of adjusted pretax operating income (loss).

(4) Net gains (losses) on investments and other financial instruments. The recognition of realized investment gains or losses can vary significantly across periods as the activity is highly discretionary based on the timing of individual securities sales due to such factors as market opportunities, our tax and capital profile and overall market cycles. Unrealized investment gains and losses arise primarily from changes in the market value of our investments that are classified as trading. These valuation adjustments may not necessarily result in economic gains or losses. We do not view them to be indicative of our fundamental operating activities. Trends in the profitability of our fundamental operating activities can be more clearly identified without the fluctuations of these realized and unrealized gains or losses. Therefore, these items are excluded from our calculation of adjusted pretax operating income (loss).

(5) Net impairment losses recognized in earnings. The recognition of net impairment losses on investments can vary significantly in both size and timing, depending on market credit cycles. We do not view them to be indicative of our fundamental operating activities. Therefore, these losses are excluded from our calculation of adjusted pretax operating income (loss).

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Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

Summarized financial information concerning our operating segments as of and for the periods indicated, is as follows:

	Three Months Ended March 31, 2014		
(In thousands)	Mortgage Insurance	Financial Guaranty	Total
Net premiums written—insurance	$212,953	$753	$213,706
Net premiums earned—insurance	$198,762	$6,903	$205,665
Net premiums earned on derivatives	—	3,445	3,445
Net investment income	14,021	10,208	24,229
Other income	1,057	70	1,127
Total revenues	213,840	20,626	234,466
Provision for losses	49,159	5,650	54,809
Estimated present value of net credit losses (recoveries) incurred	139	(501)	(362)
Change in PDR	466	—	466
Policy acquisition costs	7,017	1,597	8,614
Other operating expenses	50,358	9,551	59,909
Interest expense	5,372	14,555	19,927
Total expenses	112,511	30,852	143,363
Equity in net loss of affiliates	—	(13)	(13)
Adjusted pretax operating income (loss)	$101,329	$(10,239)	$91,090
Cash and investments	$2,735,809	$2,166,099	$4,901,908
Deferred policy acquisition costs	27,870	35,838	63,708
Total assets	3,136,537	2,392,448	5,528,985
Unearned premiums	580,453	194,335	774,788
Reserve for losses and LAE	1,893,960	29,751	1,923,711
VIE debt	3,144	92,436	95,580
Derivative liabilities	—	257,717	257,717
New Insurance Written (“NIW”) (in millions)	$6,808		

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

	Three Months Ended March 31, 2013		
(In thousands)	Mortgage Insurance	Financial Guaranty	Total
Net premiums written—insurance	$217,286	$(10,101)	$207,185
Net premiums earned—insurance	$182,992	$9,596	$192,588
Net premiums earned on derivatives	—	4,992	4,992
Net investment income	15,102	11,771	26,873
Other income	1,712	59	1,771
Total revenues	199,806	26,418	226,224
Provision for losses	131,956	103	132,059
Estimated present value of net credit recoveries incurred	(299)	(2,845)	(3,144)
Change in PDR	(629)	—	(629)
Policy acquisition costs	11,732	5,463	17,195
Other operating expenses	65,780	14,320	80,100
Interest expense	2,669	13,212	15,881
Total expenses	211,209	30,253	241,462
Equity in net income of affiliates	—	1	1
Adjusted pretax operating loss	$(11,403)	$(3,834)	$(15,237)
Cash and investments	$3,186,871	$2,486,017	$5,672,888
Deferred policy acquisition costs	29,920	44,681	74,601
Total assets	3,663,552	2,707,397	6,370,949
Unearned premiums	428,574	245,275	673,849
Reserve for losses and LAE	2,894,500	24,573	2,919,073
VIE debt	11,062	96,339	107,401
Derivative liabilities	—	430,898	430,898
NIW (in millions)	$10,906		

