SOUTHWALL TECHNOLOGIES INC /DE/
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July 20, 2004

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

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the Securities
Exchange Act of 1934 (Amendment No. 2)

Filed by the Registrant x
Filed by a Party other than the Registrant o
Check the appropriate box:

x	Preliminary Proxy Statement
o	**Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
o	Definitive Proxy Statement
o	Definitive Additional Materials
o	Soliciting Material Pursuant to §240.14a-12

SOUTHWALL TECHNOLOGIES INC.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

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(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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o Fee paid previously with preliminary materials.

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

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(3) Filing Party:

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SOUTHWALL TECHNOLOGIES INC.
3975 East Bayshore Road
Palo Alto, California 94303

, 2004

Dear Stockholder:

On February 24, 2004, we announced that we had entered into an agreement with Needham & Company, Inc., a U.S. investment banking, securities and asset management firm, certain of its affiliates and Dolphin Asset Management, a New York-based asset management firm. The agreement amended and restated an agreement entered into among the parties on December 18, 2003. Pursuant to the original agreement and the amended and restated agreement, we consummated a series of related transactions resulting in:

- the issuance and sale to Needham, its affiliates and Dolphin of convertible notes in an aggregate principal amount of $4,500,000, which are convertible into shares of our series A convertible preferred stock at a conversion price of $1.00 per share and are secured by a pledge of shares of a portion of the shares of our German subsidiary;

- the establishment of a revolving line of credit with Pacific Business Funding, or PBF, providing for borrowing availability up to $3,000,000, guaranteed by Needham;

- in connection with the establishment of the revolving line of credit and the agreement to forbear from exercising remedies in connection with defaults under other credit agreements between us and PBF, the issuance to PBF of warrants exercisable for an aggregate of 360,000 shares (subject to adjustment) of the our common stock, at an exercise price per share equal to $.01; and

- the issuance to Needham, its affiliates and Dolphin of warrants exercisable for up to 13,881,536 shares (subject to adjustment) of the our common stock, at an exercise price per share equal to $.01, in connection with the issuance of the convertible notes, in consideration of Needham s guarantee, and pursuant to anti-dilution provisions triggered by our arrangements with our creditors.

We undertook these transactions to address our urgent need to raise additional cash, and, without them, we believe we would have been required to file for bankruptcy. We believe that these transactions will provide us with additional time in seeking to achieve production qualification for new products for the electronic display market and may assist us in seeking to achieve quarterly cash break-even by the end of 2004.

Accordingly, I am pleased to invite you to attend an annual meeting of stockholders on , 2004 at 9:00 a.m., at our principal executive offices at 3975 East Bayshore Road, Palo Alto, California, to consider an amendment of our charter to increase the number of shares of capital stock we have authorized for issuance in order to allow us to be able to fulfill our contractual obligations and issue all of the shares of common stock issuable in the event of conversion the convertible notes and exercise of the warrants that we issued in connection with the transactions described above, as well as other future equity issuances, including those pursuant to our equity compensation plans. If the charter amendment is not approved, we will not have a sufficient number of shares of common stock available to meet all of our possible obligations to issue shares of common stock and could be subject to legal action by the holders of these rights, and we will be required to repay the entire principal amount of $4,500,000 under the convertible notes plus interest to the holders of the notes 45 days following the annual meeting.

In addition, we will seek stockholder approval to amend our 1997 Stock Incentive Plan and to approve our 1998 Stock Plan for Employees and Consultants, as amended. We are proposing to amend these plans to increase the number of shares available for issuance from 2,150,000 to 6,150,000 in the case of the 1997 plan and from 1,150,000 to 2,400,000 in the case of the 1998 plan, and to make certain other changes to

these plans, including to eliminate the evergreen provisions that automatically on the first day of each year have increased the number of shares available for issuance under the plans. We believe the amendments to the plans will help us to restore the competitiveness of our compensation programs. We view the amendments to the plans as critical to our ability to attract, motivate and retain the types of key employees and non-employee directors who our essential to our growth and success.

After careful review, the Board of Directors has unanimously determined that the increase in the number of authorized shares of our capital stock, as well as the other matters for which we are seeking approval at the annual meeting, are in the best interests of Southwall Technologies and its stockholders. Therefore, the Board recommends that you vote to approve each of the proposals to be considered at the annual meeting.

As a stockholder, you have the opportunity to voice your opinion on the proposals. Your vote is important. **Even if you plan to attend the annual meeting, please be sure to complete, sign and return the proxy card in the enclosed, postage-prepaid envelope as promptly as practicable.** You may revoke your proxy at any time before it is exercised at the annual meeting or vote your shares personally if you attend the annual meeting.

Attached are a Notice of Annual Meeting of Stockholders and a Proxy Statement containing a discussion of the proposals. We urge you to read this material carefully.

Thank you in advance for your participation and prompt attention.

/s/ THOMAS G. HOOD

Sincerely,
Thomas G. Hood
President and Chief Executive Officer

SOUTHWALL TECHNOLOGIES INC.

3975 East Bayshore Road
Palo Alto, California 94303

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

To Be Held on , 2004

To the stockholders of Southwall Technologies Inc.:

The Board of Directors of Southwall Technologies Inc. has called a annual meeting to seek stockholder approval of a proposed amendment to Southwall s charter and other matters listed below.

Each of the matters submitted to our stockholders at the annual meeting is described in more detail in the accompanying proxy statement. We encourage you to read the proxy statement, including the appendixes, in its entirety. The details of the annual meeting are as follows:

Date: , 2004
Time: 9:00 a.m., local time
Place: Our principal executive offices at 3975 East Bayshore Road, Palo Alto, California
Items of Business: At the annual meeting, you and our other stockholders will be asked to:

1. elect directors to serve for the ensuing year;
2. approve an amendment to our certificate of incorporation to increase:
   - the number of authorized shares of common stock from 20,000,000 to 50,000,000, and
   - the total number of authorized shares of capital stock from 25,000,000 to 55,000,000;

	3.	approve an amendment to our 1997 Stock Incentive Plan;
	4.	approve our 1998 Stock Plan for Employees and Consultants, as amended; and
	5.	transact such other business as may properly come before the meeting or any adjournment.
Record Date:	You may vote at the annual meeting if you were a stockholder of record at the close of business on June 30, 2004.	
Proxy Voting:	Your vote is important. You may vote on these matters in person or by proxy. We ask that you complete and return the enclosed proxy card promptly-whether or not you plan to attend the annual meeting-in the enclosed addressed, postage-paid envelope, so that your shares will be represented and voted at the annual meeting in accordance with your wishes. You can revoke your proxy at any time prior to its exercise by written notice received by us, by delivering to us a duly executed proxy bearing a later date, or by attending the annual meeting and voting your shares in person.	

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the transactions described in this document, passed upon the fairness or merits of these transactions, or passed upon the accuracy or adequacy of the disclosure in this document. Any representation to the contrary is a criminal offense.

This notice, the attached proxy statement and form of proxy card are first being mailed to our stockholders beginning on or about , 2004.

/s/ MAURY AUSTIN

By Order of the Board of Directors

Maury Austin
Secretary

Palo Alto, California
, 2004

If you have any questions about the proposals, including the procedures for voting your shares, please contact Maury Austin at (650) 962-9111.

PROXY STATEMENT
FOR
ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD ON , 2004

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PROXY STATEMENT SUMMARY

We have included the following summary of our recent financing transaction that gives rise to the need to increase the number of shares of our authorized common stock and related matters to provide background information about the proposals to be presented at the annual meeting. You are encouraged to read this entire proxy statement, including the appendixes. This summary is qualified in its entirety be the full text of this proxy statement, including the appendixes.

Annual Meeting *(see discussion beginning at page 7)*

We have sent you this proxy statement and the enclosed proxy card because our Board of Directors is soliciting your proxy to vote at our annual meeting of stockholders or any adjournment or postponement of the annual meeting. The annual meeting will be held at 9:00 a.m., local time, on , 2004, at our principal executive offices located at 3975 East Bayshore Road, Palo Alto, California. You may vote at the annual meeting if you were a stockholder of record at the close of business on June 30, 2004, the record date for the annual meeting.

Background of Financing *(see discussion beginning at page 17)*

During 2003, we experienced a significant decline in sales, which led to a significant deterioration in our working capital position, which raised concerns about our ability to fund our operations, continue as a going concern and meet our obligations.

On October 8, 2003, our management reviewed the revenue forecast for the fourth quarter of 2003 and determined that the anticipated sales for the quarter would not generate enough cash flow to continue operations through the end of the quarter. Management presented its findings to our

Board of Directors on October 10, 2003, and the directors instructed our management team to develop an emergency restructuring plan to improve our cash flow and to obtain new financing.

The primary elements of management s restructuring plan included:

- Shutting down a majority of our domestic manufacturing and transferring that production to our Dresden, Germany facility;
- Undertaking a series of staggered layoffs;
- Arranging new payment terms with major creditors and vendors to extend or reduce our payment obligations;
- Accelerating our cash collections;
- Reducing our operating expenses and inventory levels;
- Minimizing our capital expenditures; and
- Seeking new sources of financing.

We also began to solicit and receive proposals from potential investors and lenders. We evaluated a variety of alternatives to raise additional capital, as well as alternatives to restructure our upcoming payment obligations without raising additional capital. Our access to the traditional capital markets was, and continues to be, constrained, however, by a number of factors, including our financial position and results of operations, as well as the risks described in our filings with the SEC. As a result, we concluded that a private equity investment was the most attractive alternative to continue as a going concern.

We received and evaluated three financing proposals, including the Needham & Company, Inc., or Needham, proposal, which is described in further detail below. One proposal consisted of an initial offer to purchase up to $3.0 million of our common stock, in two tranches, at a price equal to 70% of the average

closing price of our common stock on the Nasdaq National Market during the 10 days preceding the closing dates. The initial tranches would have consisted of $2.0 million of our common stock, with the additional $1.0 million of common stock to have been purchased at the option of the investor within 18 months of the closing of the initial tranche. In addition, the investor would have received warrants for approximately 6,000,000 shares of our common stock, exercisable for five years at a per share exercise price equal to 110% of the closing price of our common stock on the Nasdaq National Market as of the business day prior the closing of the initial equity tranche. Another proposal contemplated the issuance of a $2.0 million letter of credit to Pacific Business Funding, or PBF, against which we would have been able to borrow under our existing domestic factoring agreement with PBF.

After reviewing and seeking to negotiate revisions to all of the proposals submitted, the Board unanimously determined on November 10, 2003 to proceed with the Needham offer, primarily because the Board believed that the amount of cash that we would have received under each of the two other proposals would have been insufficient to meet our short-term operational cash flow requirements.

Summary of the Financing *(see discussion beginning on page 17)*

On December 18, 2003, to raise cash to fund our operations and continue as a going concern, we entered into an investment agreement with Needham & Company, Inc., Needham Capital Partners II, L.P., Needham Capital Partners II (Bermuda), L.P., Needham Capital Partners III, L.P., Needham Capital Partners IIIA, L.P., Needham Capital Partners III (Bermuda), L.P., and Dolphin Direct Equity Partners, LP, collectively the Investors. Under the terms of the investment agreement, Needham & Company, Inc. agreed to issue guarantees of our new line of credit facility in two separate tranches of $2.25 million and $750,000, respectively, and the Investors agreed to purchase shares of our Series A 10% Cumulative Convertible Preferred Stock, par value $.001 per share, or the Series A shares, in two separate tranches of $1.5 million and $3.0 million, respectively. The new borrowings and the purchase of each equity tranche were subject to certain conditions, including, among other things, the receipt of concessions by us from creditors and landlords, the completion by us of certain restructuring actions and the achievement of cash flow break-even. Needham executed a guarantee of up to $2.25 million of our indebtedness under the new line of credit facility on December 18, 2003, and received a warrant to purchase 941,115 shares of our common stock, approximately 7.5% of our total shares currently outstanding. On January 15, 2004, Needham increased its guarantee of our obligations under the new line of credit by $750,000 and received an additional warrant to purchase 941,115 shares of common stock. A further description of the terms of all warrants is set forth below.

On February 20, 2004, the parties amended and restated the investment agreement to provide that we would issue and sell to the Investors an aggregate of $4.5 million of our convertible notes in one tranche instead of Series A shares in two separate tranches. A further description of the convertible notes is set forth below. In connection with the sale of the convertible notes, on February 20, 2004, we issued warrants to the Investors to purchase a total of 1,694,007 shares of our common stock, approximately 13.5% of our total shares currently outstanding. Under the investment agreement, and as further described in the Anti-Dilution Protection section below, we were also required to issue warrants to the Investors for an additional 10,305,299 shares of our common stock, approximately 82.1% of our total shares currently outstanding, pursuant to anti-dilution provisions in the investment agreement that were triggered by the issuance of debt and equity by us as part of the restructuring of our obligations to creditors.

Reasons for the Financing *(see discussion on page 20)*

In the short-term, the financing is intended to enable us to fund our operations, continue as a going concern and meet our financial obligations, as they become due. In addition, the financing will strengthen our balance sheet by increasing our liquidity and working capital.

The net proceeds from the financing, after payment of expenses associated with the financing, have been and will be used to settle payment disputes with and restructure some of our obligations to creditors, purchase raw materials and pay salaries and rent.

Summary of Current Ownership by Investors *(see discussion on page 19)*

Following completion of the financing, based on securities outstanding as of March 28, 2004, the following convertible securities and warrants are held by the Investors:

- if Needham and its affiliated entities were to exercise all of their warrants and convert all of their Series A shares (issuable upon conversion of their convertible notes), while maintaining their current ownership of approximately 2,200,067shares of common stock, then Needham and its affiliated entities would own approximately 15,081,834 shares of our common stock, or about 59.3% of the total shares outstanding, including such issuances to Needham and its affiliates but excluding outstanding warrants and Series A shares held by other Investors; and

- if Dolphin Direct Equity Partners, LP were to exercise all warrants and convert all of its Series A shares (issuable upon conversion of its convertible notes), then Dolphin would own approximately 5,499,769 shares of our common stock, or about 30.5% of the total shares outstanding, including such issuances to Dolphin but excluding outstanding warrants and Series A shares held by other Investors.

In addition, the convertible notes held by the Investors accrue interest 10% per year, compounded daily, payable each December 31st, which interest is also convertible into Series A shares, and the Series A shares are entitled to a cumulative dividend of 10% per year, accruing daily, payable at the discretion of the Board, which dividends are convertible into common stock.

Material Terms of the Convertible Notes *(see discussion beginning on page 21)*

In connection with the investment agreement, we issued convertible notes in an aggregate principal amount of $4.5 million to the Investors. The convertible notes:

- are convertible, at each holder s option, into our Series A shares at a conversion price of $1.00 per share (subject to adjustment);

- accrue interest at an annual rate of 10%, compounded daily, payable each December 31, which interest if accrued but unpaid is also convertible into Series A shares;

- are secured by a pledge of a portion of the stock of our subsidiary, Southwall Europe GmbH; and

- are due and payable on February 20, 2009 or earlier under certain circumstances. For instance, the failure of our stockholders to approve Proposal 2 (the amendment of our charter) will result in the acceleration of the convertible notes.

In addition, so long as any of the convertible notes are outstanding, the approval of the holders of a majority of the convertible notes will be required to effect certain corporate actions. The convertible notes are subordinate to the credit facilities with our senior lender, PBF.

Material Terms of the Series A Convertible Preferred Stock *(see discussion beginning on page 22)*

Dividends on Series A Shares. Each of the Series A shares will have a stated value of $1.00 and will be entitled to a cumulative dividend of 10% per year, payable at the discretion of the Board of Directors. Dividends on the Series A shares shall accrue daily commencing on the date of issuance and shall be deemed to accrue whether or not earned or declared and whether or not there are profits, surplus or other funds legally available for the payment of dividends. Accumulated dividends, when and if declared by the Board, will be paid in cash.

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Restrictions. So long as any Series A shares are outstanding, unless all accrued dividends on all Series A shares have been paid, we are generally prohibited from redeeming or purchasing (or setting aside any monies for the redemption or purchase of) any capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference and paying or declaring any cash dividend or making any cash distribution upon any capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference.

General Voting Rights. Except as described below or as otherwise provided by law, the holders of Series A shares have no voting rights. The approval of the holders of a majority of the Series A shares voting separately as a class will be required to effect certain corporate actions, including the authorization or issuance of shares having preferences or priorities superior to or on a parity with any rights of the Series A shares; the reclassification of any shares into shares having preferences or priorities superior to or on a parity with any rights of the Series A shares; the authorization or issuance of any obligations convertible into or exchangeable for any shares having preferences or priorities superior to or on a parity with any rights of the Series A shares; declaring or paying dividends on or making any distributions with respect to our common stock; increasing or decreasing the authorized number of Series A shares; amending our certificate of incorporation or bylaws to alter or change the preferences, rights, privileges or powers of, or the restrictions provided for the benefit of, any Series A shares; increasing the number of shares of common stock reserved for issuance under our stock option plans; engaging in any transaction constituting a liquidation or dissolution of Southwall, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity; or making any material change to our line of business.

Liquidation Preference. Upon a liquidation or dissolution of Southwall, the holders of Series A shares are entitled to be paid a liquidation preference out of assets legally available for distribution to our stockholders before any payment may be made to the holders of common stock. The liquidation preference is equal to the stated value of the Series A shares, which is $1.00 per share, plus any accumulated but unpaid dividends. Mergers, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity and certain other similar transactions may be deemed to be liquidation events for these purposes.

Conversion. Each of the Series A shares is convertible into common stock at any time at the option of the holder. Each of the Series A shares is convertible into a number of shares of common stock equal to the sum of its stated value plus any accumulated but unpaid dividends, divided by the conversion price of the Series A shares. The conversion price of the Series A shares is $1.00 per share and is subject to adjustment in the event of any stock dividend, stock split, reverse stock split or combination affecting such shares. The Series A shares also have anti-dilution protection that adjusts the conversion price downwards using a weighted-average calculation in the event we issue certain additional securities at a price per share less than the closing price per share of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed. Each Series A share is initially convertible into one share of common stock.

If the closing price of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed is $4.00 or more per share (subject to appropriate adjustment if a stock split, reverse split or similar transaction is effected) for 30 consecutive days, all outstanding Series A shares shall automatically be converted into common stock.

Redemption. The Series A shares are not redeemable.

Material Terms of the Warrants *(see discussion beginning on page 24)*

Investor Warrants. In connection with the investment agreement, we issued warrants (including warrants issued to the Investors as anti-dilution protection for the issuance of debt and equity by us as part of the restructuring of our obligations to creditors) to the Investors that may be exercised to acquire up to

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13,881,536 shares of common stock at an initial exercise price of $0.01 per share. The number of shares and the exercise price are subject to appropriate adjustment in the event of stock splits, reverse stock splits and the granting of a stock dividend on our outstanding common stock. These warrants will be exercisable for cash or through a cashless exercise feature. The warrants are exercisable immediately and have a term of approximately five years.

Upon the reclassification of our common stock or a capital reorganization, each holder of these warrants has the right to receive the same amount and kind of securities, cash or property upon exercise as it would have been entitled to receive had it been the owner of the shares of common stock underlying the warrants at the time of such transaction. Upon a merger or consolidation, a transfer of all or substantially all of our voting securities, or the sale of all or substantially all of our assets, the warrants will terminate if they have not been previously exercised. The holders of the warrants have registration rights under the registration rights agreement described below.

PBF Warrants. In connection with the credit facilities with our senior lender, PBF, we issued warrants to PBF that may be exercised to acquire up to 360,000 shares of common stock at an initial exercise price of $0.01 per share. The terms of these warrants are generally the same as the terms of the warrants issued to the Investors.

Other Proposals *(see discussions beginning on pages 13, 28 and 35)*

In addition to soliciting stockholder approval of the proposed amendment to our charter to increase our authorized shares, our Board of Directors is requesting approval of several other proposals.

We propose to have the stockholders approve amendments to our 1997 Stock Incentive Plan and our 1998 Stock Plan for Employees and Consultants, as amended. We believe that our future success depends significantly on our ability to provide incentives to new and existing employees and to outside directors in the form of equity grants. To attract, retain and motivate employees, Board members and consultants, it is important for us to be able to provide appropriate periodic equity incentives, especially in light of our recent financial difficulties and related restructurings. Although we have over 3,000,000 options currently outstanding, all of them have exercise prices that are in excess (and in many cases significantly in excess) of the recent trading prices of our common stock, and, therefore, we believe that those outstanding options do not provide the incentive that new options priced at current market prices would. Stockholder approval of the amendments to the 1997 Plan and of the 1998 Plan, as amended, will allow us to continue to make these periodic grants. In addition, the amendments to the plans would eliminate the evergreen provisions that automatically on the first day of each year increase the number of shares available for issuance under the plans.

