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HEARD ON THE STREET

When a Loss Is a Gain

New Rule Helped Radian Turn Woes Into a Net Profit

By DAVID REILLY
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Like other companies that insure bonds and mortgages, **Radian Group** Inc. had a rough first quarter. What a surprise then that it managed to post net profit of $195 million.

How that happened holds a cautionary tale for investors. Radian was in the black because its hobbled financial condition caused it to report gains of about $2 billion on some of its liabilities.

The profit was a controversial byproduct of a new accounting rule involving mark-to-market accounting. Without the benefit of this quirk, Radian's loss would have been about $215 million.

Radian

Radian's headquarters in Philadelphia

One of the basic rules of accounting says that a reduction in the value of a liability leads to a gain that usually boosts profit. Under the new rule, companies have to take into account the market's view of their own financial health when considering the market value of some liabilities. In this case, a company's poor health can lead to a reduction in the liability's value.

Radian hasn't done anything wrong. It properly applied the new rule and clearly flagged its impact when it reported earnings last week. Others might not be so forthright, meaning investors will have to be even more sharp-eyed as the credit crisis plays itself out.

The irony is that by marking these particular assets to market as the new rule requires, the weaker a company gets, the stronger it may look.

"The most bizarre aspect of this is that if I'm going bankrupt, the market's diminishing perception of my credit-worthiness fuels my profits," said Damon Silvers, associate general counsel at the AFL-CIO and a longtime critic of market-value accounting.

Another twist: If perceptions of Radian's financial health increase in coming quarters, the company could reverse the gain. That could lead it to take losses on some of its assets.

Radian Chief Financial Officer C. Robert Quint doesn't take issue with the overall notion of market-value accounting. But he said aspects of it, such as these gains, can be troubling. "For investors to really understand what's going on behind the numbers is proving more and more difficult," he said.

Other companies, notably big banks and brokers, have in recent months seen similar gains from declines in the value of their own debt, which also leads to a reduction of liabilities and a boost in profit. But the impact is more pronounced at Radian and other insurers because the gains are coming instead from their core insurance business, at least when it involves derivatives. Radian and others also saw an outsized impact because their first-time adoption of the rule led to a big, all-at-once adjustment.

Here is how it plays out. Say a company holds a bond and insures against the bond's default by buying a credit-default swap from an insurer. If the bond falls 10%, the value of the swap would increase, say, by the same amount. The bond is considered riskier, so insurance on the bond is more valuable.

In the past, a bondholder would have booked offsetting gains and losses as the bond fell in value and the insurance rose in value. But the new accounting rule on measuring market values says companies also have to consider how much something would fetch if sold today.

If the market has doubts about the financial health of the insurer that issued the credit-default swap, that swap might not fetch the full 10% premium. While the bond it insures is riskier, the insurer that issued it is riskier, too. Maybe it could be sold for only a 5% gain. In that case, the initial 10% moves in both the bond and swap wouldn't cancel each other out and the bondholder would record a loss of 5%.

For the insurer issuing the swap, though, this works in reverse. When bonds that Radian insured fell in value, the increase in the value of the swap, or liability, would be taken as a charge. The new rule added a wrinkle -- they could no longer assume that the only driver of the swap's value was the bond it insured. Instead, the insurers had to figure in the impact of their own perceived credit-worthiness and how that would affect the swap's value in a sale.

Radian's perceived credit-worthiness plummeted in the first quarter as billions of dollars of mortgages it insured fell in value. With Radian's credit-worthiness in question, the value of the credit-default swaps it issued fell in value. That led to a big decline in the value it ascribed to swaps.

Because the bonds it insured had been falling in value for a while, the swaps' values had been increasing, leading to charges in previous quarters. In the first quarter, a big chunk of that was reversed. That turned a loss into profit.

In theory, the logic of the new accounting approach holds up. But that doesn't change the fact that for investors, the real-world outcome is perverse.

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