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The reconciliation of adjusted pretax operating income (loss) to consolidated pretax income (loss) and consolidated net income (loss) is as follows:

	Three Months Ended March 31, 2014	2013
Adjusted pretax operating income (loss):		
Mortgage insurance	$101,329	$(11,403)
Financial guaranty	(10,239)	(3,834)
Total adjusted pretax operating income (loss)	$91,090	$(15,237)
Change in fair value of derivative instruments	50,086	(167,670)
Less: Estimated present value of net credit recoveries incurred	362	3,144
Less: Net premiums earned on derivatives	3,445	4,992
Change in fair value of derivative instruments expected to reverse over time	46,279	(175,806)
Net gains (losses) on investments	64,451	(5,505)
Net gains (losses) on other financial instruments	698	(5,675)
Consolidated pretax income (loss)	202,518	(202,223)
Income tax benefit	(241)	(14,723)
Consolidated net income (loss)	$202,759	$(187,500)

On a consolidated basis, “adjusted pretax operating income (loss)” is a measure not determined in accordance with GAAP. Total adjusted pretax operating income (loss) is not a measure of total profitability, and therefore should not be viewed as a substitute for GAAP pretax income (loss). Our definition of adjusted pretax operating income (loss) may not be comparable to similarly-named measures reported by other companies.

3. Derivative Instruments

We provide a significant portion of our credit protection within our financial guaranty segment in the form of CDS, which are accounted for as derivatives. Derivative instruments are recorded at fair value and changes in fair value are recorded as such in the condensed consolidated statement of operations. All of our derivative instruments are recognized in our condensed consolidated balance sheets as either derivative assets or derivative liabilities. In many of our CDS transactions, primarily our corporate collateralized debt obligations (“CDOs”), we are required to make payments to our counterparty above a specified level of subordination, upon the occurrence of credit events related to the borrowings or bankruptcy of obligors contained within pools of corporate obligations or, in the case of pools of mortgage or other asset-backed obligations, upon the occurrence of credit events related to the specific obligations in the pool. When we provide a CDS as credit protection on a specific obligation, we generally guarantee the full and timely payment of principal and interest when due on such obligation. These derivatives have various maturity dates, but the majority of the net par outstanding of our remaining insured CDS transactions, including all of our corporate CDOs, mature within four years.

We recorded premiums and origination costs related to our CDS and certain other derivative contracts in change in fair value of derivative instruments and policy acquisition costs, respectively, on our condensed consolidated statements of operations. Our classification of these contracts is the same whether we are a direct insurer or we reinsure these contracts.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following table sets forth our gross unrealized gains and gross unrealized losses on derivative assets and liabilities as of the dates indicated. Certain contracts are in an asset position because the net present value of the contractual premium we receive exceeds the net present value of our estimate of the expected future premiums that a financial guarantor of similar credit quality to us would charge to provide the same credit protection, assuming a transfer of our obligation to such financial guarantor as of the measurement date.

(In thousands)	March 31, 2014	December 31, 2013
Balance Sheets		
Derivative assets:		
Financial Guaranty credit derivative assets	$5,638	$6,323
Fixed-maturity derivative assets	8,828	10,319
Total derivative assets	14,466	16,642
Derivative liabilities:		
Financial Guaranty credit derivative liabilities	209,948	238,728
Financial Guaranty VIE derivative liabilities	47,769	68,457
Total derivative liabilities	257,717	307,185
Total derivative liabilities, net	$243,251	$290,543

The notional value of our derivative contracts at March 31, 2014 and December 31, 2013 was $11.4 billion and $12.3 billion, respectively.