Voluntary Delisting from Nasdaq *(see discussion beginning on page 27)*

Effective March 26, 2004, we voluntarily de-listed from the Nasdaq National Market, and, after trading on the pink sheets, on May 6, 2004, we began trading on the Over-the-Counter Bulletin Board market. Due to the structure of the transaction contemplated by the investment agreement, we were no longer in compliance with certain Nasdaq listing requirements. We felt that a voluntary delisting from Nasdaq and a move to the Over-the-Counter Bulletin Board Market would provide the best option to our shareholders by retaining liquidity in our common stock.

CAUTIONARY STATEMENT CONCERNING
FORWARD-LOOKING INFORMATION

This proxy statement and the documents to which we refer you and incorporate into this proxy statement by reference contain forward-looking statements. In addition, from time to time we or our representatives may make forward-looking statements orally or in writing. We base these forward-looking statements on our expectations and projections about future events, which we derive from the information currently available to us. Such forward-looking statements relate to future events or future performance.

Forward-looking statements are statements that are not historical in nature and include those that use the words may, will, should, expects, anticipates, contemplates, estimates, believes, plans, projected, predicts, potential or continue or the negative of these or similar w
evaluating these forward-looking statements, you should consider various factors, including the competitive environment of our business and the performance of financial markets and general economic conditions. These and other factors, including those contained in our public filings, may cause actual results and events to differ materially from any forward-looking statement. The forward-looking statements represent our estimates as of the date on which we filed this proxy statement with the Securities and Exchange Commission, or the SEC.

Forward-looking statements are only predictions and by their nature are subject to risks, uncertainties and assumptions. The forward-looking events discussed in this proxy statement, the documents to which we refer you and incorporate by reference into this proxy statement and other statements made from time to time by us or our representatives may not occur, and actual events and results may differ materially. Accordingly, you are cautioned not to place undue reliance on any forward-looking statements. Moreover, we assume no obligation to update these forward-looking statements to reflect actual results, changes in assumptions or changes in other factors that might affect the forward-looking statements.

QUESTIONS AND ANSWERS ABOUT THE ANNUAL MEETING

We have included the following discussion of the matters to be presented at the annual meeting to provide summary answers to some of the questions that you might have about the annual meeting and the proposals to be presented to our stockholders at the annual meeting. You are encouraged to read the entire proxy statement, including the appendixes. The information below is qualified in its entirety by the full text of this proxy statement and the attached appendixes.

About the Annual Meeting

Q. Why did Southwall send me this proxy statement?

A. We have sent you this proxy statement and the enclosed proxy card because our Board of Directors is soliciting your proxy to vote at the annual meeting, including any adjournment or postponement of the annual meeting. The annual meeting will be held at 9:00 a.m., local time, on , , 2004, at our principal executive offices located at 3975 East Bayshore Road, Palo Alto, California.

- This PROXY STATEMENT summarizes information about the proposals to be considered at the annual meeting and other information you may find useful in determining how to vote.

- The PROXY CARD is the means by which you actually authorize the persons named in the proxy card to vote your shares in accordance with your instructions.

We are mailing this proxy statement and the enclosed proxy card to stockholders for the first time on or about , 2004.

Q. What is a proxy and how does it work?

A. We are asking for your proxy. Giving your proxy means that you authorize the persons named in the proxy to vote your shares at the annual meeting in the manner that you direct, or if you do not provide directions with respect to a proposal, in the manner recommended by the Board of Directors in this proxy statement. You may direct the proxy holders to vote for or against a proposal or to abstain from voting.

Q. Who is soliciting proxies on behalf of Southwall? Who pays the expenses of the proxy solicitation?

A. Our directors, officers and employees may solicit proxies in person or by mail, telephone, facsimile or electronic mail. We have also retained a proxy solicitor, The Altman Group, to assist in the solicitation of proxies for the annual meeting at an estimated cost to us of between $10,000 and $15,000, plus reimbursement of reasonable expenses. We will reimburse brokers and other nominee holders of shares for expenses they incur in forwarding proxy materials to beneficial owners of those shares.

Q. What proposals am I being asked to approve as a Southwall stockholder?

A. We are asking for you to approve the following proposals, each of which is more fully described in the proxy statement:

Proposal 1	the election of directors to serve for the ensuing year.
Proposal 2	the amendment of our certificate of incorporation to increase the number of authorized shares of common stock from 20,000,000 to 50,000,000, and the total number of authorized shares of capital stock from 25,000,000 to 55,000,000.
Proposal 3	the approval of an amendment of our 1997 Stock Incentive Plan to increase the number shares reserved for issuance thereunder from 2,150,000 to 6,150,000 and to make certain other changes to the plan, including to eliminate the evergreen

provision that automatically on the first day of each year has increased the number of shares available for issuance under the plan by 250,000.

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Proposal 4	the approval of our 1998 Stock Plan for Employees and Consultants, as amended to increase the number of shares reserved for issuance thereunder from 1,150,000 to 2,400,000 and to make certain other changes to the plan, including to eliminate the evergreen provision that automatically on the first day of each year has increased the number of shares available for issuance under the plan by 150,000.

Q. Who may vote at the annual meeting?

A. Only holders of our common stock at the close of business on the record date, June 30, 2004, are entitled to receive notice of, and to vote their shares at, the annual meeting. As of the record date, there were issued and outstanding shares of common stock. At the annual meeting, you will be entitled to one vote for each share of common stock you held on the record date.

Q. How do I vote?

A. You may vote your shares at the annual meeting in person or by proxy:

- TO VOTE IN PERSON, you must attend the annual meeting, and then complete and submit the ballot provided at the annual meeting.

- TO VOTE BY PROXY, you must complete and return the enclosed proxy card. Your proxy card will be valid only if you sign, date and return it before the annual meeting. By completing and returning the proxy card, you will direct the designated persons to vote your shares at the annual meeting in the manner you specify in the proxy card. If you complete the proxy card with the exception of the voting instructions, then the designated persons will vote your shares in favor of the proposal described in this proxy statement. If any other business properly comes before the annual meeting, the designated persons will have the discretion to vote your shares as they deem appropriate.

Q. What if a broker holds my shares in street name ?

A. If your shares are held in street name by a broker or other nominee, your broker or other nominee will not be able to vote your shares prior to the annual meeting (whether in person or otherwise) unless you have given your broker or other nominee instructions to vote your shares on the proposals described in this proxy statement. You should instruct your broker or other nominee to vote your shares by following the procedure provided by your broker or other nominee. You may also attend the annual meeting and vote in person. If you elect to vote in person, however, you must bring to the annual meeting a legal proxy from the broker or other nominee authorizing you to vote the shares.

Q. What will happen if I do not give my broker or other nominee instructions on how to vote my shares?

A. If your shares are held in street name, your broker or other nominee will be prohibited under applicable regulations from using its discretion to vote your shares on the proposals to approve the amendment to our charter, to approve the amendments to the 1997 Plan and to approve the 1998 Plan. If your broker or other nominee instructs us that you have not provided instructions on how to vote on those proposals, your shares will be treated as broker non-votes with respect to those proposals. However, even if you do not give your broker or other nominee instructions as to how to vote on the other proposals described in this proxy statement, your broker or other nominee may be entitled to use its discretion in voting your shares in accordance with industry practice.

Q. *May I revoke my proxy?*

A. Yes. Even if you complete and return a proxy, you may revoke it at any time before it is exercised by taking one of the following actions:

- send written notice that you wish to revoke your proxy to Maury Austin, our corporate Secretary, at our address set forth in the Notice of Annual Meeting appearing before this proxy statement;

- send us another signed proxy with a later date; or

- attend the annual meeting, notify Mr. Austin that you are present, and then vote in person.

If, however, you elect to vote in person at the annual meeting and a broker or other nominee holds your shares, you must bring to the annual meeting a legal proxy from the broker or other nominee authorizing you to vote the shares.

Q. *How many shares must be present in person or by proxy to transact business at the annual meeting?*

A. Our by-laws require that shares representing a majority of the votes entitled to be cast by the holders of common stock outstanding on the record date be present in person or by proxy at the annual meeting to constitute a quorum to transact business with regard to each of the proposals. Shares as to which holders abstain from voting as to a particular matter and broker non-votes will be counted in determining whether there is a quorum of stockholders present at the annual meeting.

Q. *How many votes are required to approve the approvals?*

A. The votes necessary to approve each of the proposals is as follows:

- *Election of Directors*. The six nominees receiving the highest number of votes cast at the annual meeting will be elected, regardless of whether that number represents a majority of the votes cast.

- *Amendment of the charter.* The affirmative vote of a majority of the common stock outstanding on the record date is required to approve the amendment to our certificate of incorporation.

- *Amendments of our 1997 Stock Incentive Plan and our 1998 Stock Plan for Employees and Consultants.* The affirmative vote of a majority of the total number of votes cast at the meeting is needed to approve the amendment to our 1997 Plan and our 1998 Plan.

Abstentions and broker non-votes will not be counted as votes in favor of a proposal, and will also not be counted as votes cast or shares voting on such proposal. Accordingly, abstentions and broker non-votes will have no effect on the outcome of voting with respect to Proposals 1 (election of directors), 3 (amendment to 1997 Plan) and 4 (1998 Plan), because each of those proposals requires an affirmative vote of a majority of the shares of common stock present or represented by proxy. Abstentions and broker non-votes, however, will have the effect of negative votes with respect to Proposal 2 (the amendment of our charter), because that proposal requires the affirmative vote of the holders of a majority of all outstanding shares of common stock.

Q. *What if additional proposals are presented at the annual meeting?*

A. If other proposals are properly presented at the annual meeting for consideration, the persons named in the proxy card will have the discretion to vote on those proposals for you. As of the date of the mailing of this proxy statement, we do not know of any other proposals to be presented at the annual meeting.

Q. *Whom can I contact for more information regarding the proxy materials or voting my shares?*

A. If you have any additional questions about the proposals in this proxy statement, you should contact Maury Austin, our Chief Financial Officer, by telephone at (650) 962-9111 or by e-mail to *maustin@southwall.com*.

About the Proposals

Q. Why is Southwall proposing to amend its charter to increase the number of authorized shares?

A. Under Delaware corporate laws, we are required to obtain approval from our stockholders to amend our charter to increase the number of shares authorized for issuance. After taking into consideration our current outstanding equity obligations, together with our obligations under the investment agreement and related documents in connection with the financing described in this proxy statement, our Board of Directors has unanimously determined that it is necessary to increase the number of shares of common stock authorized for issuance by 30,000,000. Currently, we do not have authorized a sufficient number of shares of common stock to cover the maximum number of shares we would be required to issue if the holders of all of our outstanding convertible notes, warrants and options sought to convert and exercise, as applicable, those instruments into common stock. If our stockholders do not approve the charter amendment, the convertible notes will become due and payable and holders of our options, warrants and convertible notes may bring legal suits against us if they seek to exercise or convert, as applicable, such instruments and we do not have sufficient shares available. If such lawsuits were brought and were successful, there could be a material adverse effect on our financial position and results of operations, including the possibility that Southwall would need to file for bankruptcy. Furthermore, we have agreed, pursuant to the terms of the investment agreement to call a meeting of our stockholders to vote on the increase in our authorized capital stock

Q. How many shares of common stock will be available for issuance under the charter if the charter amendment is approved after giving effect to shares outstanding and shares reserved for issuance pursuant to outstanding options, warrants, convertible notes and stock plans.

A. If our stockholders approve the charter amendment, we expect to have approximately 10,400,000 shares of common stock that are not outstanding or reserved for issuance pursuant to outstanding options, warrants and convertible notes. The additional authorized shares would be available for issuance from time to time in the discretion of the Board, without further stockholder action except as may be required for a particular transaction by applicable law or other policies. Of those additional authorized shares, approximately 5,150,000 would be reserved for issuance to cover shares underlying options available but unissued under our option plans.

Q. What other alternatives did Southwall explore prior to entering into this financing?

A. During 2003, we experienced a significant deterioration in our working capital position, which has raised concerns about our ability to fund our operations and continue as a going concern in the short term and our ability to meet obligations coming due over the next few years.

On October 8, 2003, our management reviewed the revenue forecast for the fourth quarter of 2003 and determined the anticipated sales for the quarter would not generate enough cash flow to continue operations through the end of the quarter. Management presented its findings to our Board of Directors on October 10, 2003, and the directors instructed our management team to develop an emergency restructuring plan to improve our cash flow and to obtain new financing.

The primary elements of management s restructuring plan included:

- Shutting down a majority of our domestic manufacturing and transferring that production to our Dresden, Germany facility;
- Undertaking a series of staggered layoffs;
- Arranging new payment terms with major creditors and vendors to extend or reduce our payment obligations;

- Accelerating our cash collections;
- Reducing our operating expenses and inventory levels;

- Minimizing our capital expenditures; and
- Seeking new sources of funding.

We also began to solicit and receive proposals from potential investors and lenders. We evaluated a variety of public and private market alternatives to raise additional capital, as well as alternatives to restructure our upcoming payment obligations without raising additional capital. Our access to the traditional capital markets was, and continues to be, constrained, however, by a number of factors, including our financial position and results of operations, as well as the risks described in our filings with the SEC. As a result, we concluded that a private equity investment was the most attractive alternative to continue as a going concern.

We received and evaluated three financing proposals, including the Needham proposal, which is described in further detail below. One proposal consisted of an initial offer to purchase up to $3.0 million of our common stock, in two tranches, at a price equal to 70% of the average closing price of our common stock on the Nasdaq National Market during the 10 days preceding the closing dates. The initial tranches would have consisted of $2.0 million of our common stock, with the additional $1.0 million of common stock to have been purchased at the option of the investor within 18 months of the closing of the initial tranche. In addition, the investor would have received warrants for approximately 6,000,000 shares of our common stock, exercisable for five years at a per share exercise price equal to 110% of the closing price of our common stock on the Nasdaq National Market as of the business day prior the closing of the initial equity tranche. Another proposal contemplated the issuance of a $2.0 million letter of credit to PBF, against which we would have been able to borrow under our existing domestic factoring agreement with PBF. After reviewing and seeking to negotiate revisions to all of the proposals submitted, the Board unanimously determined to proceed with the Needham offer, primarily because the Board believe that the amount of cash that we would have received under each of the two other proposals would have been insufficient to meet our short-term operational cash flow requirements.

Q. What percentages of Southwall do Needham and its affiliates and Dolphin own as a result of the financing?

A. As a result of the consummation of the transactions contemplated by the investment agreement, based on securities outstanding as of March 28, 2004, the following convertible securities and warrants are held by the Investors:

- if Needham and its affiliated entities were to exercise all of their warrants and convert all of their Series A shares (issuable upon conversion of their convertible notes), while maintaining their current ownership of approximately 2,200,067shares of common stock, then Needham and its affiliated entities would own approximately 15,081,834 shares of our common stock, or about 59.3% of the total shares outstanding, including such issuances to Needham and its affiliates but excluding outstanding warrants and Series A shares held by other Investors.

- if Dolphin Direct Equity Partners, LP were to exercise all warrants and convert all of its Series A shares (issuable upon conversion of its convertible notes), then Dolphin would own approximately 5,499,769 shares of our common stock, or about 30.5% of the total shares outstanding, including such issuances to Dolphin but excluding outstanding warrants and Series A shares held by other Investors.

In addition, the convertible notes held by the Investors accrue interest 10% per year, compounded daily, payable each December 31st, which interest is also convertible into Series A shares, and the Series A shares are entitled to a cumulative dividend of 10% per year, accruing daily, payable at the discretion of the Board, which dividends are convertible into common stock.

Q. *Will the transactions contemplated pursuant to the investment agreement affect Southwall s reported earnings per share?*

A. Yes. The increase in the number of shares outstanding will result in lower earnings per share. Although we expect to incur a loss each quarter through at least the third quarter of 2004, if we have a profitable quarter, we expect that, based on securities outstanding as of March 28, 2004, earnings per share on a fully-diluted basis will be diluted by approximately 60% to 65%, compared to earnings per share on a fully-diluted basis had the financing and related transactions not been consummated.

Q. *How will we spend the $4,500,000 raised from the sale of the convertible notes?*

A. After deducting approximately $500,000 in professional fees related to the financing and restructuring, the net proceeds of the financing were approximately $4,000,000. We applied the net proceeds as follows:

- approximately $2,200,000 was spent during February and March of 2004, in the normal course of our business for general corporate purposes, including purchases of raw materials, payments to subcontractors and suppliers of approximately $1,000,000, payroll costs of approximately $800,000, and rent and lease payments;

- approximately $800,000 was paid between February 24, 2004 and March 30, 2004, to Judd Properties, LLC, the landlord of our Palo Alto executive offices and manufacturing facilities, in connection with the settlement and restructuring of our lease obligations to Judd Properties, LLC; and

- approximately $1,000,000 has been put up to support a letter of credit in favor of Judd Properties as security for our obligations to depart from and properly restore the property pursuant to our settlement and restructuring with Judd. We have agreed with Judd that, following stockholder approval of the amendment to our charter (Proposal 2), we may substitute a warrant exercisable for 1,437,396 shares of our common stock for the letter of credit as security for our obligations, in which event we will have access to the $1,000,000 that currently supports the letter of credit. We expect that that $1,000,000, if we were to substitute the warrant as security for our obligations to Judd, would be used for working capital and general corporate purposes.

Q. *Will there be any adverse consequences to Southwall if the stockholders do not approve Proposal 2?*

A. If we do not obtain stockholder approval of Proposal 2, we will be unable to meet our obligations to issue shares of capital stock under the investment agreement, and we will be required to repay the aggregate principal amount of $4,500,000 under the convertible notes plus interest to the holders of the convertible notes 45 days following the annual meeting. If the holders of the convertible notes were to demand payment following a failure to approve the charter amendment, there would be an event of default under our senior loan agreements, and it is highly unlikely that we would be able to repay or refinance the amounts then due under the convertible notes and our senior loan obligations. In such an event, Southwall might be required to file for bankruptcy. In addition, without the proceeds from the convertible notes, the amount of capital available to us for general working purposes will be severely limited and we will not be able to fund our operations, service our existing debt obligations or continue as a going concern. In the likely event we are unable to secure an alternative financing plan, we will become insolvent and be required to file for bankruptcy protection. Furthermore, there can be no assurances that we will not be sued by the holders of our options, warrants or convertible notes if we do not have enough authorized shares of common stock to make the required issuances if they seek to exercise or convert those securities, as applicable.

PROPOSAL 1
ELECTION OF DIRECTORS

There are currently eight members of our Board of Directors. The Board has fixed the number of directors for the ensuing year at six and has nominated for such positions the six people listed below, other than Bruce M. Jaffe and Robert C. Stempel, who have decided not to stand for reelection to the Board. As a condition to the Investors investments under the investment agreement, we placed George Boyadjieff on our Board of Directors as Chairman. Noriyuki Nakamura resigned as a director in February 2004. The persons named in the enclosed proxy card as proxies will vote to elect each of the nominees unless you withhold authority to vote for the election of one or more nominees by marking the proxy card to that effect. Each of the six nominees has agreed to serve, but if any of them shall become unable or unwilling to serve, the proxies, unless authority has been withheld as to such nominee, may be voted for election of a substitute nominee designated by our Board of Directors or the Board may reduce the number of directors. Proxies may not be voted for more than six persons.

There are no family relationships among any of our executive officers or directors.

The following information as of the date of this proxy statement is furnished with respect to each director and nominee for election as a director. The information presented includes information each director and nominee has given us about his age, all positions he holds with us, his principal occupation and business experience during the past five years, and the names of other publicly-held companies of which he serves as a director. Information about the number of shares of common stock beneficially owned by each director or nominee, directly and indirectly, as of March 28, 2004, appears above under the heading Security Ownership of Certain Beneficial Owners and Management.

Name	Age
William A. Berry(2)	65
George Boyadjieff, Chairman(3)	65
Thomas G. Hood	48
Bruce M. Jaffe(1)(2)	60
Jami K. Nachtsheim(1)(3)	45
Joseph B. Reagan(1)(2)	69
Walter C. Sedgwick(1)(3)	57
Robert C. Stempel(2)	70

(1) Member of the Compensation Committee.

(2) Member of the Audit Committee.

(3) Member of the Nominating and Corporate Governance Committee.

Mr. Berry has served on our Board of Directors since May 2003. Since July 2003, Mr. Berry has served as a Special Projects Manager of ERPI, the Electric Power Research Institute, a non-profit energy research organization providing science and technology-based solutions to global energy companies. From April 1997 to July 2003, Mr. Berry served as the Chief Financial Officer of EPRI. From 1992 to March 1996, Mr. Berry was the Senior Vice President and Chief Financial Officer of Compression Labs, Inc., a manufacturer of visual communications systems based on digital technology, and from 1989 to 1992 was the President of Optical Shields, Inc. Mr. Berry worked at Raychem Corporation from 1967 until 1988, where he was a Corporate Vice President and Chief Administrative Officer from 1985 to 1988. He is a director of FAFCO, Inc., a manufacturer of solar pool heating systems. Mr. Berry holds a BS in industrial engineering and an MBA from Stanford University.

Mr. Boyadjieff joined our Board of Directors as Chairman on December 19, 2003. Mr. Boyadjieff was the Chief Executive Officer of Varco International, Inc., a diversified oil service company, from 1991 through 2002, and the chairman of Board of Directors of Varco from 1998 through 2003. Mr. Boyadjieff

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retired from active leadership of Varco in 2003. Mr. Boyadjieff holds a BS and an MS in mechanical engineering from the University of California at Berkeley.

Mr. Hood has served as our President and Chief Executive Officer since July 1998 and as a member of our Board of Directors since March 1998. From March 1998 until July 1998, he served as Interim President and Chief Executive Officer. From July 1996 to March 1998, he served as Senior Vice President, General Manager, Energy Products Division. From January 1995 to July 1996, he was Vice President, General Manager, International Operations, and from October 1991 to January 1995, he was Vice President, Marketing and Sales. He is the inventor of record on ten of our patents. Mr. Hood has an MS degree in Mechanical Engineering from New Mexico State University and a BS in mechanical engineering from Union College.

Mr. Jaffe has served as a member of our Board of Directors since April 2003. Since November 2000, Mr. Jaffe has served on the Audit Committee and Board of Directors of Metron Technology, a leading global provider of marketing, sales, service and support solutions to semiconductor materials and equipment suppliers and semiconductor manufacturers. Since August 2000, Mr. Jaffe has served on the Audit Committee and Board of Directors of Pemstar, Inc., a provider of engineering, manufacturing and fulfillment services. Since April 2003, Mr. Jaffe has served as Vice President and Chief Financial Officer of LogicVision, Inc., a software developer for embedded test technology for semiconductors. From July 1997 to July 1999, Mr. Jaffe served as the Chief Financial Officer of Bell Microproducts, an international, value-added provider of high-technology products, solutions, and services to the industrial and commercial markets. From October 1967 to November 1996, Mr. Jaffe served in a variety of management positions with Bell Industries including, President, Chief Operating Officer and Chief Financial Officer. He was also a director of Bell Industries from 1981 to 1996. Mr. Jaffe holds a BS in Business Accounting from the University of Southern California.

Ms. Nachtsheim has been a member of our Board of Directors since April 2003. Ms. Nachtsheim retired in June 2000 after 20 years with Intel Corporation, a semiconductor chipmaker. Ms. Nachtsheim served in a variety of positions at Intel, most recently as Corporate Vice President of the Sales and Marketing Group and Director of Worldwide Marketing, from 1998 until her retirement. From January 2003 to December 2003, Ms. Nachtsheim served on the Board of Directors of Vixel Corporation, a creator of disruptive storage networking technologies. Ms. Nachtsheim is a graduate of Arizona State University with a bachelor degree in Business Management.

Dr. Reagan has served as a member of our Board of Directors since June 1993 and was Chairman of the Board of Directors from May 2000 until December 2003. He previously served as a director from October 1987 through May 1992. Dr. Reagan is a technology and senior management consultant to industry and to the United States Government. He retired in 1996 after 37 years with the Lockheed Martin Corporation where he was a Corporate Vice President and General Manager of the Research and Development Division of the Missiles and Space Company. Dr. Reagan holds BS and MS degrees in Physics from Boston College and a PhD in Space Science from Stanford University.

Mr. Sedgwick has served as a member of our Board of Directors since January 1979. Mr. Sedgwick has been a private investor since 1994.

Mr. Stempel has served as a member of the Company s Board of Directors since May 2000. He is Chairman of Energy Conversion Devices, Inc. (ECD), an energy and information company headquartered in Troy, Michigan. In February 2004, Mr. Stempel was appointed Chief Executive Officer of ECD. Mr. Stempel retired as Chairman and Chief Executive Officer of General Motors Corporation in November 1992. He was named Chairman and Chief Executive Officer in August 1990. Prior to serving as Chairman, he had been President and Chief Operating Officer of General Motors since September 1987.

The Board of Directors recommends a vote FOR the election of all of the above nominees that are nominated for election as directors.

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PROPOSAL 2
CHARTER AMENDMENT TO INCREASE
THE NUMBER OF AUTHORIZED SHARES

Overview

At the annual meeting, we will ask our stockholders to approve an amendment to our certificate of incorporation to increase the number of authorized shares of common stock from 20,000,000 to 50,000,000. In addition, to effect this change, the total number of shares of capital stock authorized in our charter would be increased from 25,000,000 to 55,000,000.

Under Delaware corporate law, we are required to obtain approval from our stockholders to amend our charter to increase the number of shares authorized for issuance. After taking into consideration our current outstanding equity obligations, together with our obligations under the investment agreement and related documents in connection with the financing described in this proxy statement, our Board of Directors has unanimously determined that it is necessary to increase the number of shares of common stock authorized for issuance by 30,000,000. Currently, we do not have authorized a sufficient number of shares of common stock to cover the maximum number of shares we would be required to issue if the holders of all of our outstanding convertible notes, warrants and options sought to convert and exercise, as applicable, those instruments into common stock. If our stockholders do not approve the charter amendment, holders of our options, warrants and convertible notes may bring legal suits against us if they seek to exercise or convert, as applicable, such instruments and we do not have sufficient shares available. If such lawsuits were brought and were successful, there could be a material adverse effect on our financial position and results of operations, including the possibility that Southwall would need to file for bankruptcy.

In addition, if the charter amendment is not approved at the annual meeting, the convertible notes that we issued to Needham and its affiliates and Dolphin in the aggregate principal amount of $4,500,000 shall become due and payable 45 days following the date of the annual meeting. If the holders of the convertible notes were to demand payment following a failure to approve the charter amendment, there would be an event of default under our senior loan agreements, and it is highly unlikely that we would be able to repay the amounts then due under the convertible notes and our senior loan agreements. Without the proceeds from the convertible notes, the amount of capital available to us for general working purposes will be severely limited and we will not be able to fund our operations, service our existing debt obligations or continue as a going concern. In the likely event we are unable to secure an alternative financing plan, we will become insolvent and be required to file for bankruptcy.

If approved by our stockholders, the increase in authorized shares would become effective as soon as upon our filing of a certificate of amendment to our charter with the Delaware Secretary of State, which we intend to do promptly after approval of the annual meeting.

Reasons for Proposal

Our charter currently authorized us to issue up to 25,000,000 shares of capital stock, consisting of 20,000,000 shares of our common stock and 5,000,000 shares of preferred stock. Our authorized preferred stock has all been designated as Series A 10% Cumulative Convertible Preferred Stock, or Series A shares. The Series A shares, which are reserved for issuance upon conversion of our convertible notes, are described below. The table below depicts our outstanding common stock and common stock equivalents as of March 28, 2004. The percentages below are based on the actual number of shares of common stock outstanding on March 23, 2004, plus the maximum number of shares of common stock issuable upon conversion of the convertible notes and exercise of all outstanding warrants and options and shares reserved for issuance under our stock plans (as amended) (that is, 39,560,768 shares).

	Shares	**Percent of Fully-Diluted Shares**
Common Stock issued and outstanding(1)	12,631,072	32 %
Common Stock issuable upon conversion of convertible notes(2)	4,500,000	11 %
Common Stock issuable upon exercise of warrants	14,241,536	36 %
Common Stock issuable upon exercise of outstanding options(3)	3,041,548	8 %
Common stock available for issuance under existing stock option and stock purchase plans(4)	5,146,612	13 %

(1) Includes 82,880 shares of common stock, we have committed to issue, following the approval of our stockholders of the charter amendment, to members of our Board of Directors in lieu of cash fees to which they are otherwise entitled.

(2) As discussed below, the convertible notes are convertible, at each holder s option, into Series A shares, which are convertible, at each holder s option, into shares of common stock. The number of shares in the table above assumes the conversion of the aggregate principal amount of $4,500,000 of the convertible notes but not any accrued but unpaid interest. Interest, which accrues on the convertible notes at the rate of 10% per annum, compounded daily, is payable each December 31st and is also convertible into Series A shares.

(3) Includes options to purchase 390,000 shares we have committed to issue to George Boyadjieff, the chairman of our Board of Directors, upon the approval by our stockholders of the charter amendment.

(4) Including the additional shares of common stock proposed to be added to our 1997 Stock Incentive Plan and 1998 Stock Plan for Employees and Consultants by Proposals 3 and 4 below.

As of March 28, 2004, the total number of our outstanding shares of common stock together with our future obligations to issue common stock (not including shares of common stock that we have reserved under our existing stock plans but do not underlie outstanding options) exceeds the number of shares we have authorized under our charter by approximately 14,500,000. Therefore, if the holders of all of our outstanding convertible notes, warrants and options seek to convert or exercise, as applicable, those instruments into shares of common stock, we will not have a sufficient number of shares of common stock available, unless we have amended our charter. If our stockholders approve the amendment to our charter, we will have approximately 10,400,000 shares of common stock available for future issuances in excess of our outstanding common stock, our future obligations to issue common stock, and other shares we have reserved for issuance under our stock plans.

The Board of Directors believes that it is very important to have available for issuance a number of authorized shares of common stock that will be available for our future corporate needs, above the number of shares required to meet our obligations described above. The additional authorized shares would be

available for issuance from time to time in the discretion of the Board, without further stockholder action except as may be required for a particular transaction by applicable law or other policies. The shares would be issuable for any proper corporate purpose, including future acquisitions, capital raising transactions consisting of either equity or convertible debt, stock splits or issuances under current and future stock plans. The Board believes that these additional shares will provide us with needed flexibility to issue shares in the future without potential expenses and delays incident to obtaining stockholder approval for a particular issuance. Except to the extent of our existing obligations on the date of the mailing of this proxy statement and the matters described herein, we do not currently have any plans, understandings or agreements for the issuance or use of the additional shares of common stock to be approved under this proposal.

Financing and Related Transactions

Overview

On December 18, 2003, to raise cash to fund our operations and continue as a going concern, we entered into an investment agreement with Needham & Company, Inc., Needham Capital Partners II, L.P., Needham Capital Partners II (Bermuda), L.P., Needham Capital Partners III, L.P., Needham Capital Partners IIIA, L.P., Needham Capital Partners III (Bermuda), L.P., and Dolphin Direct Equity Partners, LP, collectively, the Investors. On February 20, 2004, we amended and restated that agreement. Under the terms of that agreement, we agreed to issue and sell $4.5 million of Secured Convertible Promissory Notes that are convertible into our Series A 10% Cumulative Convertible Preferred Stock, par value $.001 per share, or the Series A shares, at a conversion price of $1.00 per share, together with warrants initially exercisable for 13,881,536 shares of our common stock. If the Investors were to exercise all warrants and convert all Series A shares issuable to them pursuant to the terms of the investment agreement, our senior lender, Pacific Business Funding, or PBF, were to exercise all warrants currently issued to it, and our option holders were to exercise all options currently outstanding, we would have 34,414,156 shares of common stock outstanding. We currently have 20,000,000 shares of common stock authorized under our certificate of incorporation. At the annual meeting, we will seek approval of an amendment to our certificate of incorporation increasing the number of authorized shares available for issuance to a number that would allow us to meet fully our obligations to issue shares of capital stock under the investment agreement. If this Proposal 2 is not approved, the amounts due under the convertible notes will accelerate and we will not be able meet our obligations under the investment agreement. The resulting lack of capital will prevent us from funding our operations and continuing as a going concern.

This proxy statement summarizes the material terms of the convertible notes, the certificate of designation for the Series A shares and the definitive agreements relating to the financing, including the investment agreement. The form of the Amended and Restated Certificate of Designation, Preferences and Rights of Series A 10% Cumulative Preferred Stock and the Amended and Restated Investment Agreement are included as exhibits to our Current Report on Form 8-K/A, dated and filed with the SEC on March 3, 2004. You are encouraged to read all of these materials carefully. The summaries of these materials in this proxy statement are qualified in their entirety by reference to these materials.

Background

During 2003, we experienced a significant decline in sales, which led to a significant deterioration in our working capital position, which raised concerns about our ability to fund our operations, continue as a going concern and meet our obligations.

In addition, in the third quarter of 2003, we determined that due to reduced demand for our products, anticipated revenues through the remainder of 2003 and 2004 would be substantially below historical levels. As our U.S. operations have a higher operating cash break-even point compared to our Dresden

operations, we believed that the lower than anticipated revenues indicated that an impairment analysis of the long-lived assets of our U.S. operations was necessary at September 28, 2003. Subsequently, in the fourth quarter of 2003, as a result of our decision to close the Tempe operation, we concluded that a further impairment analysis of the long-lived assets of the U.S. operation was necessary at December 31, 2003. Our evaluation concluded that an impairment charge was required to write down the carrying amount of our long-lived assets to their fair market values, of $19.4 million and $8.6 million for the periods ended September 28, 2003 and December 31, 2003, respectively.

On October 8, 2003, our management reviewed the revenue forecast for the fourth quarter of 2003 and determined the anticipated sales for the quarter would not generate enough cash flow to continue operations through the end of the quarter. Management presented its findings to our Board of Directors on October 10, 2003 and the directors instructed our management team to develop an emergency restructuring plan to improve our cash flow and to obtain new financing.

The primary elements of management s restructuring plan included:

- Shutting down a majority of our domestic manufacturing and transferring that production to our Dresden, Germany facility;
- Undertaking a series of staggered layoffs;
- Arranging new payment terms with major creditors and vendors to extend or reduce our payment obligations;
- Accelerating our cash collections;
- Reducing our operating expenses and inventory levels;
- Minimizing our capital expenditures; and
- Seeking additional funding sources.

We also began to solicit and receive proposals from potential investors and lenders. We evaluated a variety of public and private market alternatives to raise additional capital, as well as alternatives to restructure our upcoming payment obligations without raising additional capital. Our access to the traditional capital markets was, and continues to be, constrained, however, by a number of factors, including the risks described in our filings with the SEC. As a result, we concluded that a private equity investment was the most attractive alternative to continue as a going concern.

We received and evaluated three financing proposals, including the Needham proposal, which is described in further detail below. One proposal consisted of an initial offer to purchase up to $3.0 million of our common stock, in two tranches, at a price equal to 70% of the average closing price of our common stock on the Nasdaq National Market during the 10 days preceding the closing dates. The initial tranches would have consisted of $2.0 million of our common stock, with the additional $1.0 million of common stock to have been purchased at the option of the investor within 18 months of the closing of the initial tranche. In addition, the investor would have received warrants for approximately 6,000,000 shares of our common stock, exercisable for five years at a per share exercise price equal to 110% of the closing price of our common stock on the Nasdaq National Market as of the business day prior the closing of the initial equity tranche. Another proposal contemplated the issuance of a $2.0 million letter of credit to PBF, against which we would have been able to borrow under our existing domestic factoring agreement with PBF.

All three proposals, including the Needham proposal, were presented to our Board of Directors. After reviewing and seeking to negotiate revisions to all of the proposals submitted, the Board unanimously determined on November 10, 2003 to proceed with the Needham & Company, Inc. offer, primarily because the Board believed that the amount of cash that we would have received under each of the two other proposals would have been insufficient to meet our short-term operational cash flow requirements. We

entered into a non-binding letter of intent with Needham on November 11, 2003 to sell $3.0 million of Series A shares at a price of $1.00 per share. Needham also agreed to guarantee up to $2.0 million of additional borrowing under our existing Domestic Factoring Agreement with our senior lender, PBF. In connection with the guarantee and the sale of the Series A shares, we agreed to issue warrants to Needham exercisable for a number of shares of our common stock equal to 10% of the total shares outstanding, at a nominal exercise price, which warrants terminated by their terms upon the execution of the investment agreement described below. During the negotiations of the investment agreement, the parties agreed to increase the aggregate number of Series A shares to be sold to 4.5 million. The parties also increased the guarantee to $3.0 million and determined that it would apply to a new line of credit facility with PBF.

On December 18, 2003, we entered into the investment agreement with the Investors. Under the terms of the investment agreement, Needham agreed to issue the guarantees of our new line of credit facility in two separate tranches of $2.25 million and $750,000, respectively, and the Investors agreed to purchase the Series A shares in two separate tranches of $1.5 million and $3.0 million, respectively. The new borrowings and the purchase of each equity tranche were subject to certain conditions, including, among other things, the receipt of concessions by us from creditors and landlords, the completion by us of certain restructuring actions and the achievement of cash flow break-even at quarterly revenue levels below those of the third quarter 2003. Needham executed a guarantee of up to $2.25 million under the new line of credit facility on December 18, 2003, and received a warrant to purchase 941,115 shares of our common stock, approximately 7.5% of our total shares currently outstanding at an exercise price of $0.01 per share. On January 15, 2004, Needham executed a guarantee with respect to an additional $750,000 under the new line of credit and received an additional warrant to purchase 941,115 shares of common stock at an exercise price of $0.01 per share. A further description of the terms of all warrants is set forth below.

On February 20, 2004, the parties amended and restated the investment agreement to provide that we would issue and sell to the Investors an aggregate of $4.5 million of our convertible notes in one tranche instead of Series A shares in two separate tranches. A further description of the convertible notes is set forth below. Under the investment agreement, and as further described in the Anti-Dilution Protection section below, we were also required to issue additional common stock warrants to the Investors as anti-dilution protection for the issuance of debt and equity by us as part of the restructuring of our obligations to creditors. In connection with the sale of the convertible notes and honoring the Investors anti-dilution protection, on February 20, 2004 we issued warrants to the Investors to purchase a total of 10,305,299 shares of our common stock, at an exercise price of $0.01 per share, approximately 82.1% of our total shares currently outstanding.

Summary of Current Ownership by Investors

Following completion of the financing, based on securities outstanding as of March 28, 2004, the following convertible securities and warrants are held by the Investors:

- if Needham and its affiliated entities were to exercise all of their warrants and convert all of their Series A shares (issuable upon conversion of its convertible notes), while maintaining their current ownership of approximately 2,200,067shares of common stock, then Needham and its affiliated entities would own approximately 15,081,834 shares of our common stock, or about 59.3% of the total shares outstanding, including such issuances to Needham and its affiliates but excluding outstanding warrants and Series A shares held by other Investors.

- if Dolphin Direct Equity Partners, LP were to exercise all warrants and convert all of its Series A shares (issuable upon conversion of its convertible notes), then Dolphin would own approximately 5,499,769 shares of our common stock, or about 30.5% of the total shares outstanding, including such issuances to Dolphin but excluding outstanding warrants and Series A shares held by other Investors.

In addition, the convertible notes held by the Investors accrue interest 10% per year, compounded daily, payable each December 31st, which interest is also convertible into Series A shares, and the Series A shares are entitled to a cumulative dividend of 10% per year, accruing daily, payable at the discretion of the Board, which dividends are convertible into common stock.

Reasons for the Financing

In the short-term, the financing will enable us to fund our operations, continue as a going concern and meet our obligations, as they become due.

After deducting approximately $500,000 in professional fees related to the financing and restructuring, the net proceeds of the financing were approximately $4,000,000. We applied the net proceeds as follows:

- approximately $2,200,000 was spent during February and March of 2004, in the normal course of our business for general corporate purposes, including purchases of raw materials, payments to subcontractors and suppliers of approximately $1,000,000, payroll costs of approximately $800,000, and rent and lease payments;

- approximately $800,000 was paid between February 24, 2004 and March 30, 2004, to Judd Properties, LLC, the landlord of our Palo Alto executive offices and manufacturing facilities, in connection with the settlement and restructuring of our lease obligations to Judd Properties, LLC; and

- approximately $1,000,000 has been put up to support a letter of credit in favor of Judd Properties as security for our obligations to depart from and properly restore the property pursuant to our settlement and restructuring with Judd. We have agreed with Judd that, following stockholder approval of the amendment to our charter (Proposal 2), we may substitute a warrant exercisable for 1,437,396 shares of our common stock for the letter of credit as security for our obligations, in which event we will have access to the $1,000,000 that currently supports the letter of credit. We expect that that $1,000,000, if we were to substitute the warrant as security for our obligations to Judd, would be used for working capital and general corporate purposes.

We believe the financing, along with our current restructuring of debt and operations and recent improvements in financial performance, will provide greater stability and position us for long-term growth.