The components of the gains (losses) included in change in fair value of derivative instruments are as follows:

	Three Months Ended March 31,	
(In thousands)	2014	2013
Statements of Operations		
Net premiums earned—derivatives	$3,445	$4,992
Financial Guaranty credit derivatives	28,016	(175,724)
Financial Guaranty VIE derivatives	20,117	3,062
Other derivatives	(1,492)	—
Change in fair value of derivative instruments	$50,086	$(167,670)

The valuation of derivative instruments may result in significant volatility from period to period in gains and losses as reported on our condensed consolidated statements of operations. Generally, these gains and losses result, in part, from changes in corporate credit or asset-backed spreads and changes in the market's perception of the creditworthiness of any: (i) underlying corporate entities; (ii) assets underlying asset-backed securities ("ABS"); or (iii) primary obligors of obligations for which we provide second-to-pay credit protection. Additionally, when determining the fair value of our liabilities, we are required to incorporate into the fair value of those liabilities an adjustment that reflects our own non-performance risk, and consequently, changes in the market's perception of our non-performance risk can also result in gains and losses on our derivative instruments. Any incurred gains or losses (which include any claim payments) on our financial guaranty contracts that are accounted for as derivatives are recognized as a change in fair value of derivative instruments. Because our fair value determinations for derivative and other financial instruments are based on assumptions and estimates that are inherently subject to risk and uncertainty, the fair value amounts could vary significantly from period to period. See Note 4 for information on the fair value of our financial instruments.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following table shows selected information about our derivative contracts:

	March 31, 2014		
($ in thousands)	Number of Contracts	Par/ Notional Exposure	Total Net Asset (Liability)
Product			
Corporate CDOs	17	$6,957,838	$ (2,457)
Non-Corporate CDOs and other derivative transactions:			
Trust preferred securities ("TruPs")	13	956,989	(30,202)
CDOs of commercial mortgage-backed securities ("CMBS")	3	1,381,000	(56,312)
Other:			
Structured finance	4	500,950	(75,691)
Public finance	21	1,278,666	(31,096)
Total Non-Corporate CDOs and other derivative transactions	41	4,117,605	(193,301)
Assumed financial guaranty credit derivatives:			
Structured finance	26	156,168	(8,151)
Public finance	4	90,197	(401)
Total Assumed	30	246,365	(8,552)
Financial Guaranty VIE derivative liabilities (1)	1	78,575	(47,769)
Other (2)	1	—	8,828
Grand Total	90	$11,400,383	$ (243,251)

(1) Represents the fair value of a CDS included in a VIE that we have consolidated.
(2) Represents derivative assets related to other purchased derivatives for which we do not have loss exposure that exceeds our net asset amount.

4. Fair Value of Financial Instruments

Certain assets and liabilities are recorded at fair value. These include: available for sale securities, trading securities, VIE debt, derivative instruments, and certain other assets. All derivative instruments are recognized in our condensed consolidated balance sheets as either derivative assets or derivative liabilities. All changes in fair value of trading securities, VIE debt, derivative instruments, and certain other assets are included in our condensed consolidated statements of operations. All changes in the fair value of available for sale securities are recorded in accumulated other comprehensive income (loss).

Our estimated fair value measurements are intended to reflect the assumptions market participants would use in pricing an asset or liability based on the best information available. Assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and the risks inherent in the inputs to the model. Changes in economic conditions and capital market conditions, including but not limited to, credit spread changes, benchmark interest rate changes, market volatility and changes in the value of underlying collateral or of any third-party guaranty or insurance, could cause actual results to differ materially from our estimated fair value measurements. We define fair value as the current amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the event that our investments or derivative contracts were sold, commuted, terminated or settled with a counterparty or transferred in a forced liquidation, the amounts received or paid may be materially different from those determined in accordance with the accounting standard regarding fair value measurements. Differences may also arise between our recorded fair value and the settlement or termination value with a counterparty based upon consideration of information that may not be available to another market participant. Those differences, which may be material, are recorded as realized gains/(losses) in our condensed consolidated statements of operations in the period in which the transaction occurs. There were no significant changes to our fair value methodologies during the three months ended March 31, 2014.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

When determining the fair value of our liabilities, we are required to incorporate into the fair value of those liabilities an adjustment that reflects our own non-performance risk. Our five-year CDS spread is an observable quantitative measure of our non-performance risk and is used by typical market participants to determine the likelihood of our default; the CDS spread actually used in the valuation of specific fair value liabilities is typically based on the remaining term of the insured obligation. Assuming all other factors are held constant, as our CDS spread tightens or widens, it has the effect of increasing or decreasing, respectively, the fair value of our liabilities with a corresponding impact on our results of operations.