Consequences if Stockholder Approval is Not Obtained

If we do not obtain stockholder approval of this Proposal 2, we will be unable to meet our obligations to issue shares of capital stock under the investment agreement, and we will be required to pay the aggregate principal amount of $4,500,000 under the convertible notes plus interest to the holders of the convertible notes 45 days following the annual meeting. If the holders of the convertible notes were to demand payment following a failure to approve the charter amendment, there would be an event of default under our senior loan agreements, and it is highly unlikely that we would be able to repay or refinance the amounts then due under the convertible notes and our senior loan obligations. In such an event, Southwall might be required to file for bankruptcy. In addition, without the proceeds from the convertible notes, the amount of capital available to us for general working purposes will be severely limited and we will not be able to fund our operations, service our existing debt obligations or continue as a going concern. In the likely event we are unable to secure an alternate financing plan, we will become insolvent and be required to file for bankruptcy protection.

Furthermore, there can be no assurances that we will not be sued by the holders of our options, warrants or convertible notes if we do not have enough authorized shares of common stock to make the

required issuances if they seek to exercise or convert those securities, as applicable, or that those holders will not otherwise seek repayment of some or all of the amounts paid to us by them.

Principal Effects on Outstanding Common Stock

The financing will result in substantial dilution to our common stockholders. Based on securities outstanding as of March 28, 2004, our common stockholders would experience dilution of 147% if all convertible notes were converted into Series A shares and then into common stock and all warrants issued as part of the financing were exercised. Further dilution will occur if, as part of our restructuring efforts, we issue any equity or instruments exercisable or convertible into equity to any creditor, landlord, employee, director, agent or consultant. In such a situation we are required to issue additional warrants to each of the Investors in such amounts as would allow the Investors to maintain their aggregate ownership percentage (on a fully-diluted basis) as if such issuance had not occurred. Other than the dilutive effect on a stockholder s voting power, the nature and terms of such issuances could render more difficult or discourage an attempt to obtain a controlling interest in Southwall or the removal of the incumbent Board of Directors and may discourage unsolicited takeover attempts which might be desirable to stockholders.

The issuance of additional shares of common stock will also have a dilutive effect on our earnings per share and the trading price of our outstanding common stock may be reduced as a result of such issuances. Holders of common stock do not have any preemptive rights to subscribe for the purchase of any shares of common stock, which means that current holders of common stock do not have a prior right to purchase any new issue of common stock in order to maintain their proportionate ownership.

Holdings of common stock are entitled to one vote per share on all matters submitted to a vote of our stockholders and to receive ratably dividends, if any, as may be declared from time to time by the Board of Directors from funds legally available therefore, subject to the payment of any outstanding preferential dividends declared with respect to any preferred stock that may from time to time be outstanding. Upon our liquidation, winding up or dissolution, holders of common stock are entitled to share ratably in any assets available for distribution to stockholders after payment of all of our obligations, subject to the rights to receive preferential distributions of the holders of any preferred stock then outstanding.

Material Terms of the Secured Convertible Promissory Notes

In connection with the investment agreement, we issued convertible notes in an aggregate principal amount of $4.5 million to the Investors. The convertible notes:

- are convertible, at each holder s option, into our Series A shares at a conversion price of $1.00 per share;
- accrue interest at an annual rate of 10%, compounded daily, payable each December 31, which interest if accrued but unpaid is also convertible into Series A shares;
- are secured by a pledge of a portion of the stock of our subsidiary, Southwall Europe GmbH; and
- are due and payable on February 20, 2009 or earlier under certain circumstances. For instance, the failure of our stockholders to approve Proposal 2 (the amendment of our charter) will result in the acceleration of the convertible notes.

In addition, so long as any of the convertible notes are outstanding, the approval of the holders of a majority of the convertible notes will be required to effect the corporate actions set forth below under Material Terms of the Series A Shares General Voting Rights of the Series A shares. The convertible notes are subordinate to the credit facilities with our senior lender, PBF.

Material Terms of the Series A Shares

Dividends on Series A Shares

Each of the Series A shares will have a stated value of $1.00 and will be entitled to a cumulative dividend of 10% per year, payable at the discretion of the Board of Directors. Dividends on the Series A shares shall accrue daily commencing on the date of issuance and shall be deemed to accrue whether or not earned or declared and whether or not there are profits, surplus or other funds legally available for the payment of dividends. Accumulated dividends, when and if declared by the Board, will be paid in cash.

Restrictions

So long as any Series A shares are outstanding, unless all accrued dividends on all Series A shares have been paid, we are prohibited from:

- redeeming or purchasing any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference), except the repurchase of shares of common stock held by officers, directors or employees, upon death, disability, or termination of employment;

- paying or declaring any cash dividend or making any cash distribution upon any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference); and

- setting aside any monies for the purchase or redemption of any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference), except as described above.

General Voting Rights

Except as described below or as otherwise provided by law, the holders of Series A shares have no voting rights. The approval of the holders of a majority of the Series A shares voting separately as a class will be required to effect certain corporate actions, including:

- the authorization or issuance of shares of any class or series of stock having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;

- the reclassification of any shares of capital stock into shares having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;

- the authorization or issuance of any debt or other obligations convertible into or exchangeable for any shares of stock having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;

- declaring or paying dividends on or making any distributions with respect to our common stock;

- increasing or decreasing the authorized number of Series A shares;

- amending or repealing any provision of, or adding any provision to, our certificate of incorporation or bylaws if such action would alter or change the preferences, rights, privileges or powers of, or the restrictions provided for the benefit of, any Series A shares;

- increasing the number of shares of common stock reserved for issuance under our stock option plans, other than the annual increase currently provided in such plans and other than a further increase of not more than 1,000,000 shares;

- engaging in any transaction or series of related transactions constituting a liquidation or dissolution of Southwall, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity; or

- making any material change to our line of business.

Liquidation Preference

Upon a liquidation or dissolution of Southwall, the holders of Series A shares are entitled to be paid a liquidation preference out of assets legally available for distribution to our stockholders before any payment may be made to the holders of common stock. The liquidation preference is equal to the stated value of the Series A shares, which is $1.00 per share, plus any accumulated but unpaid dividends. Mergers, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity and certain other similar transactions may be deemed to be liquidation events for these purposes.

Conversion

Each of the Series A shares is convertible into common stock at any time at the option of the holder. Each of the Series A shares is convertible into a number of shares of common stock equal to the sum of its stated value plus any accumulated but unpaid dividends, divided by the conversion price of the Series A shares. The conversion price of the Series A shares is $1.00 per share and is subject to adjustment in the event of any stock dividend, stock split, reverse stock split or combination affecting such shares. The Series A shares also have anti-dilution protection that adjusts the conversion price downwards using a weighted-average calculation in the event we issue certain additional securities at a price per share less than the closing price per share of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed. The weighted-average formula factors in the effect on all outstanding stock of certain additional securities issued at the lower price and adjusts the conversion price downwards based upon such overall effect on our capitalization. Therefore, the more shares that are issued at the lower price, and the lower the price at which the shares are issued, the greater the downward adjustment to the conversion price. Each Series A share is initially convertible into one share of common stock. If the conversion price is adjusted downwards, each Series A share will be convertible into more than one share of our common stock and our common stockholders will experience further dilution. In the event the anti-dilution provision are triggered, the new conversion price will be determined by multiplying the Series A conversion price in effect immediately prior to such issuance by the following:

(A) the sum of (i) the number of shares of common stock outstanding immediately prior to such issue and (ii) the number of shares of common stock which the aggregate amount of cash received by us for the additional securities would purchase at the closing price per share of the common stock on the Nasdaq National Market or other stock exchange on which the common stock is listed

divided by,

(B) the total number of shares of common stock outstanding immediately after the issuance of the additional shares.

The following example demonstrates the application of the weighted-average formula and assumes the conversion price is $1.00, 12,000,000 shares of common stock are outstanding prior to the issuance of the additional securities, the closing price of the common stock on the applicable exchange $4.00 and we issue 1,000,000 shares of common stock at $2.00 per share. Given these assumptions, by way of example only, the weighted-average formula would be as follows: $1.00 multiplied by (12,000,000 plus (2,000,000

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divided by $4.00)) divided by 13,000,000, resulting in a new conversion price for the Series A shares of $0.96, meaning that each Series A share would be convertible into approximately 1.04 shares of common stock.

No such adjustments of the conversion price will be made upon the issuance of shares or options pursuant to (i) our stock option plans, (ii) agreements with the holders of the Series A shares, (iii) the conversion of the Series A shares, or (iv) certain transactions for which certain stockholders will be entitled to receive common stock or securities convertible into common stock under the investment agreement.

If the closing price of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed is $4.00 or more per share (subject to appropriate adjustment if a stock split, reverse split or similar transaction is effected) for 30 consecutive days, all outstanding Series A shares shall automatically be converted. The closing price of our common stock on the Over-the-Counter Bulletin Board on June 25, 2004, was $0.46 per share.

Redemption

The Series A shares are not redeemable.

Material Terms of the Warrants

Investor Warrants

In connection with the investment agreement, we issued warrants to the Investors that may be exercised to acquire up to 13,881,536 shares of common stock (including warrants issued to the Investors as anti-dilution protection for the issuance of debt and equity by us as part of the restructuring of our obligations to creditors) at an initial exercise price of $0.01 per share. The number of shares and the exercise price are both subject to appropriate adjustment in the event of stock splits, reverse stock splits and the granting of a stock dividend on our outstanding common stock. These warrants will be exercisable for cash or through a cashless exercise feature. The warrants are exercisable immediately and have a term of approximately five years.

Upon the reclassification of our common stock or a capital reorganization, each holder of these warrants has the right to receive the same amount and kind of securities, cash or property upon exercise as it would have been entitled to receive had it been the owner of the shares of common stock underlying the warrants at the time of such transaction. Upon a merger or consolidation, a transfer of all or substantially all of our voting securities, or the sale of all or substantially all of our assets, the warrants will terminate if they have not been previously exercised. The holders of the warrants have registration rights under the registration rights agreement described below.

On December 18, 2003, we issued warrants to the Investors exercisable for 941,115 shares of our common stock. The closing price of our common stock on the Nasdaq National Market on that date was $0.88 per share. On January 15, 2004, we issued warrants to the Investors exercisable for another 941,115 shares of our common stock. The closing price of our common stock on that date was $1.29 per share. On February 20, 2004, we issued a third tranche of warrants to the Investors exercisable for 11,999,306 shares of our common stock. The closing price of our common stock on that date was $1.58 per share. In many cases the current price of a company s common stock is used as the basis of determining the fair value of issued warrants. We concluded, however, that it was inappropriate to use the quoted price of the common stock as a basis for valuing the warrants for accounting purposes because the stock was thinly traded and because of the extent of the dilution resulting from the transactions under the investment agreement. We retained independent appraisers, Standard & Poor s, to assist us in valuing the warrants for purposes of preparing our financial statements. After speaking with our management, reviewing our financial forecasts, analyzing our competitors and their financial positions completed an independent appraisal of our

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enterprise value and apportioned that value among the various debt and equity securities, including the warrants issued by us. Standard & Poor s estimated the fair value of the warrants issued to the Investors to range between $0.39 to $0.44 per share of common stock depending on the specific dates of issuance.

PBF Warrants

In connection with the credit facilities with our senior lender, PBF, we issued warrants to PBF that may be exercised to acquire up to 360,000 shares of common stock at an initial exercise price of $0.01 per share. All other terms of these warrants mirrored the terms of the warrants issued to the Investors.

Material Terms of Registration Rights Agreement

Under a registration rights agreement we entered into in connection with the issuance of securities and the warrants described above, we granted the Investors and PBF registration rights with respect to certain shares of common stock issuable upon conversion of such Series A shares and warrants. Pursuant to the registration rights agreement, after December 18, 2004, we are required to file up to three demand registration statements with the SEC upon the written request of holders of 50% or more of the securities that are subject to the registration rights agreement as long as they are requesting the registration of at least 40% or more of the securities that are subject to the registration rights agreement. After December 18, 2004, if we are eligible to use a simplified registration form, we are required to file demand registration statements with the SEC upon the written request of holders of 50% or more of the securities that are subject to the registration rights agreement as long as the securities that are requested to be registered are anticipated to have an aggregate price to the public of at least $1,000,000. We are entitled to delay any demand for registration for up to 90 days if the registration would be seriously detrimental to Southwall. In addition, we have granted the Investors and PBF unlimited incidental, or piggyback, registration rights to have the securities listed above included in any registration statement, subject to certain restrictions, which we propose to file. We are required to use reasonable efforts to cause all registration statements to be declared effective for a period ending on the earlier of one year from the date a registration statement is declared effective or the date on which all shares of common stock registered pursuant to such registration statement are sold. The registration rights, with respect to each holder of the rights, will terminate on the date on which all shares of common stock of such holder subject to the registration rights agreement may be sold without registration pursuant to Rule 144 of the Securities Act of 1933, as amended, or the Securities Act. We will pay for the costs associated with each registration. In addition, one of our creditors, Judd Properties, LLC, is a party to the registration rights agreement. See Agreements with Major Creditors Judd Properties, LLC.

Observation Rights

Under the investment agreement, we agreed that for so long as Needham or any of its affiliates owns 5% or more of our common stock (on a fully-diluted basis) or any portion of Needham s guarantee of the PBF credit agreement remains in effect, we will permit one Needham designee to attend all of our Board meetings.

Relationships with Needham & Company, Inc.

Needham & Company, Inc. was the lead managing underwriter of our follow-on public offering that was completed in July 2002. In connection with that offering, Needham & Company, Inc. received approximately $543,375 in the form of underwriting discounts. In addition, Bruce J. Alexander, a managing director of Needham & Company, Inc. was a member of our Board of Directors from May 1981 until May 2003.

Other Agreements with the Investors

Issuance of Equity

Other than certain issuances of equity in connection with our option plan and as part of the restructuring of our obligations to creditors, the investment agreement contains provisions that prohibit us from issuing any equity or warrants, options, rights or other instruments exercisable or convertible into equity of Southwall to any creditor, landlord, employee, director, agent or consultant until such time as we have received the approval of our stockholders to increase the number of authorized shares of our common stock issuable under our certificate of incorporation.

Anti-Dilution Protection

If, as part of our restructuring efforts, we issue any equity or warrants, options, rights or other instruments exercisable or convertible into equity, to any creditor, landlord, employee, director, agent or consultant, then we are required to issue additional warrants to each of the Investors in such amounts as would allow the investors to maintain their aggregate ownership percentage (on a fully-diluted basis) as if such issuance had not occurred. Likewise, as part of our restructuring efforts, if we issue notes or other debt instruments to any of our creditors, then we are required to issue additional warrants to each of the Investors representing the right to purchase that number of shares of common stock equal to the product of (x) 1.25 and (y) the original principal amount of such note or debt instrument.

Stockholder Meeting

The investment agreement requires us to hold a stockholder meeting for the purpose of seeking approval of an amendment to our certificate of incorporation increasing the number of authorized shares available for issuance to a number that would allow us to meet fully our obligations to issue shares of capital stock under the investment agreement. The inclusion of Proposal 2 in this proxy statement is a result of this requirement.

Agreements with Major Creditors

Teijin Limited

Teijin Limited, or Teijin, previously guaranteed our outstanding debt owed to UFJ Bank Limited (formerly known as Sanwa Bank Limited). On November 5, 2003, we defaulted on this debt and Teijin honored its guarantee by satisfying the obligation. Under the terms of Teijin s guarantee, we were obligated to immediately repay the amounts paid by Teijin. As part of the restructuring plan, we entered into an agreement with Teijin to satisfy Teijin s claim. The agreement included a payment schedule that spread the payments out over a period of four years until 2008. The obligations owed to Teijin will not accrue interest if paid according to the payment schedule. Teijin previously held a security interest in one of our production machines which they have released. We may dispose of the machine provided that we pay to Teijin the net proceeds of any disposition. Our obligations to Teijin are guaranteed by our subsidiary, Southwall Europe GmbH.

Judd Properties, LLC

We reached an agreement with Judd Properties, LLC, or Judd, to restructure our obligations under the lease for our executive offices and Palo Alto manufacturing facilities. We agreed to a payment schedule that extends our obligations and provides us with options to extend the lease. We further agreed to issue a warrant issuable for 4% of our capital stock on a fully diluted basis to be held in an escrow account pending our departure from the premises. Upon our departure, if we fail to restore the property in accordance with the original lease the warrant will be released to Judd. The warrant is exercisable for

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1,437,396 shares of our common stock at a nominal exercise price. The other terms of the warrant mirror the terms of the warrants issued to the Investors. Judd will be a party to the registration rights agreement described above and hold certain other registration rights with respect to the warrant shares. Because we did not have available enough authorized shares of common stock to issue upon exercise of the warrant, we were required to issue a letter of credit in the amount of $1.0 million to be held by Judd as security for our obligations until such time as the requisite number of authorized shares are approved by our stockholders.

Portfolio Financial Servicing Company, Bank of America and Lehman Brothers

On February 20, 2004, we entered into a settlement agreement with Portfolio Financial Servicing Company, Bank of America and Lehman Brothers, which extinguished a claim arising out of sale-leaseback agreements that we had entered into in connection with the acquisition of two of our production machines. As part of the settlement, we agreed to pay an aggregate of $2.0 million plus interest over a period of six years. The settlement requires us to make an interest payment in 2004 and, beginning in 2005, to make quarterly principal and interest payments until 2010.

Richard A. Christina and Diane L. Christina Trust

On December 1, 2003, we reached an agreement with the Richard A. Christina and the Diane L. Christina Trust to modify the lease agreement for a building that we rent from the Trust in Palo Alto, California. Under the terms of the agreement, we agreed to pay the Trust $300,000.

Greenwood and Son Real Estate Investments

On January 29, 2004, we reached an agreement with Greenwood and Son Real Estate Investments to restructure the remaining scheduled lease payments for our Tempe facility, following our decision to discontinue operations in our Tempe facility as of December 31. Under the terms of the settlement agreement, we agreed to pay the regular monthly rent of $40,000 for the months of February and March 2004, and agreed to pay a cash buy-out of $368,000 for the remaining obligations under the existing lease agreement. The cash buy-out will be paid ratably over a twelve-month starting on April 1, 2004.

Voluntary Delisting from Nasdaq

Effective March 26, 2004, we voluntarily de-listed from the Nasdaq National Market, and, after trading on the pink sheets, on May 6, 2004, we began trading on the Over-the-Counter Bulletin Board Market. Due to the structure of the transaction contemplated by the investment agreement, we were no longer in compliance with certain Nasdaq listing requirements. We felt that a voluntary delisting from Nasdaq and a move to the Over-the-Counter Bulletin Board Market would provide the best option to our shareholders by retaining liquidity in our common stock.

Board Recommendation and Required Stockholder Vote

The Board of Directors unanimously recommends that the stockholders vote FOR the proposal to increase the number of shares of common stock available for issuance under our charter.

The affirmative FOR vote of the holders of a majority of the outstanding shares of our common stock is required for approval of this proposal.

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PROPOSAL 3
APPROVAL OF AMENDMENT TO
1997 STOCK INCENTIVE PLAN

Overview

On March 25, 2004, our Board of Directors adopted, subject to stockholder approval, an amendment to our 1997 Stock Incentive Plan, or the 1997 Plan, to increase the number of shares reserved for issuance and to eliminate the evergreen provisions that automatically on the first day of each year have increased the number of shares available for issuance, and directed that such amendment be submitted to the stockholders for their approval. The amendment to the 1997 Plan approved by the Board increased the number of shares authorized for issuance under the 1997 Plan from 2,150,000 to 6,150,000. The following summary of the 1997 Plan does not purport to be complete and is qualified in its entirety by reference to the full text of the 1997 Plan, which is attached as *Appendix A* to this proxy statement.

The 1997 Plan was adopted by the Board of Directors on March 20, 1997, and approved by the stockholders on May 21, 1997.

Purposes

The purpose of the 1997 Plan is to provide employees, directors and consultants with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in us as an incentive to remain with us. The 1997 Plan contains four separate equity incentive programs: (i) a discretionary option grant program, (ii) a salary investment option grant program, (iii) a stock issuance program and (iv) a director fee option grant program. The principal features of these programs are described below.

Administration

The 1997 Plan is administered by the Board, which may delegate its powers under the 1997 Plan to one or more committees of the Board. With respect to the discretionary option grant, salary investment option grant and stock issuance programs, the administrator of the 1997 Plan has authority in its discretion to: (1) establish such rules and regulations as it may deem appropriate for proper administration of such programs and (2) construe and interpret the provisions of such programs and any options or stock issuances issued pursuant to such programs. More specifically, the administrator of 1997 Plan has authority to: (1) select employees, directors or consultants to whom options or stock may be granted; (2) determine the time or times such option or stock grants are to be made; (3) determine the number of shares covered by each grant and the consideration for such shares or options; (4) determine the status of the granted option as either an incentive option or a non-statutory option; (5) determine the time or times when each option is to become exercisable; (6) determine the vesting schedule (if any); and (7) determine the maximum term for which the option is to remain outstanding. Administration of the director fee option grant program is self-executing in accordance with the terms of such program and the administrator of the 1997 Plan does not have any discretionary functions with respect to option grants or stock issuances made under such program. While the administrator will make awards from time to time under the 1997 Plan, it has no current plans, proposals or arrangements to make any specific grants under the 1997 Plan, except for director fee option grants.

Shares Subject to the 1997 Plan

The stock subject to options and awards under the 1997 Plan is authorized but unissued shares of our common stock or shares of treasury common stock. Any shares subject to an option that for any reason expires or is terminated unexercised as to such shares shall be available for subsequent issuance under the 1997 Plan. Unvested shares issued under the 1997 Plan and subsequently canceled or repurchased by us pursuant to our repurchase rights under the 1997 Plan may again be the subject of an award under the 1997 Plan. Giving effect to the March 25, 2004 increase authorized by the Board of Directors, the maximum number of shares of common stock that may be issued under the 1997 Plan may not exceed

6,150,000 shares, subject to adjustment, as described below. On March 26, 2004, the closing sale price of our common stock was $1.00 per share.

Limitations

The amendment authorized by the Board on March 25, 2004 increased the maximum number of option shares per calendar year that one individual may receive under the 1997 Plan from 200,000 to 1,000,000.

Eligibility

Nonstatutory stock options, or NSO s, and stock issuances may be granted to employees, directors and consultants. Incentive stock options, or ISO s, may be granted only to employees. Only employees are eligible to participate in the salary investment option grant program and only non-employee directors may participate in the director fee option grant program. As of March 28, 2004, approximately 150 employees, as well as our eight non-employee directors were eligible to participate in the 1997 Plan. As of April 6, 2004, 1,867,549 shares had been issued or reserved for issuance pursuant to outstanding options under the 1997 Plan.

Terms and Conditions of Options issued under the Discretionary Option Grant Program

Exercise Price. The exercise price for shares issued upon exercise of options will be determined by the administrator of the 1997 Plan. The exercise price of NSO s shall not be less than 85% of the fair market value of our common stock on the date the option is granted. The exercise price of ISO s may not be less than 100% of the fair market value of our common stock on the date the option is granted. The exercise price of ISO s granted to a 10% or greater stockholder may not be less than 110% of the fair market value of our common stock on the date of grant.

Form of Consideration. Subject to the documents evidencing the option, the 1997 Plan permits payment to be made by cash, check, promissory note of the participant, other shares of our common stock (with some restrictions), consideration received by us under a cashless exercise program implemented by us in connection with the 1997 Plan, or any combination thereof.

Term of Options. The term of an option may be no more than ten years from the date of grant, except that the term of an option granted to a 10% or greater stockholder may not exceed five years from the date of grant.

Effect of Termination of Service. No option may be exercised more than eighteen months following cessation of service for any reason, or such other period as determined by the administrator of the 1997 Plan and set forth in the documents evidencing the option. If, on the date of cessation of service, a participant is not fully vested, the shares covered by the unvested portion will revert to the 1997 Plan. If service is terminated for misconduct or unsatisfactory performance, all outstanding options shall terminate immediately and cease to be outstanding, unless the administrator of the 1997 Plan determines otherwise.

Repurchase Rights. If a participant ceases service while holding options exercisable for unvested shares, we have the right to repurchase, at the exercise price paid per share, any or all of those unvested shares. The terms of the repurchase right shall be established by the administrator of the 1997 Plan and set forth in the document evidencing such repurchase right.

Limits on Transferability. ISO s granted under the 1997 Plan may not be transferred during a participant s lifetime and will not be transferable other than by will or by the laws of descent and distribution following the participant s death. NSO s may be assigned during a participant s lifetime to members of the participant s family or to a trust established exclusively for such family members pursuant to the participant s estate plan.

Acceleration of Options/Termination of Repurchase Rights. The administrator of the 1997 Plan has the discretion to provide for the automatic acceleration of one or more outstanding options upon the

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occurrence of a Corporate Transaction. For purposes of the 1997 Plan, a Corporate Transaction means (i) the sale, transfer or other disposition of all or substantially all of our assets in complete liquidation or dissolution or (ii) a merger or consolidation in which securities possessing more than 50% of the total combined voting power of our outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such transaction. An outstanding option may not accelerate, however, if and to the extent: (i) such option is, in connection with the Corporate Transaction, either to be assumed by the successor corporation (or parent thereof) or to be replaced with a comparable option to purchase shares of the capital stock of the successor corporation (or parent thereof), (ii) such option is to be replaced with a cash incentive program of the successor corporation which preserves the spread existing on the unvested option shares at the time of the Corporate Transaction and provides for subsequent payout in accordance with the same vesting schedule applicable to those option shares or (iii) the acceleration of such options is subject to other limitations imposed by the administrator of the 1997 Plan at the time of the option grant. Also upon a Corporate Transaction, our repurchase rights will terminate automatically unless assigned to the successor corporation.

The administrator of the 1997 Plan has the authority to provide for the automatic acceleration of one or more outstanding options under the discretionary option grant program in the event of a Change in Control or in the event the optionee s service terminates by reason of an involuntary termination within a designated period (not to exceed 18 months) following the effective date of any Corporate Transaction or Change in Control in which those options are assumed or replaced and do not otherwise accelerate. Any options so accelerated will remain exercisable until the earlier of (i) the expiration of the option term and (ii) the expiration of the one-year period after the effective date of the involuntary termination. In addition, the administrator of the 1997 Plan may provide that one or more of our repurchase rights with respect to shares held by the optionee at the time of such involuntary termination will immediately terminate, and the shares subject to those terminated repurchase rights will accordingly vest in full. For purposes of the 1997 Plan, a Change in Control means a change in ownership or control through either of the following transactions: (i) the acquisition, directly or indirectly by any person or related group of persons (other than us or a person that directly or indirectly controls, is controlled by, or is under common control with, us), of beneficial ownership of securities possessing more than 25% of the total combined voting power of our outstanding securities pursuant to a tender or exchange offer made directly to our stockholders which the Board of Directors does not recommend such stockholders accept, or (ii) a change in the composition of the Board over a period of 36 consecutive months or less such that the majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (A) have been Board members continuously since the beginning of such period or (B) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (A) who were still in office at the time the Board approved such election or nomination.

Other Provisions. The document evidencing each option grant may contain other terms, provisions and conditions not inconsistent with the 1997 Plan, as may be determined by the 1997 Plan administrator.

Terms and Conditions of Options issued under the Salary Investment Option Grant Program

Right to Participate. The administrator of the 1997 Plan has complete discretion in determining whether the salary investment option grant program is to be in effect for a given calendar year and in selecting the employees eligible to participate in the program. As a condition to such participation, each selected individual who elects to participate must, prior to the start of each calendar year of participation, file an irrevocable authorization directing us to reduce his or her base salary for that calendar year by an amount not less that $10,000 nor more than $50,000. To the extent the administrator of the plan approves the salary reduction authorization, the affected individual will be granted NSO s under the program. Except as described below, the terms of each option granted under the salary investment option grant

program are substantially the same as the terms in effect for option grants made under the discretionary option grant program.

Exercise Price. The exercise price of all NSO s issued pursuant to the salary investment option grant program is one-third of the fair market value of our common stock on the date of the option grant.

Number of Option Shares. The number of option shares will be determined by dividing the total dollar amount of the approved reduction in the participant s base salary by two-thirds of the fair market value per share of our common stock on the option grant date.

Exercise and Term of Options. Provided the participant continues in service, the option shares will become exercisable in a series of 12 successive equal monthly installments upon the participant s completion of each calendar month of service in the calendar year for which the salary reduction is in effect. The term of an option issued pursuant to this program may be no more than 10 years from the date of grant.

Effect of Termination of Service. If the participant ceases service for any reason while holding any options under the salary investment option grant program, each option that is exercisable at the time of such cessation of service shall remain exercisable until the earlier of (i) the expiration of the ten year option term or (ii) the expiration of the three year period measured from the date of cessation of service. If, on the date of cessation of service, a participant is not fully vested, the shares covered by the unvested portion will revert to the 1997 Plan.

Acceleration of Options/Termination of Repurchase Rights. Upon a Corporate Transaction or a Change in Control while the participant remains in service, each outstanding option held by a participant under the salary investment option grant program will automatically accelerate so that each such option will become fully exercisable with respect to the total number of shares of common stock at the time subject to such option and may be exercised for any or all of those shares as fully vested shares of common stock. Each such outstanding option will remain exercisable for the fully vested shares until the earlier of (i) the expiration of the 10 year option term or (ii) the expiration of the 3 year period measured from the date of the participant s cessation of service.

The administrator of the 1997 Plan may also provide that, upon the occurrence of a Hostile Take-Over, the participant will have a 30 day period in which to surrender to us each of his or her outstanding option grants in return for a cash distribution in an amount equal to the excess of (i) the Take-Over Price of the shares of common stock at the time subject to each surrendered option (whether or not the participant is vested in those shares) over (ii) the aggregate exercise price payable for such shares. For purposes of the 1997 Plan, Hostile Take-Over means the acquisition, directly or indirectly, by any person or related group of persons (other than us or a person that directly or indirectly controls, is controlled by, or is under common control with, us) of beneficial ownership of securities possessing more than 50% of the total combined voting power of our outstanding securities pursuant to a tender offer or exchange offer made directly to our stockholders which the Board does not recommend the stockholders accept. Take-Over Price means the greater of (i) the fair market value per share of our common stock on the date the option is surrendered to us in connection with a Hostile Take-Over or (ii) the highest reported price per share of our common stock paid by the tender offeror in effecting such Hostile Take-Over. However, if the surrendered option is an ISO, the Take-Over Price shall not exceed the clause (i) price per share.

Terms and Conditions of Stock issued under the Stock Issuance Program

Rights to Issuance. Shares of our common stock may be issued under the stock issuance program through direct and immediate issuances without any intervening option grants. Each stock issuance under the stock issuance program shall be evidenced by a stock issuance agreement.

Purchase Price. The purchase price for shares issued under the stock issuance program will be determined by the administrator of the 1997 Plan, but may not be less than 100% of the fair market value of our common stock on the date the stock is issued.

Form of Consideration. The 1997 Plan permits payment to be made by cash, check, promissory note of the participant or past services rendered to us (or any parent or subsidiary). The administrator may grant shares to participants based on the attainment of specific financial performance targets for the Company.

Vesting. In the discretion of the administrator of the 1997 Plan, shares issued under the stock issuance program may be fully and immediately vested upon issuance, or may vest in one or more installments over the participant s period of service or upon attainment of performance goals. The recipient of shares issued under the stock issuance program will have full stockholder rights with respect to any shares issued, whether or not the participant s interest in those shares is vested. If the participant ceases to remain in service while holding one or more unvested shares of our common stock issued under the stock issuance program, or should performance objectives not be attained, the shares shall immediately be surrendered to us for cancellation unless the administrator of the 1997 Plan determines otherwise.

Acceleration of Vesting/Termination of Repurchase Rights. In the event of any Corporate Transaction, all outstanding repurchase rights under the stock issuance program will terminate automatically, and all of the shares subject to such terminated rights will immediately vest in full, except to the extent (i) those repurchase rights are to be assigned to the successor corporation in connection with the Corporate Transaction or (ii) such accelerated vesting is precluded by limitations imposed in the stock issuance agreement. Notwithstanding the above, the administrator of the 1997 Plan has the discretionary authority, exercisable either at the time the unvested shares are issued or any time while the repurchase rights remain outstanding, to provide that those rights shall automatically terminate in whole or in part, and the shares subject to those terminated rights will immediately vest, in the event of (i) a Corporate Transaction, whether or not those repurchase rights are to be assigned to the successor corporation in connection with such Corporate Transaction, (ii) a Change in Control or (iii) an involuntary termination of the participant within a designated period (not to exceed 18 months) following the Corporate Transaction or Change in Control.

Terms and Conditions of Options Issued under the Director Fee Option Grant Program

Right to Participate. Each non-employee Board member has the right to participate in the director fee option grant program. Under such program, a non-employee Board member may apply all or a portion of the annual retainer fee, otherwise payable in cash, to the acquisition of option grants. The non-employee Board member must make the election prior to the first day of the calendar year for which the annual retainer fee which is subject to the election is otherwise payable. Each option granted under the director fee option grant program will be an NSO. Except as described below, the terms of each option granted under the director fee option grant program are substantially the same as the terms in effect for option grants made under the discretionary option grant program.

Exercise Price. The exercise price of all NSO s issued pursuant to the director fee option grant program is one-third of the fair market value of our common stock on the date of the option grant.

Number of Option Shares. The number of option shares will be determined by dividing the portion of the annual retainer fee subject to the participant s election by two-thirds of the fair market value per share of our common stock on the option grant date.

Exercise and Term of Options. Fifty percent of the option shares will become exercisable upon the participant s completion of 6 months of Board service in the calendar year for which his or her election under the director fee option grant program is in effect, and the balance of the option shares will become exercisable in a series of 6 equal monthly installments upon the participant s completion of each additional

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month of Board service during the calendar year. The term of an option issued pursuant to this program may be no more than 10 years from the date of grant.

Effect of Termination of Service. If the participant ceases Board service for any reason (other than death or permanent disability) while holding any options under the director fee option grant program, each option that is exercisable at the time of such cessation of Board service shall remain exercisable until the earlier of (i) the expiration of the ten year option term or (ii) the expiration of the three year period measured from the date of cessation of Board service. If, on the date of cessation of service, a participant s options are not fully vested, the shares covered by the unvested portion will revert to the 1997 Plan.

Death or Permanent Disability. If the participant ceases Board service as a result of death or permanent disability, each option held by the participant under the director fee option grant program will immediately become exercisable for all of the shares of our common stock at the time subject to the option, and the option may be exercised for any or all of those shares as fully vested shares until the earlier of (i) the expiration of the ten year option term or (ii) the expiration of the three year period measured from the date of such cessation of Board service. If the participant dies after cessation of Board service but while holding one or more options under the director fee option grant program, each such option may be exercised, for any or all of the shares for which the option is exercisable at the time of the participant s cessation of Board service, by the personal representative of the participant s estate or by the person or persons to whom the option is transferred pursuant to the participant s will or in accordance with the laws of descent and distribution. Such right will lapse, and the option will terminate, upon the earlier of (i) the expiration of the ten-year option term or (ii) the three-year period measured from the date of the participant s cessation of Board service.

Acceleration of Options/Termination of Repurchase Rights. Upon a Corporate Transaction or a Change in Control while the participant remains a Board member, each outstanding option held by such participant under the director fee option grant program will automatically accelerate so that each such option will become fully exercisable with respect to the total number of shares of common stock at the time subject to such option and may be exercised for any or all of those shares as fully vested shares of our common stock. Each such outstanding option will remain exercisable for the fully vested shares until the earlier of (i) the expiration of the ten-year option term or (ii) the expiration of the three-year period measured from the date of the participant s cessation of service.

In the event of a Hostile Take-Over, the participant will have a 30 day period in which to surrender to us each of his or her outstanding option grants in return for a cash distribution in an amount equal to the excess of (i) the Take-Over Price of the shares of common stock at the time subject to each surrendered option (whether or not the participant is vested in those shares) over (ii) the aggregate exercise price payable for such shares.

Adjustments

Changes in Capitalization. In the event of a stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding common stock as a class without our receipt of consideration, appropriate adjustment shall be made to (1) the number and class of securities available under the 1997 Plan, (2) the per-participant limit, (3) the number and class of securities and exercise price per share subject to each outstanding award, and (4) the terms of each other outstanding option shall be appropriately adjusted in a manner which shall preclude the enlargement or dilution of rights and benefits under such options.

Amendment and Termination

Our Board may at any time amend or modify the 1997 Plan in any or all respects. The Board will obtain stockholder approval of any amendment to the 1997 Plan to the extent necessary and desirable to comply with applicable laws. No amendment or modification shall adversely affect the rights and

obligations with respect to stock options or unvested stock issuances of any participant, unless the participant consents to such amendment or modification. The 1997 Plan will terminate upon the earlier of (i) May 21, 2007 or (ii) the termination of all outstanding options.

2003 Option Grants Under the 1997 Plan

The following table set forth the number of outstanding options granted during 2003 under the 1997 Plan to the specified individuals and groups:

Name	Number of Options
Thomas G. Hood	60,000
Wolfgang Heinze	10,000
Michael E. Seifert	25,000
Sicco W.T. Westra	15,000
Bruce M. Lairson	25,000
All current executive officers as a group (six persons)	200,000
All employees who were not executive officers as a group (143 persons)	35,000

Federal Income Tax Consequences

ISOs A participant who receives an ISO will recognize no taxable income for regular federal income tax purposes upon either the grant or the exercise of such ISO. However, when a participant exercises an ISO, the difference between the fair market value of the shares purchased and the option price of those shares will be includable in determining the participant s alternative minimum taxable income.

If the shares are retained by the participant for at least one year from the date of exercise and two years from the date of grant of the options, gain will be taxable to the participant upon sale of the shares as a long-term capital gain. In general, the adjusted basis for the shares acquired upon exercise will be the option price paid with respect to such exercise. We will not be entitled to a tax deduction arising from the exercise of an ISO if the employee qualifies for such long-term capital gain treatment.

NSOs A participant will not recognize taxable income for federal income tax purposes at the time an NSO is granted. However, the participant will recognize compensation taxable as ordinary income at the time of exercise for all shares that are not subject to a substantial risk of forfeiture. The amount of such compensation will be the difference between the option price and the fair market value of the shares on the date of exercise of the option. We will be entitled to a deduction for federal income tax purposes at the same time and in the same amount as the participant is deemed to have recognized compensation income with respect to shares received upon exercise of the NSO. The participant s basis in the shares will be adjusted by adding the amount so recognized as compensation to the purchase price paid by the participant for the shares.

The participant will recognize gain or loss when he or she disposes of shares obtained upon exercise of an NSO in an amount equal to the difference between the selling price and the participant s tax basis in such shares. Such gain or loss will be treated as long-term or short-term capital gain or loss, depending upon the holding period.

The Board of Directors unanimously recommends that you vote FOR the amendment of our 1997 Plan, and proxies solicited by the Board will be voted in favor of the amendment of our 1997 Plan unless a stockholder has indicated otherwise on the proxy.

PROPOSAL 4
APPROVAL OF
OUR 1998 STOCK PLAN FOR EMPLOYEES AND CONSULTANTS

Overview

Our 1998 Stock Plan for Employees and Consultants, or the 1998 Plan, was adopted by our Board of Directors in August, 1998. On March 25, 2004, our Board of Directors adopted an amendment to our 1998 Plan to increase the number of shares reserved for issuance and to eliminate the evergreen provisions that automatically on the first day of each year have increased the number of shares available for issuance, and directed that such amendment be submitted to the stockholders for their approval. The amendment to the 1998 Plan approved by the Board increased the number of shares authorized for issuance under the 1998 Plan from 1,150,000 to 2,400,000. The following summary of the 1998 Plan does not purport to be complete and is qualified in its entirety by reference to the full text of the 1998 Plan, which is attached as *Appendix B* to this proxy statement. The 1998 Plan has not previously been approved by our stockholders.

Purposes

The purpose of the 1998 Plan is to provide non-officer employees who are not members of the Board and consultants with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in us as an incentive to remain with us. The 1998 Plan contains two separate equity incentive programs: (i) a discretionary option grant program and (ii) a stock issuance program. The principal features of these programs are described below.

Administration

The 1998 Plan is administered by the Board, which may delegate its powers under the 1998 Plan to one or more committees of the Board. The administrator of the 1998 Plan has authority in its discretion to: (1) establish such rules and regulations as it may deem appropriate for proper administration of the discretionary option grant program and stock issuance program and (2) construe and interpret the provisions of the programs and any options or stock issuances issued pursuant to such programs. More specifically, the administrator of the 1998 Plan has authority to: (1) select non-officer employees who are not members of the Board and consultants to whom options or stock may be granted; (2) determine the time or times such option or stock grants are to be made; (3) determine the number of shares to be covered by each grant and the consideration for such shares or options; (4) determine the time or times when each option is to become exercisable; (5) determine the vesting schedule (if any); and (6) determine the maximum term for which the option is to remain outstanding. While the administrator will make awards from time to time under the 1998 Plan, it has no current plans, proposals or arrangements to make any specific grants under the Plan.

Shares Subject to the 1998 Plan

The stock subject to options and awards under the 1998 Plan is authorized but unissued shares of our common stock or shares of treasury common stock. Any shares subject to an option that for any reason expires or is terminated unexercised as to such shares shall be available for subsequent issuance under the 1998 Plan. Unvested shares issued under the 1998 Plan and subsequently canceled or repurchased by us pursuant to our repurchase rights under the 1998 Plan may again be the subject of an award under the 1998 Plan. After giving effect to the March 25, 2004 increase authorized by the Board of Directors, the maximum number of shares of common stock that may be issued under the 1998 Plan may not exceed 2,250,000 shares, subject to adjustment, as described below. On March 26, 2004, the closing sale price of our common stock was $1.00 per share.