In accordance with GAAP, we established a three-level valuation hierarchy for disclosure of fair value measurements based on the transparency of inputs to the valuation of an asset or liability as of the measurement date. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level I measurements) and the lowest priority to unobservable inputs (Level III measurements). The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the measurement in its entirety. The three levels of the fair value hierarchy are described below:

Level I	— Unadjusted quoted prices for identical assets or liabilities in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
Level II	— Prices or valuations based on observable inputs other than quoted prices in active markets for identical assets and liabilities; and
Level III	— Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable. Level III inputs are used to measure fair value only to the extent that observable inputs are not available.

The level of market activity used to determine the fair value hierarchy is based on the availability of observable inputs market participants would use to price an asset or a liability, including market value price observations. We provide a qualitative description of the valuation techniques and inputs used for Level II recurring and non-recurring fair value measurements in our audited annual financial statements as of December 31, 2013. For a complete understanding of those valuation techniques and inputs used as of March 31, 2014, these unaudited condensed consolidated financial statements should be read in conjunction with the audited annual financial statements and notes thereto included in our 2013 Form 10-K.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following is a list of those assets and liabilities that are measured at fair value by hierarchy level as of March 31, 2014:

(In millions)	Level I	Level II	Level III	Total
Assets and Liabilities at Fair Value				
Investment Portfolio:				
U.S. government and agency securities	$980.0	$370.9	$—	$1,350.9
State and municipal obligations	—	619.0	19.1	638.1
Money market instruments	639.5	—	—	639.5
Corporate bonds and notes	—	1,026.0	—	1,026.0
Residential mortgage-backed securities (“RMBS”)	—	282.4	—	282.4
CMBS	—	282.6	—	282.6
Other ABS	—	234.4	—	234.4
Foreign government and agency securities	—	46.7	—	46.7
Equity securities (1)	130.0	96.4	0.4	226.8
Other investments (2)	—	2.2	82.1	84.3
Total Investments at Fair Value (3)	1,749.5	2,960.6	101.6	4,811.7
Derivative assets	—	8.8	5.6	14.4
Other assets (4)	—	—	92.5	92.5
Total Assets at Fair Value	$1,749.5	$2,969.4	$199.7	$4,918.6
Derivative liabilities	$—	$—	$257.7	$257.7
VIE debt (5)	—	—	95.6	95.6
Total Liabilities at Fair Value	$—	$—	$353.3	$353.3

(1) Comprising broadly diversified domestic equity mutual funds included within Level I and various preferred and common stocks invested across numerous companies and industries included within Levels II and III.
(2) Comprising TruPs ($0.6 million) and short-term certificates of deposit (“CDs”) ($1.6 million) included within Level II and lottery annuities ($0.3 million), TruPs ($0.2 million), and a guaranteed investment contract held by a consolidated VIE ($81.6 million) within Level III.
(3) Does not include fixed-maturities held to maturity ($0.1 million) and certain other invested assets ($46.8 million), primarily invested in limited partnerships, accounted for as cost-method investments and not measured at fair value.
(4) Primarily comprising manufactured housing loan collateral related to two consolidated financial guaranty VIEs.
(5) Comprising consolidated debt related to NIMS VIEs ($3.1 million) and financial guaranty VIEs ($92.5 million).