Limitations

The amendment authorized by the Board on March 25, 2004, increased the maximum number of option shares per calendar year that one individual may receive under the 1998 Plan from 50,000 to 100,000.

Eligibility

Nonstatutory stock options, or NSO s, and stock issuances may be granted to employees who are not officers or members of the Board, consultants and other independent advisors.

Terms and Conditions of Options

Exercise Price. The exercise price for shares issued upon exercise of options will be determined by the administrator of the 1998 Plan but may not be less than 85% of the fair market value of our common stock on the date the option is granted.

Form of Consideration. Subject to the documents evidencing the option, the 1998 Plan permits payment to be made by cash, check, promissory note of the participant, other shares of our common stock (with some restrictions), consideration received by us under a cashless exercise program implemented by us in connection with the 1998 Plan, or any combination thereof.

Term of Options. The term of an option may be no more than ten years from the date of grant.

Effect of Termination of Service. No option may be exercised more than eighteen months following cessation of service for any reason, or such other period as determined by the administrator of the 1998 Plan and set forth in the documents evidencing the option. If, on the date of cessation of service, a participant is not fully vested, the shares covered by the unvested portion will revert to the 1998 Plan. If service is terminated for misconduct or unsatisfactory performance, all outstanding options shall terminate immediately and cease to be outstanding, unless the administrator of the 1998 Plan determines otherwise.

Repurchase Rights. If a participant ceases service while holding options exercisable for unvested shares, we have the right to repurchase, at the exercise price paid per share, any or all of those unvested shares. The terms of the repurchase right shall be established by the administrator of the 1998 Plan and set forth in the document evidencing such repurchase right.

Limits on Transferability. NSO s may be assigned during a participant s lifetime to members of the participant s family or to a trust established exclusively for such family members pursuant to the participant s estate plan.

Acceleration of Options/Termination of Repurchase Rights. In the event of a Corporate Transaction, the vesting of each option held by a non-officer employee shall automatically accelerate unless it is expressly assumed or replaced with a comparable option or cash incentive program by the successor corporation (or parent thereof). For purposes of the 1998 Plan, a Corporate Transaction means (i) the sale, transfer or other disposition of all or substantially all of our assets in complete liquidation or dissolution or (ii) a merger or consolidation in which securities possessing more than 50% of the total combined voting power of our outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such transaction. An outstanding option may not accelerate, however, if and to the extent: (i) such option is, in connection with the Corporate Transaction, either to be assumed by the successor corporation (or parent thereof) or to be replaced with a comparable option to purchase shares of the capital stock of the successor corporation (or parent thereof), (ii) such option is to be replaced with a cash incentive program of the successor corporation which preserves the spread existing on the unvested option shares at the time of the Corporate Transaction and provides for subsequent payout in accordance with the same vesting

schedule applicable to those option shares or

(iii) the acceleration of such options is subject to other limitations imposed by the administrator of the 1998 Plan at the time of the option grant. Also upon a Corporate Transaction, our repurchase rights will terminate automatically unless assigned to the successor corporation.

The administrator of the 1998 Plan has the authority to provide for the automatic acceleration of one or more outstanding options in the event of a Change in Control or in the event the optionee s service terminates by reason of an involuntary termination within a designated period (not to exceed 18 months) following the effective date of any Corporate Transaction or Change in Control. In addition, the administrator of the 1998 Plan may provide that one or more of our repurchase rights with respect to shares held by the optionee at the time of such involuntary termination will immediately terminate, and the shares subject to those terminated repurchase rights will accordingly vest in full. For purposes of the 1998 Plan, a Change in Control means a change in ownership or control through either of the following transactions: (i) the acquisition, directly or indirectly by any person or related group of persons (other than us or a person that directly or indirectly controls, is controlled by, or is under common control with, us), of beneficial ownership of securities possessing more than 25% percent of the total combined voting power of our outstanding securities pursuant to a tender or exchange offer made directly to our stockholders which the Board of Directors does not does not recommend such stockholders accept, or (ii) a change in the composition of the Board over a period of 36 consecutive months or less such that the majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (a) have been Board members continuously since the beginning of such period or (b) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (a) who were still in office at the time the Board approved such election or nomination.

Other Provisions. The stock option agreement for each option grant may contain other terms, provisions and conditions not inconsistent with the 1998 Plan, as may be determined by the 1998 Plan administrator.

Terms and Conditions Stock Issued under the Stock Issuance Program

Rights to Issuance. Shares of our common stock may be issued under the stock issuance program through direct and immediate issuances without any intervening option grants. Each stock issuance under the stock issuance program shall be evidenced by a stock issuance agreement.

Purchase Price. The purchase price for shares issued under the stock issuance program will be determined by the administrator of the 1998 Plan, but may not be less than 100% of the fair market value of our common stock on the date the stock is issued.

Form of Consideration. The 1998 Plan permits payment to be made by cash, check, promissory note of the participant or past services rendered to us (or any parent or subsidiary).

Vesting. In the discretion of the administrator of the 1998 Plan, shares issued under the stock issuance program may be fully and immediately vested upon issuance, or may vest in one or more installments over the participant s period of service or upon attainment of performance goals. The recipient of shares issued under the stock issuance program will have full stockholder rights with respect to any shares issued, whether or not the participant s interest in those shares is vested. If the participant ceases to remain in service while holding one or more unvested shares of our common stock issued under the stock issuance program, or should performance objectives not be attained, the shares shall immediately be surrendered to us for cancellation unless the administrator of the 1998 Plan determines otherwise.

Acceleration of Vesting/Termination of Repurchase Rights. In the event of any Corporate Transaction, all outstanding repurchase rights under the stock issuance program will terminate automatically, and all the shares subject to such terminated rights will immediately vest in full, except to the extent (i) those

repurchase rights are to be assigned to the successor corporation in connection with the Corporate Transaction or (ii) such accelerated vesting is precluded by limitations imposed in the stock issuance agreement. Notwithstanding the above, the administrator of the 1998 Plan has the discretionary authority, exercisable either at the time the unvested shares are issued or any time while the repurchase rights remain outstanding, to provide that those rights shall automatically terminate in whole or in part, and the shares subject to those terminated rights will immediately vest, in the event of (i) a Corporate Transaction, whether or not those repurchase rights are to be assigned to the successor corporation in connection with such Corporate Transaction, (ii) a Change in Control or (iii) an involuntary termination of the participant within a designated period (not to exceed 18 months) following the Corporate Transaction or Change in Control.

Adjustments

Changes in Capitalization. In the event of a stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding common stock as a class without our receipt of consideration, appropriate adjustment shall be made to (1) the number and class of securities available under the 1998 Plan, (2) the per-participant limit, (3) the number and class of securities and exercise price per share subject to each outstanding award, and (4) the terms of each other outstanding option shall be appropriately adjusted in a manner which shall preclude the enlargement or dilution of rights and benefits under such options.

Amendment and Termination

Our Board may at any time amend or modify the 1998 Plan in any or all respects. The Board will obtain stockholder approval of any amendment to the 1998 Plan to the extent necessary and desirable to comply with applicable laws. No amendment or modification shall adversely affect the rights and obligations with respect to stock options or unvested stock issuances of any participant, unless the participant consents to such amendment or modification. The 1998 Plan will terminate upon the earlier of (i) July 21, 2008 or (ii) the termination of all outstanding options.

2003 Option Grants Under the 1998 Plan

The following table set forth the number of outstanding options granted during 2003 under the 1998 Plan to the specified individuals and groups:

Name	Number of Options
Thomas G. Hood	
Wolfgang Heinze	
Michael E. Seifert	
Sicco W.T. Westra	
Bruce M. Lairson	
All current executive officers as a group (six persons)	
All employees who were not executive officers as a group (143 persons)	179,500

Federal Income Tax Consequences

NSOs A participant will not recognize taxable income for federal income tax purposes at the time an NSO is granted. However, the participant will recognize compensation taxable as ordinary income at the time of exercise for all shares that are not subject to a substantial risk of forfeiture. The amount of such compensation will be the difference between the option price and the fair market value of the shares on the date of exercise of the option. We will be entitled to a deduction for federal income tax purposes at the same time and in the same amount as the participant is deemed to have recognized compensation income

with respect to shares received upon exercise of the NSO. The participant s basis in the shares will be adjusted by adding the amount so recognized as compensation to the purchase price paid by the participant for the shares.

The participant will recognize gain or loss when he or she disposes of shares obtained upon exercise of an NSO in an amount equal to the difference between the selling price and the participant s tax basis in such shares. Such gain or loss will be treated as long-term or short-term capital gain or loss, depending upon the holding period.

The Board of Directors unanimously recommends that you vote FOR the approval of the 1998 Plan, and proxies solicited by the Board will be voted in favor of the 1998 Plan unless a stockholder has indicated otherwise on the proxy.

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SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth material information regarding beneficial ownership of our common stock as of March 24, 2004 by:

- each person who we know to own beneficially more than 5% of our common stock;
- each of our executive officers, for whom compensation information is provided elsewhere in this proxy statement;
- each director and nominee for director; and
- all executive officers and directors as a group.

Except as noted below, the address of each person listed on the table is c/o Southwall Technologies Inc., 3975 East Bayshore Road, Palo Alto, California 94303, and each person has sole voting and investment power over the shares shown as beneficially owned, except to the extent authority is shared by spouses under applicable law. Beneficial ownership is determined in accordance with the rules of the SEC. The information below regarding persons beneficially owning more than 5% of our common stock is based solely on public filings made by such persons with the SEC through March 24, 2004.

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Name and Address	Common Stock Beneficially Owned	Percent of Outstanding Shares(1)
Needham Investment Management, LLC	2,200,067	17.5 %
445 Park Avenue		
New York, New York 10022		
Needham & Company, Inc.(2)	1,913,909	13.2 %
445 Park Avenue		
New York, New York 10022		
Needham Capital Partners II, L.P.(2)	3,206,483	20.4 %
445 Park Avenue		
New York, New York 10022		
Needham Capital Partners III, L.P.(2)	5,613,409	30.9 %
445 Park Avenue		
New York, New York 10022		
Needham Capital Partners IIIA, L.P.(2)	579,727	4.4 %
445 Park Avenue		
New York, New York 10022		
Needham Capital Partners III (Bermuda), L.P.(2)	1,118,769	8.2 %
445 Park Avenue		
New York, New York 10022		
Needham Capital Partners II (Bermuda), L.P.(2)	449,469	3.5 %
445 Park Avenue		
New York, New York 10022		
Dolphin Direct Equity Partners, L.P.(2)	5,499,769	30.5 %
129 East 17th Street		
New York, New York 10003		
Wellington Management Company, LLP	1,000,000	8.0 %
75 State Street		
Boston, Massachusetts 02109		
Teijin Limited	667,696	5.3 %
6-7, Minami-honmachi, 1-Chome		
Chuo-ku, Osaka 541, Japan		
William A. Berry(5)	5,000	
George Boyadjieff	0	
Jami K. Nachtsheim(5)	5,000	
Bruce M. Jaffe(5)	5,000	
Joseph B. Reagan(3)	92,867	
Walter C. Sedgwick(4)	419,829	3.3 %
Robert C. Stempel(5)	20,844	*
Thomas G. Hood(6)	300,627	2.3 %
Wolfgang Heinze(5)	31,965	*
Bruce M. Lairson(5)	5,477	*
Michael Seifert(5)	18,750	*
Sicco W.T. Westra(5)	95,965	*
All current officers and directors as a Group (16 persons)(7)	1,033,685	7.9 %

* Less than 1%

(1) The number of shares of common stock deemed outstanding consists of (i) 12,548,192 shares of common stock outstanding as of March 24, 2004, and (ii) shares issuable pursuant to outstanding options, warrants or

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convertible notes held by the respective persons or group that are exercisable within 60 days of March 24 2004, as set forth below.

(2) Consists of shares of common stock issuable upon conversion of Series A shares (issuable upon conversion of convertible notes) and upon exercise of warrants that were issued pursuant to an investment agreement.

(3) Includes options to purchase 62,496 shares that are exercisable within 60 days of March 24, 2004, 30,371 shares held in a family limited partnership, and 13,696 shares held in trust.

(4) Includes options to purchase 49,764 shares that are exercisable within 60 days of March 24, 2004, 99,000 shares held by two public foundations of which Mr. Sedgwick is an officer, 17,272 shares held by his son and 6,000 shares held in a trust of which Mr. Sedgwick is a trustee.

(5) Consists of options that are exercisable within 60 days of March 24, 2004.

(6) Includes options to purchase 259,502 shares that are exercisable within 60 days of March 24, 2004, and 100 shares held by Mr. Hood s son and 100 shares held by Mr. Hood s daughter.

(7) Includes options to purchase an aggregate of 560,497 shares that are exercisable within 60 days of March 24, 2004, the shares held in a family limited partnership and trust described in note 3 above, the shares held in trust and by Mr. Sedgwick s son described in note 4 above, and the shares held by Mr. Hood s son and daughter described in note 6 above.

EXECUTIVE OFFICERS OF REGISTRANT

The names, ages and positions of our current executive officers are as follows:

Name	Age	Position
Thomas G. Hood	48	President, Chief Executive Officer and Director
Maury Austin	46	Interim Chief Financial Officer and Secretary
Sicco W.T. Westra	53	Senior Vice President, Business Development
Wolfgang Heinze	55	Vice President, General Manager Southwall Europe GmbH
John Lipscomb	54	Vice President, Corporate Controller
Dennis Capovilla	44	Vice President, Sales

Thomas G. Hood has served as our President and Chief Executive Officer since July 1998 and as a member of our board of directors since March 1998. From March 1998 until July 1998, he served as Interim President and Chief Executive Officer. From July 1996 to March 1998, he served as Senior Vice President, General Manager, Energy Products Division. From January 1995 to July 1996, he was Vice President, General Manager, International Operations, and from October 1991 to January 1995, he was Vice President, Marketing and Sales. He is the inventor of record on ten of our patents. Mr. Hood has an MS degree in Mechanical Engineering from New Mexico State University and a BS in mechanical engineering from Union College.

Maury Austin has been our interim Chief Financial Officer and Secretary since February 2004. From 2000 until 2003, he served as Chief Financial Officer for Vicinity Corporation, a supplier of products that enable businesses and governments to market local availability of their products. From 1999 until 2000, he served as the Chief Financial Officer of Symmetricom, Inc., a supplier of network synchronization and timing solutions. From 1997 until 1999, he served as the Chief Financial/Operating Officer of Flashpoint Technology, Inc., a provider of software for digital imaging devices. Prior to FlashPoint, Mr. Austin spent nine years at Apple Computer in various executive management positions culminating his Apple career as the Vice President and General Manager for the Imaging Division. Mr. Austin holds an MBA from Santa Clara University and a B.S. in Business Administration from University of California at Berkeley.

Sicco W.T. Westra has been Senior Vice President, Business Development since June 2002. From August 1998 until June 2002, he was the Senior Vice President, Engineering and Chief Technical Officer of Southwall. From February 1998 until August 1998, he served as the Director of Global Production Management for Applied Materials, Inc., a provider of products and services to the semiconductor industry. From March 1994 to August 1998, he served as a Manager of Business Development for BOC Coating Technology, Inc., a manufacturer of sputter-coating equipment. Dr. Westra holds a PhD. From the University of Leiden in the Netherlands.

Wolfgang Heinze joined Southwall in January 1999 as Plant Manager of our Dresden factory. In December 2000, Mr. Heinze was promoted to the position of Vice President, General Manager Southwall Europe GmbH. Prior to joining Southwall, Mr. Heinze had been the Chief Executive Officer of FUBA Printed Circuits, GmbH, a manufacturer of printed circuit boards, from February 1991 to April 1998. Mr. Heinze has a MD of Commercial Science from the Technical University in Merseburg, Germany.

John Lipscomb has been our Vice President, Corporate Controller since November 2000. From March 1996 to November 2000, he served as a Finance Director with Informix Software, a developer of relational databases and with ABB LTD, a developer of software applications for the power utility industry. From June 1988 to February 1996, he served in various senior level financial management positions with Apple Computer, a computer manufacturer. Mr. Lipscomb has a B.A. degree in Accounting from the University of Massachusetts at Amherst.

Dennis Capovilla joined Southwall in July 2003. Dennis came to Southwall from Palm, Inc., a manufacturer of personal digital assistant devices, where he was the Vice President, Enterprise sales since 2002. From 1997 to 2002 he was with FATBRAIN, LLC, an e-commerce provider of books and information products, as the President and CEO from 2000-2002, the President and COO from 1999 to 2000, and the VP of Sales and Business Development from 1997-1999. From 1993-1997, Dennis was with Apple Computer, Inc., a computer manufacturer, as the Director, Americas Imaging Division and Worldwide Printer Supplies (1996-1997), Manager Printer Supplies Business unit (1995-1996) and as Worldwide Product Marketing Manager, Imaging Systems (1993-1995). Prior, Dennis held various Sales and Marketing Management positions with Versatec, Inc. and Xerox Corporation. Dennis holds a B.S. in Marketing from the University of Santa Clara.

CORPORATE GOVERNANCE

General

We believe that good corporate governance is important to ensure that Southwall is managed for the long-term benefit of
x;font-size:10pt;">Subsequent events

We have considered subsequent events through the date of this filing.

Note 2. New Accounting Pronouncements
Adopted Accounting Standards
Improvements to Employee Share-Based Compensation Accounting
In March 2016, the Financial Accounting Standards Board ("FASB") issued updated guidance that simplifies several aspects of the accounting for employee share-based compensation including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification of related amounts within the statement of cash flows. The updated guidance requires that, prospectively, all tax effects related to share-based compensation be made through the statement of operations at the time of settlement. In contrast, the previous guidance required excess tax benefits to be recognized in paid-in capital. The updated guidance also removes the requirement to delay recognition of a tax benefit until it reduces current taxes payable. This change is required to be applied on a modified retrospective basis, with a cumulative effect adjustment to opening retained earnings. Additionally, all tax related cash flows resulting from share-based compensation are to be reported as operating activities on the statement of cash flows, a change from the existing requirement to present tax benefits as an inflow from financing activities and an outflow from operating activities. Finally, for tax withholding purposes, entities will be allowed to withhold an amount of shares up to the employee's maximum individual tax rate (as opposed to the minimum statutory tax rate) in the relevant jurisdiction without resulting in liability classification of the award. The change in tax withholding is to be applied on a modified retrospective approach. This updated guidance became effective January 1, 2017. We adopted this guidance in the first quarter of 2017 and as a result of the adoption:

- We recognized discrete tax benefits of $1.5 million in the provision for income taxes on our statement of operations for the six months ended June 30, 2017 related to excess tax benefits upon vesting of share-based awards during the period.
- We recognized a cumulative effect adjustment related to the recognition of a deferred tax asset related to

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suspended tax benefits from vesting transactions occurring in prior years and from the elimination of our forfeiture estimate on share-based awards, which was previously applied only to awards with service conditions.

- Prior to adoption, cash flows related to excess tax benefits from share-based compensation were included in financing activities. We have reclassified excess tax benefits related to share-based compensation for the prior year period to operating activities.
- Prior to adoption, cash flows related to employee taxes paid for withheld shares were included in operating activities. We have reclassified employee taxes paid for withheld shares for the prior year period to financing activities.

Prospective Accounting Standards

Stock Compensation - Scope of Modification Accounting

In May 2017, the FASB issued updated guidance related to a change in the terms or conditions (modification) of a share-based award. The updated guidance provides that an entity should account for the effects of a modification unless the fair value and vesting conditions of the modified award and the classification of the award (equity or liability instrument) are the same as the original award immediately before the modification. The updated guidance addresses the current diversity in practice on applying modification accounting, as some entities evaluate whether changes to awards are substantive, which is not prescribed within the current accounting guidance. The updated guidance is effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted, including adoption in any interim period. We are currently evaluating the impacts the adoption of this guidance will have on our consolidated financial statements, but do not expect it to have a material impact on our consolidated financial statements or disclosures.

Premium Amortization on Purchased Callable Debt Securities

In March 2017, the FASB issued updated guidance to amend the amortization period for certain purchased callable debt securities held at a premium shortening the amortization period to the earliest call date. Under current GAAP, there is diversity in practice in the amortization period for premiums of callable debt securities and in how the potential for exercise of a call is factored into current impairment assessments. This updated guidance aligns with how callable debt securities, in the United States, are generally quoted, priced, and traded assuming a model that incorporates consideration of calls (also referred to as “yield-to-worst” pricing). The updated guidance is effective for annual periods beginning after December 15, 2018, including interim periods within those annual periods. We are currently evaluating the impacts the adoption of this

guidance will have on our consolidated financial statements, but do not expect it to have a material impact on our consolidated financial statements or disclosures. We currently account for premium amortization on our purchased callable debt securities on a yield-to-worst basis, which generally aligns with the earliest call date.

Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost

In March 2017, the FASB issued updated guidance that improves the reporting of net benefit cost in the financial statements. The updated guidance requires that an employer report the service cost component in the same financial statement caption as other compensation costs arising from services rendered by employees during the period. The other components of net benefit cost are required to be presented in the statement of operations separately from the service cost component and outside a subtotal of income from operations, if one is presented. Current guidance does not prescribe where the amount of net benefit cost should be presented in an employer’s statement of operations and does not require entities to disclose by line item the amount of net benefit cost that is included in the statement of operations. The updated guidance is effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. We are currently evaluating the impacts the adoption of this guidance will have on our consolidated financial statements, but do not expect it to have a material impact on our consolidated financial statements or disclosures.

Measurement of Credit Losses on Financial Instruments

In June 2016, the FASB issued updated guidance that requires immediate recognition of estimated credit losses expected to occur over the remaining life of many financial instruments. Entities will be required to utilize a current expected credit losses ("CECL") methodology that incorporates their forecasts of future economic conditions into their loss estimate unless such forecast is not reasonable and supportable, in which case the entity will revert to historical loss experience. Any allowance for CECL reduces the amortized cost basis of the financial instrument to the amount an entity expects to collect. Credit losses relating to available-for-sale fixed maturity securities are to be recorded through an allowance for credit losses, rather than a write-down of the asset, with the amount of the allowance limited to the amount by which fair value is less than amortized cost. In addition, the length of time a security has been in an unrealized loss position will no longer impact the determination of whether a credit loss exists. The updated guidance is not prescriptive about certain aspects of estimating expected credit losses, including the specific methodology to use, and therefore will require significant judgment in application. The updated guidance is effective for annual periods beginning after December 15, 2019, including interim periods within those annual periods. Early

adoption is permitted for annual and interim periods in fiscal years beginning after December 15, 2018. We are currently evaluating the impacts the adoption of this guidance will have on our consolidated financial statements, but do not expect it to have a material impact on our consolidated financial statements or disclosures.

Recognition and Measurement of Financial Assets and Financial Liabilities
In January 2016, the FASB issued updated guidance to address the recognition, measurement, presentation, and disclosure of certain financial instruments. The updated guidance requires equity investments, except those accounted for under the equity method of accounting, that have a readily determinable fair value to be measured at fair value with changes in fair value recognized in net income. Equity investments that do not have readily determinable fair values may be remeasured at fair value either upon the occurrence of an observable price change or upon identification of an impairment. A qualitative assessment for impairment is required for equity investments without readily determinable fair values. The updated guidance also eliminates the requirement to disclose the method and significant assumptions used to estimate the fair value of financial instruments measured at amortized cost on the balance sheet. Further, the updated guidance clarifies that entities should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entities other deferred tax assets. The updated guidance is effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods and will require recognition of a cumulative effect adjustment at adoption. We do not currently expect the adoption of this guidance to impact our consolidated financial position or liquidity.

Note 3. Debt
2017 debt transactions
2% Notes
On March 21, 2017, we issued an irrevocable notice of redemption in respect of our outstanding 2% Notes, with a redemption date of April 21, 2017. In April, holders of approximately $202.5 million of the outstanding principal exercised their rights to convert their notes into shares of our common stock. The remaining $5.1 million of outstanding principal was redeemed for cash. The conversions of the 2% Notes at a rate of 143.8332 shares per $1,000 principal amount resulted in the issuance of approximately 29.1 million shares of our common stock in April. The conversions and cash redemption eliminated our debt obligation. A loss on debt extinguishment of $0.07 million was recognized on the redemption of the $5.1 million of 2% Notes. No gain or loss was recognized from the conversions as the outstanding debt issuance costs associated with the conversions are included in the debt

carrying value, which was credited to shareholders’ equity at the time of conversion.

Credit Facility
On March 21, 2017, we entered into a Credit Agreement with various lenders which provides for a $175 million unsecured revolving credit facility maturing on March 21, 2020. Revolving credit borrowings bear interest at a floating rate, which will be, at our option, either a eurocurrency rate or a base rate, in each case plus an applicable margin. The applicable margins are subject to adjustment based on our senior unsecured long-term debt rating, or if we do not have such a rating, our corporate or issuer rating. Amounts under the facility may be borrowed, repaid and reborrowed from time to time until the maturity of the revolving credit facility. Voluntary prepayments and commitment reductions are permitted at any time without fee subject to a minimum dollar requirement and, for outstanding eurocurrency loans, customary breakage costs.

We are required under the Credit Agreement to pay commitment fees on the average daily amount of the unused revolving commitments of the lenders, and an annual administrative fee to the administrative agent. The Credit Agreement contains affirmative, negative and financial covenants which are customary for financings of this type, including, among other things, limits on the creation of liens, limits on the incurrence of indebtedness, restrictions on dispositions, maximum debt-to-capital ratio, minimum consolidated stockholders' equity, minimum policyholder's position of MGIC, and compliance with the financial requirements of the PMIERs. The Credit Agreement includes

customary events of default for facilities of this type (with customary grace periods, as applicable) and provides that, upon the occurrence of an event of default, payments of all outstanding loans may be accelerated and/or the lenders' commitments may be terminated. Upon the occurrence of certain insolvency or bankruptcy related events of default, all amounts payable under the Credit Agreements shall automatically become immediately due and payable, and the lenders' commitments will automatically terminate. In addition, upon the occurrence of certain insolvency or bankruptcy related events of default, or the failure to pay interest, principal or fees, the interest rates on all outstanding obligations will be increased.

In March, we borrowed $150 million under the revolving credit facility, to fund a portion of the redemption price of the 2% Notes if holders did not elect to convert their 2% Notes. In April, we repaid the amount borrowed under the revolving credit facility because most holders elected to convert their notes. Costs incurred to enter into the Credit Agreement have been deferred and recorded as Other

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assets and will be amortized over the term of the Credit Agreement.

5% Notes
On May 1, 2017, our 5% Notes due in 2017 ("5% Notes") matured and we repaid the outstanding $145 million in aggregate par value, plus accrued interest with cash at our holding company.

First half 2016 debt transactions
5% Notes
During the first six months of 2016, we purchased $188.5 million in aggregate par value of our 5% Notes at an aggregate purchase price of $195.5 million for which we recognized losses on debt extinguishment on our consolidated statements of operations for the three and six months ended June 30, 2016.

9% Debentures
In February 2016, MGIC purchased $132.7 million in aggregate par value of our 9% Debentures at a purchase price of $150.7 million. The purchase of the 9% Debentures resulted in an $8.3 million loss on debt extinguishment on the consolidated statement of operations for the six months ended June 30, 2016, which represents the difference between the fair value and the carrying value of the liability component on the purchase date. Our shareholders' equity was separately reduced by $6.3 million related to the reacquisition of the equity component. For GAAP accounting purposes, the 9% Debentures owned by MGIC are considered retired and are eliminated in our consolidated financial statements and the underlying common stock equivalents, approximately 9.8 million shares, are not included in the computation of diluted shares.

Debt obligations
The par value of our long-term debt obligations and their aggregate carrying values as of June 30, 2017 and December 31, 2016 were as follows.

(In millions)	June 30, 2017	December 31, 2016
FHLB Advance	$155.0	$ 155.0
5% Notes	—	145.0
2% Notes	—	207.6
5.75% Notes	425.0	425.0
9% Debentures[1]	256.9	256.9
Long-term debt, par value	836.9	1,189.5
Debt issuance costs	(7.0)	(10.8)
Long-term debt, carrying value	$829.9	$ 1,178.7

(1) Convertible at any time prior to maturity at the holder's option, at an initial conversion rate, which is subject to adjustment, of 74.0741 shares per $1,000 principal amount, representing an initial conversion price of approximately $13.50 per share.

If a holder elects to convert their debentures, deferred interest owed on the debentures being converted is also converted into shares of our common stock. The conversion rate for any deferred interest is based on the average price that our shares traded at during a 5-day period immediately prior to the election to convert. In lieu of issuing shares of common stock upon conversion of the debentures, we may, at our option, make a cash payment to converting holders for all or some of the shares of our common stock otherwise issuable upon conversion.

The 5.75% Senior Notes due 2023 ("5.75% Notes") and 9% Convertible Junior Subordinated Debentures due in 2063 ("9% Debentures") are obligations of our holding company, MGIC Investment Corporation, and not of its subsidiaries. The Federal Home Loan Bank Advance (the "FHLB Advance") is an obligation of MGIC.

Interest payments on our debt obligations appear below.

	Six Months Ended June 30,	
(In millions)	2017	2016
Revolving credit facility	$0.5	$—
FHLB Advance	1.5	0.9
5% Notes	3.6	6.9
2% Notes	2.1	5.0
5.75% Notes	12.9	—
9% Debentures	11.6	15.9
Total interest payments	$32.2	$28.7

Note 4. Reinsurance

The reinsurance agreements we have entered into are discussed below. The effect of all of our reinsurance agreements on premiums earned and losses incurred is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2017	2016	2017	2016
Premiums earned:				
Direct	$261,180	$263,566	$520,608	$518,953
Assumed	62	182	160	390
Ceded	(30,106)	(32,292)	(60,529)	(66,546)
Net premiums earned	$231,136	$231,456	$460,239	$452,797
Losses incurred:				
Direct	$31,396	$54,863	$63,809	$147,295
Assumed	61	339	166	440
Ceded	(4,118)	(8,612)	(9,017)	(16,133)
Losses incurred, net	$27,339	$46,590	$54,958	$131,602

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Quota share reinsurance

In March 2017, we entered into a quota share reinsurance agreement (“2017 QSR Transaction”) with an effective date of January 1, 2017 with a group of unaffiliated reinsurers, each with a financial strength rating of A- or better by Standard and Poor’s, A.M. Best or both. We utilize quota share reinsurance to manage our exposure to losses resulting from our mortgage guaranty insurance policies and to provide reinsurance capital credit under the PMIERs. Our 2017 QSR Transaction provides coverage on new business written January 1, 2017 through December 29, 2017 that meets certain eligibility requirements. Under the agreement we cede losses incurred and premiums on or after the effective date through December 31, 2028, at which time the agreement expires. Early termination of the agreement can be elected by us effective December 31, 2021 for a fee, or under specified scenarios for no fee upon prior written notice including if we will receive less than 90% of the full credit amount under the PMIERs for the risk ceded in any required calculation period.

Our 2015 quota share reinsurance agreement (“2015 QSR Transaction”), which became effective on July 1, 2015, covers eligible risk in force written before 2017. The group of unaffiliated reinsurers under our 2015 QSR Transaction each has an insurer financial strength rating of A- or better by Standard and Poor’s Rating Services, A.M. Best or both. The 2015 QSR Transaction cedes losses incurred and premiums through December 31, 2024, at which time the agreement expires. Early termination of the agreement can be elected by us effective December 31, 2018 for a fee, or under specified scenarios for no fee upon prior written notice, including if we will receive less than 90% of the full credit amount under the PMIERs for the risk ceded in any required calculation period.

The structure of both the 2017 QSR Transaction and 2015 QSR Transaction is a 30% quota share for all policies covered, with a 20% ceding commission as well as a profit commission. Generally, under the QSR Transactions, we will receive a profit commission provided that the loss ratio on the loans covered under the agreement remains below 60%.

Following is a summary of our quota share reinsurance agreements, excluding captive agreements discussed below, for the three and six months ended June 30, 2017 and 2016.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2017	2016	2017	2016
Ceded premiums written and earned, net of profit commission [1]	$28,917	$29,961	$57,812	$61,627
Ceded losses incurred	4,424	6,070	9,111	14,583
Ceding commissions [2]	12,248	11,946	24,251	23,522
Profit commission	32,325	29,767	63,442	55,982

(1) Under our QSR Transactions, premiums are ceded on an earned and received basis as defined in the agreements.

(2) Ceding commissions are reported within Other underwriting and operating expenses, net on the consolidated statements of operations.

Under the terms of QSR Transactions, ceded premiums, ceding commission and profit commission are settled net on a quarterly basis. The ceded premium due after deducting the related ceding commission and profit commission is reported within “Other liabilities” on the consolidated balance sheets.

The reinsurance recoverable on loss reserves related to our QSR Transactions was $33.1 million as of June 30, 2017 and $31.8 million as of December 31, 2016. The reinsurance recoverable balance is secured by funds on deposit from the reinsurers which are based on the funding requirements of PMIERs that address ceded risk.

Captive reinsurance

In the past, MGIC also obtained captive reinsurance. In a captive reinsurance arrangement, the reinsurer is affiliated with the lender for whom MGIC provides mortgage insurance. As part of our settlement with the Consumer Financial Protection Bureau ("CFPB") in 2013 and with the Minnesota Department of Commerce in 2015, MGIC has agreed to not enter into any new captive reinsurance agreement or reinsure any new loans under any existing captive reinsurance agreement for a period of ten years subsequent to the respective settlements. In accordance with the CFPB settlement, all of our active captive arrangements were placed into run-off. In addition, the GSEs will not approve any future reinsurance or risk sharing transaction with a mortgage enterprise or an affiliate of a mortgage enterprise.

The reinsurance recoverable on loss reserves related to captive agreements was $12.0 million as of June 30, 2017, which was supported by $86.0 million of trust assets, while as of December 31, 2016, the reinsurance recoverable on loss reserves related to captive agreements was $19.0 million, which was supported by $91.0 million of trust assets. Each captive reinsurer is required to maintain a separate trust account to support its combined reinsured risk on all annual books. MGIC is the sole beneficiary of the trusts.

Note 5. Litigation and Contingencies

Before paying an insurance claim, we review the loan and servicing files to determine the appropriateness of the claim amount. When reviewing the files, we may determine that we have the right to rescind coverage on the loan. In our SEC reports, we refer to insurance rescissions and denials of claims collectively as "rescissions" and variations of that term. In addition, all of our insurance policies provide that we can reduce or deny a claim if the servicer did not comply

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with its obligations under our insurance policy. We call such reduction of claims “curtailments.” In recent quarters, an immaterial percentage of claims received in a quarter have been resolved by rescissions. In each of 2016 and the first half of 2017, curtailments reduced our average claim paid by approximately 5.5%.

Our loss reserving methodology incorporates our estimates of future rescissions, curtailments, and reversals of rescissions and curtailments. A variance between ultimate actual rescission, curtailment and reversal rates and our estimates, as a result of the outcome of litigation, settlements or other factors, could materially affect our losses.

When the insured disputes our right to rescind coverage or curtail claims, we generally engage in discussions in an attempt to settle the dispute. If we are unable to reach a settlement, the outcome of a dispute ultimately would be determined by legal proceedings.

Under ASC 450-20, until a liability associated with settlement discussions or legal proceedings becomes probable and can be reasonably estimated, we consider our claim payment or rescission resolved for financial reporting purposes and do not accrue an estimated loss. Where we have determined that a loss is probable and can be reasonably estimated, we have recorded our best estimate of our probable loss. If we are not able to implement settlements we consider probable, we intend to defend MGIC vigorously against any related legal proceedings.

In addition to matters for which we have recorded a probable loss, we are involved in other discussions and/or proceedings with insureds with respect to our claims paying practices. Although it is reasonably possible that when these matters are resolved we will not prevail in all cases, we are unable to make a reasonable estimate or range of estimates of the potential liability. We estimate the maximum exposure associated with matters where a loss is reasonably possible to be approximately $291 million, although we believe (but can give no assurance that) we will ultimately resolve these matters for significantly less than this amount. This estimate of our maximum exposure does not include interest or consequential or exemplary damages.
Mortgage insurers, including MGIC, have been involved in litigation and regulatory actions related to alleged violations of the anti-referral fee provisions of the Real Estate Settlement Procedures Act, which is commonly known as RESPA, and the notice provisions of the Fair Credit Reporting Act, which is commonly known as FCRA. While these proceedings in the aggregate have not resulted in material liability for MGIC, there can be no assurance that the outcome of future proceedings, if any, under these laws would not have a material adverse affect on us. In addition, various regulators, including the CFPB, state insurance

commissioners and state attorneys general may bring other actions seeking various forms of relief in connection with alleged violations of RESPA. The insurance law provisions of many states prohibit paying for the referral of insurance business and provide various mechanisms to enforce this prohibition. While we believe our practices are in conformity with applicable laws and regulations, it is not possible to predict the eventual scope, duration or outcome of any such reviews or investigations nor is it possible to predict their effect on us or the mortgage insurance industry.

Through a non-insurance subsidiary, we utilize our underwriting skills to provide an outsourced underwriting service to our customers known as contract underwriting. As part of the contract underwriting activities, that subsidiary is responsible for the quality of the underwriting decisions in accordance with the terms of the contract underwriting agreements with customers. That subsidiary may be required to provide certain remedies to its customers if certain standards relating to the quality of our underwriting work are not met, and we have an established reserve for such future obligations. Claims for remedies may be made a number of years after the underwriting work was performed. The underwriting remedy expense for 2016 and the first half of 2017 was immaterial to our consolidated financial statements.

In addition to the matters described above, we are involved in other legal proceedings in the ordinary course of business. In our opinion, based on the facts known at this time, the ultimate resolution of these ordinary course legal

proceedings will not have a material adverse effect on our financial position or results of operations.

See Note 11 – "Income Taxes" for a description of federal income tax contingencies.

Note 6. Earnings per Share
Basic earnings per share ("EPS") is calculated by dividing net income by the weighted average number of shares of common stock outstanding. Diluted EPS includes the components of basic EPS and also gives effect to dilutive common stock equivalents. We calculate diluted EPS using the treasury stock method and if-converted method. Under the if-converted method, diluted EPS reflects the potential dilution that could occur if our convertible debt instruments result in the issuance of common stock. The determination of potentially issuable shares does not consider the satisfaction of the conversion requirements and the shares are included in the determination of diluted EPS as of the beginning of the period, if dilutive. During the quarter ended June 30, 2017, we had several debt issuances that could result in contingently issuable shares and consider each potential issuance of shares separately to reflect the maximum potential dilution. Nonetheless, our dilutive common stock equivalents may not reflect all of the contingently issuable shares that could be required to be

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issued upon any debt conversion. For purposes of calculating basic and diluted EPS, vested restricted stock and restricted stock units ("RSUs") are considered outstanding.

The following table reconciles the numerators and denominators used to calculate basic and diluted EPS.

(In thousands, except per share data)	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Basic earnings per share:				
Net income	$118,622	$109,221	$208,420	$178,412
Weighted average common shares outstanding - basic	366,918	340,678	354,035	340,411
Basic earnings per share	$0.32	$0.32	$0.59	$0.52
Diluted earnings per share:				
Net income	$118,622	$109,221	$208,420	$178,412
Interest expense, net of tax [1]:				
2% Notes	84	1,982	907	3,964
5% Notes	427	1,728	1,709	4,406
9% Debentures	3,757	3,757	7,514	8,379
Diluted income available to common shareholders	$122,890	$116,688	$218,550	$195,161
Weighted average common shares outstanding - basic	366,918	340,678	354,035	340,411
Effect of dilutive securities:				
Unvested RSUs	1,140	1,209	1,314	1,444
2% Notes	3,827	71,917	16,771	71,917
5% Notes	3,557	13,307	7,154	15,449
9% Debentures	19,028	19,028	19,028	21,133
Weighted average common shares outstanding - diluted	394,470	446,139	398,302	450,354
Diluted earnings per share	$0.31	$0.26	$0.55	$0.43

[1] Tax effected at a rate of 35%.

Note 7. Investments

The amortized cost, gross unrealized gains and losses and fair value of the investment portfolio at June 30, 2017 and December 31, 2016 are shown below.

June 30, 2017

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses [1]	Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$64,043	$ 364	$ (478)	$63,929
Obligations of U.S. states and political subdivisions	2,131,471	42,983	(9,165)	2,165,289
Corporate debt securities	1,823,823	12,699	(8,897)	1,827,625
ABS	21,988	10	(11)	21,987
RMBS	209,874	78	(7,612)	202,340
CMBS	310,997	1,548	(5,467)	307,078
CLOs	112,769	332	(138)	112,963
Total debt securities	4,674,965	58,014	(31,768)	4,701,211
Equity securities	7,183	41	(15)	7,209
Total investment portfolio	$4,682,148	$ 58,055	$ (31,783)	$4,708,420

December 31, 2016

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses [1]	Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$73,847	$ 407	$ (724)	$73,530
Obligations of U.S. states and political subdivisions	2,147,458	20,983	(25,425)	2,143,016
Corporate debt securities	1,756,461	6,059	(18,610)	1,743,910
ABS	59,519	74	(28)	59,565
RMBS	231,733	102	(7,626)	224,209
CMBS	327,042	769	(7,994)	319,817
CLOs	121,151	226	(202)	121,175
Total debt securities	4,717,211	28,620	(60,609)	4,685,222
Equity securities	7,144	8	(24)	7,128
Total investment portfolio	$4,724,355	$ 28,628	$ (60,633)	$4,692,350

(1) At June 30, 2017 and December 31, 2016, there were no other-than-temporary impairment losses recorded in other comprehensive income.