At March 31, 2014, our total Level III assets were approximately 4.1% of total assets measured at fair value and total Level III liabilities accounted for 100% of total liabilities measured at fair value. Realized and unrealized gains and losses on Level III assets and liabilities in the rollforward represent gains and losses for the periods in which they were classified as Level III.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following is a list of those assets and liabilities that are measured at fair value by hierarchy level as of December 31, 2013:

(In millions)	Level I	Level II	Level III	Total
Assets and Liabilities at Fair Value				
Investment Portfolio:				
U.S. government and agency securities	$755.0	$402.9	$—	$1,157.9
State and municipal obligations	—	602.3	18.7	621.0
Money market instruments	672.6	—	—	672.6
Corporate bonds and notes	—	1,036.6	—	1,036.6
RMBS	—	560.4	—	560.4
CMBS	—	288.9	—	288.9
Other ABS	—	194.9	0.9	195.8
Foreign government and agency securities	—	40.7	—	40.7
Equity securities (1)	128.3	97.1	0.4	225.8
Other investments (2)	—	2.2	81.5	83.7
Total Investments at Fair Value (3)	1,555.9	3,226.0	101.5	4,883.4
Derivative assets	—	10.3	6.3	16.6
Other assets (4)	—	—	91.9	91.9
Total Assets at Fair Value	$1,555.9	$3,236.3	$199.7	$4,991.9
Derivative liabilities	$—	$—	$307.2	$307.2
VIE debt (5)	—	—	94.6	94.6
Total Liabilities at Fair Value	$—	$—	$401.8	$401.8

(1) Comprising broadly diversified domestic equity mutual funds included within Level I and various preferred and common stocks invested across numerous companies and industries included within Levels II and III.
(2) Comprising TruPs ($0.6 million) and short-term CDs ($1.6 million) included within Level II and lottery annuities ($0.3 million), TruPs ($0.2 million), and a guaranteed investment contract held by a consolidated VIE ($81.0 million) within Level III.
(3) Does not include fixed-maturities held to maturity ($0.4 million) and certain other invested assets ($47.4 million), primarily invested in limited partnerships, accounted for as cost-method investments and not measured at fair value.
(4) Primarily comprising manufactured housing loan collateral related to two consolidated financial guaranty VIEs.
(5) Comprising consolidated debt related to NIMS VIEs ($2.8 million) and financial guaranty VIEs ($91.8 million).

At December 31, 2013, our total Level III assets approximated 4.0% of total assets measured at fair value and our total Level III liabilities accounted for 100% of total liabilities measured at fair value. Realized and unrealized gains and losses on Level III assets and liabilities in the rollforward represent gains and losses for the periods in which they were classified as Level III.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following tables quantify the estimated impact of our non-performance risk on our derivative assets, derivative liabilities and net VIE liabilities (in aggregate by type) presented in our condensed consolidated balance sheets as of the dates indicated:

(In basis points)	March 31, 2014	December 31, 2013	March 31, 2013	December 31, 2012
Radian Group's five-year CDS spread	288	323	513	913

(In millions)	Fair Value Liability before Consideration of Radian Non-Performance Risk March 31, 2014	Impact of Radian Non-Performance Risk March 31, 2014	Fair Value Liability Recorded March 31, 2014
Product			
Corporate CDOs	$ 26.0	$ 23.5	$ 2.5
Non-Corporate CDO-related (1)	357.6	155.7	201.9
NIMS-related (2)	5.2	2.1	3.1
Total	$ 388.8	$ 181.3	$ 207.5

(In millions)	Fair Value Liability before Consideration of Radian Non-Performance Risk December 31, 2013	Impact of Radian Non-Performance Risk December 31, 2013	Fair Value Liability Recorded December 31, 2013
Product			
Corporate CDOs	$ 30.4	$ 29.0	$ 1.4
Non-Corporate CDO-related (1)	409.7	178.7	231.0
NIMS-related (2)	5.0	2.2	2.8
Total	$ 445.1	$ 209.9	$ 235.2

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(1) Includes the net fair value liability recorded within derivative assets and derivative liabilities and the net fair value liabilities included in our consolidated VIEs.
(2) Includes NIMS VIE debt.

Non-performance risk is commonly measured by default probability, with a credit spread tightening indicating a lesser probability of default. Radian Group's five-year CDS spread at March 31, 2014 implies a market view that there is a 21.1% probability that Radian Group will default in the next five years as compared to a 22.9% implied probability of default at December 31, 2013. The cumulative impact on our derivative assets, derivative liabilities and VIE liabilities attributable to the market's perception of our non-performance risk decreased by $28.6 million during the first three months of 2014, as presented in the tables above. This decrease was in part due to the decrease in net derivative liabilities outstanding, as well as the market's perception of the lower probability that Radian Group may default.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following is a rollforward of Level III assets and liabilities measured at fair value for the quarter ended March 31, 2014:

(In millions)	Beginning Balance at January 1, 2014	Realized and Unrealized Gains (Losses) Recorded in Earnings (1)	Purchases	Sales	Issuances	Settlements	Transfers Into (Out of) Level III (2)	Ending Balance at March 31, 2014
Investments:								
State and municipal obligations	$18.7	$ 0.4	$—	$—	$—	$—	$ —	$19.1
Other ABS	0.9	—	—	—	—	0.4	(0.5)	—
Equity securities	0.4	—	—	—	—	—	—	0.4
Other investments	81.5	0.6	—	—	—	—	—	82.1
Total Level III Investments	101.5	1.0	—	—	—	0.4	(0.5)	101.6
Other assets	91.9	5.8	—	—	—	5.2	—	92.5
Total Level III Assets	$193.4	$ 6.8	$—	$—	$—	$ 5.6	$ (0.5)	$194.1
Derivative liabilities, net	$300.9	$ 52.2	$—	$—	$—	$ (3.4)	$ —	$252.1
VIE debt	94.6	(5.1)	—	—	—	4.1	—	95.6
Total Level III Liabilities, net	$395.5	$ 47.1	$—	$—	$—	$ 0.7	$ —	$347.7

(1) Includes unrealized gains (losses) relating to assets and liabilities still held as of March 31, 2014 as follows: $0.2 million for other investments, $3.6 million for other assets, $48.6 million for derivative liabilities and $(4.4) million for VIE debt.

(2) Transfers are recognized at the end of the period as the availability of market observed inputs change from period to period.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following is a rollforward of Level III assets and liabilities measured at fair value for the quarter ended March 31, 2013:

(In millions)	Beginning Balance at January 1, 2013	Realized and Unrealized Gains (Losses) Recorded in Earnings (1)	Purchases	Sales	Issuances	Settlements	Transfers Into (Out of) Level III (2)	Ending Balance at March 31, 2013
Investments:								
State and municipal obligations	$19.0	$0.2	$—	$—	$—	$—	$ —	$19.2
Corporate bonds and notes	—	—	2.7	—	—	—	—	2.7
CMBS	—	—	3.1	—	—	—	—	3.1
Other ABS	1.7	—	—	—	—	0.2	—	1.5
Equity securities	1.0	—	—	0.6	—	—	—	0.4
Other investments	79.0	(1.6)	0.4	0.1	—	0.4	—	77.3
Total Level III Investments	100.7	(1.4)	6.2	0.7	—	0.6	—	104.2
NIMS derivative assets	1.6	—	—	—	—	—	—	1.6
Other assets	99.2	3.3	—	—	—	6.0	—	96.5
Total Level III Assets	$201.5	$1.9	$6.2	$0.7	$—	$6.6	$ —	$202.3
Derivative liabilities, net	$254.9	$(167.7)	$—	$—	$—	$(3.5)	$ —	$426.1
VIE debt	108.9	(3.3)	—	—	—	4.8	—	107.4
Total Level III Liabilities, net	$363.8	$(171.0)	$—	$—	$—	$1.3	$ —	$533.5

(1) Includes unrealized gains (losses) relating to assets and liabilities still held as of March 31, 2013 as follows: $(1.5) million for investments, $0.8 million for other assets, $(172.6) million for derivative liabilities and $(2.5) million for VIE debt.

(2) Transfers are recognized at the end of the period as the availability of market observed inputs change from period to period.

There were no transfers between Level I and Level II for the quarters ended March 31, 2014 or 2013.

For markets in which inputs are not observable or limited, we use significant judgment and assumptions that a typical market participant would use to evaluate the market price of an asset or liability. Given the level of judgment necessary, another market participant may derive a materially different estimate of fair value. These assets and liabilities are classified in Level III of our fair value hierarchy. For fair value measurements categorized within Level III of the fair value hierarchy, we use certain significant unobservable inputs in estimating fair value. Those inputs primarily relate to the probability of default, the expected loss upon default and our own non-performance risk as it relates to our liabilities.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following table summarizes the significant unobservable inputs used in our recurring Level III fair value measurements as of March 31, 2014:

(In millions)	Fair Value Net Asset (Liability) March 31, 2014 (1)	Valuation Technique	Unobservable Input	Range/ Weighted Average
Level III Assets/Liabilities:				
State and municipal obligations	$19.1	Discounted cash flow	Discount rate	12.3 %
			Expected loss	11.1 %
Other investments	81.6	Discounted cash flow	Discount rate	1.0 %
Corporate CDOs	(2.5)	Base correlation model	Radian correlation to corporate index	85.0 %
			Average credit spread	0.1 % - 0.9 %
			Own credit spread (2)	0.9 % - 3.8 %
CDOs of CMBS	(56.3)	Discounted cash flow	Radian correlation to CMBS transaction index	72.0 % - 85.0 %
			Own credit spread (2)	0.9 % - 3.8 %
TruPs CDOs	(30.2)	Discounted cash flow	Principal recovery	75.0 %
			Principal recovery (stressed)	65.0 %
			Probability of conditional liquidity payment	0.2 % - 10.0 %
			Own credit spread (2)	0.9 % - 3.8 %
TruPs - related VIE	(47.8)	Discounted cash flow	Discount rate	8.8 %
Other non-corporate CDOs and derivative transactions	(115.3)	Risk-based model	Average life (in years)	<1 - 20
			Own credit spread (2)	0.9 % - 3.8 %
NIMS VIE	(3.1)	Discounted cash flow	NIMS credit spread	43.2 %
			Own credit spread (2)	7.2 %

(1) Excludes certain assets and liabilities for which we do not develop quantitative unobservable inputs. The fair value estimates for these assets and liabilities are developed using third-party pricing information, generally without adjustment.
(2) Represents the range of our CDS spread that a typical market participant might use in the valuation analysis based on the remaining term of the investment.

Radian Group Inc.
Notes to Unaudited Condensed Consolidated Financial Statements — (Continued)

The following table summarizes the significant unobservable inputs used in our recurring Level III fair value measurements as of December 31, 2013:

(In millions)	Fair Value Net Asset (Liability) December 31, 2013 (1)	Valuation Technique	Unobservable Input	Range/ Weighted Average
Level III Assets/Liabilities:				
State and municipal obligations	$18.7	Discounted cash flow	Discount rate	12.3 %
			Expected loss	11.1 %
Other investments	81.0	Discounted cash flow	Discount rate	1.2 %
Corporate CDOs	(1.4)	Base correlation model	Radian correlation to corporate index	85.0 %
			Average credit spread	0.1 % - 0.9 %
			Own credit spread (2)	0.8 % - 4.3 %
CDOs of CMBS	(67.8)	Discounted cash flow	Radian correlation to CMBS transaction index	72.0 % - 85.0 %
			Own credit spread (2)	0.8 % - 4.3 %
TruPs CDOs	(43.9)	Discounted cash flow	Principal recovery	75.0 %
			Principal recovery (stressed)	