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The FHLB Advance is secured by eligible collateral whose fair value must be maintained at 102% of the outstanding principal balance. As of June 30, 2017 that collateral is included in our total investment portfolio amount shown above with a total fair value of $165.9 million.

The amortized cost and fair values of debt securities at June 30, 2017, by contractual maturity, are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Because most asset-backed and mortgage-backed securities and collateralized loan obligations provide for periodic payments throughout their lives, they are listed in separate categories.

June 30, 2017

(In thousands)	Amortized Cost	Fair Value
Due in one year or less	$341,831	$342,028
Due after one year through five years	1,356,023	1,362,799
Due after five years through ten years	1,026,851	1,030,223
Due after ten years	1,294,632	1,321,793
	$4,019,337	$4,056,843
ABS	21,988	21,987
RMBS	209,874	202,340
CMBS	310,997	307,078
CLOs	112,769	112,963
Total as of June 30, 2017	$4,674,965	$4,701,211

At June 30, 2017 and December 31, 2016, the investment portfolio had gross unrealized losses of $31.8 million and $60.6 million, respectively. For those securities in an unrealized loss position, the length of time the securities were in such a position, as measured by their month-end fair values, is as follows:

June 30, 2017	Less Than 12 Months		12 Months or Greater		Total	
(In thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$52,769	$(471)	$993	$(7)	$53,762	$(478)
Obligations of U.S. states and political subdivisions	622,767	(8,595)	17,400	(570)	640,167	(9,165)
Corporate debt securities	649,134	(7,664)	27,241	(1,233)	676,375	(8,897)
ABS	3,362	(11)	—	—	3,362	(11)
RMBS	43,815	(885)	155,030	(6,727)	198,845	(7,612)
CMBS	172,505	(5,439)	7,237	(28)	179,742	(5,467)
CLOs	7,275	(138)	—	—	7,275	(138)
Equity securities	455	(7)	139	(8)	594	(15)
Total	$1,552,082	$(23,210)	$208,040	$(8,573)	$1,760,122	$(31,783)

December 31, 2016	Less Than 12 Months		12 Months or Greater		Total	
(In thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$48,642	$(724)	$—	$—	$48,642	$(724)
Obligations of U.S. states and political subdivisions	1,136,676	(24,918)	13,681	(507)	1,150,357	(25,425)

Corporate debt securities	915,777	(16,771)	35,769	(1,839)	951,546	(18,610)
ABS	3,366	(28)	656	—	4,022	(28)
RMBS	46,493	(857)	171,326	(6,769)	217,819	(7,626)
CMBS	205,545	(7,529)	38,587	(465)	244,132	(7,994)
CLOs	13,278	(73)	34,760	(129)	48,038	(202)
Equity securities	568	(15)	137	(9)	705	(24)
Total	$2,370,345	$(50,915)	$294,916	$(9,718)	$2,665,261	$(60,633)

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The unrealized losses in all categories of our investments at June 30, 2017 and December 31, 2016 were primarily caused by the difference in interest rates at each respective period, compared to interest rates at the time of purchase. There were 404 and 607 securities in an unrealized loss position at June 30, 2017 and December 31, 2016, respectively.

During each of the three and six months ended June 30, 2017 and 2016 there were no other-than-temporary impairments ("OTTI") recognized. The net realized investment gains (losses) on the investment portfolio are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2017	2016	2017	2016
Realized investment gains (losses) on investments:				
Fixed maturities	$(52)	$831	$(177)	$3,886
Equity securities	10	5	13	6
Net realized investments (losses) gains	$(42)	$836	$(164)	$3,892

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2017	2016	2017	2016
Realized investment gains (losses) on investments:				
Gains on sales	$644	$1,404	$829	$5,509
Losses on sales	(686)	(568)	(993)	(1,617)
Net realized investments (losses) gains	$(42)	$836	$(164)	$3,892

Note 8. Fair Value Measurements

Under the authoritative guidance, fair value is disclosed using a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value and categorizes assets and liabilities into Levels 1, 2, and 3 based on inputs available to determine their fair values. To determine the fair value of securities available-for-sale in Level 1 and Level 2 of the fair value hierarchy, independent pricing sources have been utilized. One price is provided per security based on observable market data. To ensure securities are appropriately classified in the fair value hierarchy, we review the pricing techniques and methodologies of the independent pricing sources and believe that their policies adequately consider market activity, either based on specific transactions for the issue valued or based on modeling of securities with similar credit quality, duration, yield and structure that were recently traded. A variety of inputs are utilized by the independent pricing sources including benchmark yields, reported

trades, non-binding broker/dealer quotes, issuer spreads, two sided markets, benchmark securities, bids, offers and reference data including data published in market research publications. Inputs may be weighted differently for any security, and not all inputs are used for each security evaluation.

Market indicators, industry and economic events are also considered. This information is evaluated using a multidimensional pricing model. This model combines all inputs to arrive at a value assigned to each security. Quality controls are performed by the independent pricing sources throughout this process, which include reviewing tolerance reports, trading information, data changes, and directional moves compared to market moves. In addition, on a quarterly basis, we perform quality controls over values received from the pricing sources which also includes reviewing tolerance reports, trading information, data changes, and directional moves compared to market moves. We have not made any adjustments to the prices obtained from the independent pricing sources.

In accordance with fair value accounting guidance, we applied the following fair value hierarchy in order to measure fair value for assets and liabilities:

Level 1 - Quoted prices for identical instruments in active markets that we can access. Financial assets utilizing Level 1 inputs primarily include U.S. Treasury securities and equity securities.

Level 2 - Quoted prices for similar instruments in active markets that we can access; quoted prices for identical or similar instruments in markets that are not active; and inputs, other than quoted prices, that are observable in the marketplace for the instrument. The observable inputs are used in valuation models to calculate the fair value of the instruments. Financial assets utilizing Level 2 inputs primarily include obligations of U.S. government corporations and agencies, corporate bonds, mortgage-backed securities, asset-backed securities, and most municipal bonds.

The independent pricing sources utilize these approaches to determine the fair value of the instruments in Level 2 of the fair value hierarchy based on type of instrument:

Corporate Debt & U.S. Government and Agency Bonds are evaluated by surveying the dealer community, obtaining relevant trade data, benchmark quotes and spreads and incorporating this information into the evaluation process.

Obligations of U.S. States & Political Subdivisions are evaluated by tracking, capturing, and analyzing quotes for active issues and trades reported via the Municipal Securities Rulemaking Board records. Daily briefings and reviews of current economic conditions, trading

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levels, spread relationships, and the slope of the yield curve provide further data for evaluation.

Residential Mortgage-Backed Securities (“RMBS”) are evaluated by monitoring interest rate movements, and other pertinent data daily. Incoming market data is enriched to derive spread, yield and/or price data as appropriate, enabling known data points to be extrapolated for valuation application across a range of related securities.

Commercial Mortgage-Backed Securities (“CMBS”) are evaluated using valuation techniques that reflect market participants’ assumptions and maximize the use of relevant observable inputs including quoted prices for similar assets, benchmark yield curves and market corroborated inputs. The inputs for securities covered, including executed trades, broker quotes, credit information, collateral attributes and/or cash flow waterfall as applicable, are regularly reviewed as part of the evaluation.

Asset-Backed Securities (“ABS”) are evaluated using spreads and other information solicited from market buy- and sell-side sources, including primary and secondary dealers, portfolio managers, and research analysts. Cash flows are generated for each tranche, benchmark yields are determined, and deal collateral performance and tranche level attributes including trade activity, bids, and offer are applied, resulting in tranche-specific prices.

Collateralized loan obligations ("CLO") are evaluated by manager rating, seniority in the capital structure, assumptions about prepayment, default and recovery and their impact on cash flow generation. Loan level net asset values are determined and aggregated for tranches and as a final step, prices are checked against available recent trade activity.

Level 3 - Valuations derived from valuation techniques in which one or more significant inputs or value drivers are unobservable or from par values for equity securities restricted in their ability to be redeemed or sold. The inputs used to derive the fair value of Level 3 securities reflect our own assumptions about the assumptions a market participant would use in pricing an asset or liability. Financial assets utilizing Level 3 inputs primarily include equity securities that can only be redeemed or sold at their par value and only to the security issuer and a state premium tax credit investment. The state premium tax credit investment has a maturity of less than 2 years, a credit rating of AAA, and its balance reflects its remaining scheduled payments discounted at an average annual rate of 7.1%. Our non-financial assets that are classified as Level 3 securities consist of real estate acquired through claim settlement. The fair value of real estate acquired is the lower of our acquisition cost or a percentage of the appraised value. The percentage applied to the appraised value is based upon our historical sales experience adjusted for current trends.

Fair value measurements for assets measured at fair value included the following as of June 30, 2017 and December 31, 2016:

June 30, 2017

(In thousands)	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$63,929	$13,342	$50,587	$ —

Obligations of U.S. states and political subdivisions	2,165,289	—	2,164,712	577
Corporate debt securities	1,827,625	—	1,827,625	—
ABS	21,987	—	21,987	—
RMBS	202,340	—	202,340	—
CMBS	307,078	—	307,078	—
CLOs	112,963	—	112,963	—
Total debt securities	4,701,211	13,342	4,687,292	577
Equity securities [(1)]	7,209	2,941	—	4,268
Total investment portfolio	$4,708,420	$16,283	$4,687,292	$ 4,845
Real estate acquired [(2)]	$10,271	$—	$—	$ 10,271

(1) Equity securities in Level 3 are carried at cost, which approximates fair value.

(2) Real estate acquired through claim settlement, which is held for sale, is reported in Other assets on the consolidated balance sheets.

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December 31, 2016

(In thousands)	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$73,530	$30,690	$42,840	$ —
Obligations of U.S. states and political subdivisions	2,143,016	—	2,142,325	691
Corporate debt securities	1,743,910	—	1,743,910	—
ABS	59,565	—	59,565	—
RMBS	224,209	—	224,209	—
CMBS	319,817	—	319,817	—
CLOs	121,175	—	121,175	—
Total debt securities	4,685,222	30,690	4,653,841	691
Equity securities [1]	7,128	2,860	—	4,268
Total investment portfolio	$4,692,350	$33,550	$4,653,841	$ 4,959
Real estate acquired [2]	$11,748	$—	$—	$ 11,748

(1) Equity securities in Level 3 are carried at cost, which approximates fair value.

(2) Real estate acquired through claim settlement, which is held for sale, is reported in Other assets on the consolidated balance sheets.

For assets measured at fair value using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances for the three and six months ended June 30, 2017 and 2016 is shown in the following tables. There were no transfers into or out of Level 3 in those periods and there were no losses included in earnings for those periods attributable to the change in unrealized losses on assets still held at the end of the applicable period.

Three Months Ended June 30, 2017

(In thousands)	Debt Securities	Equity Securities	Total Investments	Real Estate Acquired
Balance at March 31, 2017	$ 683	$ 4,268	$ 4,951	$10,730
Total realized/unrealized gains (losses):				
Included in earnings and reported as losses incurred, net	—	—	—	(63)
Purchases	—	—	—	9,421
Sales	(106)	—	(106)	(9,817)
Balance at June 30, 2017	$ 577	$ 4,268	$ 4,845	$10,271

Three Months Ended June 30, 2016

(In thousands)	Debt Securities	Equity Securities	Total Investments	Real Estate Acquired
Balance at March 31, 2016	$ 1,192	$ 3,421	$ 4,613	$12,849
Total realized/unrealized gains (losses):				
Included in other comprehensive income	—	3,519	3,519	—
Included in earnings and reported as losses incurred, net	—	—	—	651
Purchases	—	—	—	6,748
Sales	(136)	—	(136)	(10,606)

Balance at June 30, 2016	$ 1,056	$ 6,940	$ 7,996	$9,642

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Six Months Ended June 30, 2017

(In thousands)	Debt Securities	Equity Securities	Total Investments	Real Estate Acquired
Balance at December 31, 2016	$ 691	$ 4,268	$ 4,959	$ 11,748
Total realized/unrealized gains (losses):				
Included in earnings and reported as losses incurred, net	—	—	—	(226)
Purchases	—	—	—	18,104
Sales	(114)	—	(114)	(19,355)
Balance at June 30, 2017	$ 577	$ 4,268	$ 4,845	$ 10,271

Six Months Ended June 30, 2016

(In thousands)	Debt Securities	Equity Securities	Total Investments	Real Estate Acquired
Balance at December 31, 2015	$ 1,228	$ 2,855	$ 4,083	$ 12,149
Total realized/unrealized gains (losses):				
Included in other comprehensive income	—	3,519	3,519	—
Included in earnings and reported as losses incurred, net	—	—	—	358
Purchases	—	3,091	3,091	19,015
Sales	(172)	(2,525)	(2,697)	(21,880)
Balance at June 30, 2016	$ 1,056	$ 6,940	$ 7,996	$ 9,642

Authoritative guidance over disclosures about the fair value of financial instruments requires additional disclosure for financial instruments not measured at fair value. Certain financial instruments, including insurance contracts, are excluded from these fair value disclosure requirements. The carrying values of cash and cash equivalents (Level 1) and accrued investment income (Level 2) approximated their fair values. Additional fair value disclosures related to our investment portfolio are included in Note 7 – “Investments.”

Financial Liabilities Not Measured at Fair Value

We incur financial liabilities in the normal course of our business. The following table presents the carrying value and fair value of our financial liabilities disclosed, but not carried, at fair value at June 30, 2017 and December 31, 2016. The fair values of our 5% Notes, 2% Notes, 5.75% Notes, and 9% Debentures were based on observable market prices. The fair value of the FHLB Advance was estimated using discounted cash flows on current incremental borrowing rates for similar borrowing arrangements. In all cases the fair values of the financial liabilities below are categorized as Level 2.

	June 30, 2017		December 31, 2016	
(In thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial liabilities:				
FHLB Advance	155,000	154,140	$ 155,000	$ 151,905
5% Notes	—	—	144,789	147,679
2% Notes	—	—	204,672	308,605
5.75% Notes	417,983	457,878	417,406	445,987
9% Debentures	256,872	338,190	256,872	323,040
Total financial liabilities	$ 829,855	$ 950,208	$ 1,178,739	$ 1,377,216

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Note 9. Other Comprehensive Income

The pretax and related income tax (expense) benefit components of our other comprehensive income (loss) for the three and six months ended June 30, 2017 and 2016 are included in the following table.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2017	2016	2017	2016
Net unrealized investment gains arising during the period	$39,614	$86,674	$58,261	$165,058
Income tax expense	(13,865)	(30,336)	(20,391)	(57,893)
Net of taxes	25,749	56,338	37,870	107,165
Net changes in benefit plan assets and obligations	(220)	(266)	(454)	(740)
Income tax benefit	78	93	159	259
Net of taxes	(142)	(173)	(295)	(481)
Net changes in unrealized foreign currency translation adjustment	—	16	45	(1,480)
Income tax (expense) benefit	—	(5)	(14)	516
Net of taxes	—	11	31	(964)
Total other comprehensive income	39,394	86,424	57,852	162,838
Total income tax expense	(13,787)	(30,248)	(20,246)	(57,118)
Total other comprehensive income, net of tax	$25,607	$56,176	$37,606	$105,720

The pretax and related income tax (expense) benefit components of the amounts reclassified from our accumulated other comprehensive loss ("AOCL") to our consolidated statements of operations for the three and six months ended June 30, 2017 and 2016 are included in the following table.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2017	2016	2017	2016
Reclassification adjustment for net realized (losses) gains [(1)]	$(1,392)	$98	$(2,139)	$710
Income tax benefit (expense)	487	(34)	748	(126)
Net of taxes	(905)	64	(1,391)	584
Reclassification adjustment related to benefit plan assets and obligations [(2)]	220	266	454	740
Income tax expense	(78)	(93)	(159)	(259)
Net of taxes	142	173	295	481
Reclassification adjustment related to foreign currency [(3)]	—	—	—	1,467
Income tax expense	—	—	—	(513)
Net of taxes	—	—	—	954
Total reclassifications	(1,172)	364	(1,685)	2,917
Total income tax benefit (expense)	409	(127)	589	(898)
Total reclassifications, net of tax	$(763)	$237	$(1,096)	$2,019

(1) Increases (decreases) Net realized investment (losses) gains on the consolidated statements of operations.
(2) Decreases (increases) Other underwriting and operating expenses, net on the consolidated statements of operations.
(3) Increases (decreases) Other revenue on the consolidated statements of operations.

A rollforward of AOCL for the six months ended June 30, 2017, including amounts reclassified from AOCL, are included in the table below.

	Six Months Ended June 30, 2017			
(In thousands)	Net unrealized gains and losses on available-for-sale securities	Net benefit plan assets and obligations recognized in shareholders' equity	Net unrealized foreign currency translation	Total AOCL
Balance, December 31, 2016, net of tax	$(20,797)	$ (54,272)	$ (31)	$(75,100)
Other comprehensive income before reclassifications	36,479	—	31	36,510
Less: Amounts reclassified from AOCL	(1,391)	295	—	(1,096)
Balance, June 30, 2017, net of tax	$17,073	$ (54,567)	$ —	$(37,494)

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Note 10. Benefit Plans

The following tables provide the components of net periodic benefit cost for our pension, supplemental executive retirement and other postretirement benefit plans for three and six months ended June 30, 2017 and 2016:

	Three Months Ended June 30,			
	Pension and Supplemental Executive Retirement Plans		Other Postretirement Benefit Plans	
(In thousands)	2017	2016	2017	2016
Service cost	$2,484	$2,402	$220	$201
Interest cost	3,879	4,024	186	180
Expected return on plan assets	(5,013)	(4,865)	(1,312)	(1,221)
Recognized net actuarial loss	1,549	1,567	—	—
Amortization of prior service cost	(106)	(171)	(1,663)	(1,663)
Net periodic benefit cost (benefit)	$2,793	$2,957	$(2,569)	$(2,503)

	Six Months Ended June 30,			
	Pension and Supplemental Executive Retirement Plans		Other Postretirement Benefit Plans	
(In thousands)	2017	2016	2017	2016
Service cost	$4,778	$4,565	$407	$376
Interest cost	7,737	7,953	353	352
Expected return on plan assets	(10,049)	(9,754)	(2,624)	(2,443)
Recognized net actuarial loss	3,084	2,928	—	—
Amortization of prior service cost	(213)	(343)	(3,325)	(3,325)
Net periodic benefit cost (benefit)	$5,337	$5,349	$(5,189)	$(5,040)

We currently intend to make contributions totaling $9.4 million to our qualified pension plan and supplemental executive retirement plan in 2017.

Note 11. Income Taxes

We have approximately $1.2 billion of net operating loss (“NOL”) carryforwards on a regular tax basis and $0.3 billion of NOL carryforwards for computing the alternative minimum tax as of June 30, 2017. Any unutilized carryforwards are scheduled to expire at the end of tax years 2031 through 2033.

We evaluate the realizability of our deferred tax assets including our NOL carryforwards on a quarterly basis. Based on our analysis, we have concluded that all of our deferred tax assets are fully realizable and therefore no valuation allowance existed at June 30, 2017 and December 31, 2016.

Tax Contingencies

As previously disclosed, the Internal Revenue Service (“IRS”) completed examinations of our federal income tax returns for the years 2000 through 2007 and issued proposed assessments for taxes, interest and penalties related to our treatment of the flow-through income and loss from an investment in a portfolio of residual interests of Real Estate Mortgage Investment Conduits (“REMICs”). The IRS indicated that it did not believe that, for various reasons, we had established sufficient tax basis in the REMIC residual interests to deduct the losses from taxable income. We appealed these assessments within the IRS and in August 2010, we reached a tentative settlement agreement with the IRS which was not finalized.

In 2014, we received Notices of Deficiency (commonly referred to as "90 day letters") covering the 2000-2007 tax years. The Notices of Deficiency reflect taxes and penalties related to the REMIC matters of $197.5 million and at June 30, 2017, there would also be interest related to these matters of approximately $195.7 million. In 2007, we made a payment of $65.2 million to the United States Department of the Treasury which will reduce any amounts we would ultimately owe. The Notices of Deficiency also reflect additional amounts due of $261.4 million, which are primarily associated with the disallowance of the carryback of the 2009 net operating loss to the 2004-2007 tax years. We believe the IRS included the carryback adjustments as a precaution to keep open the statute of limitations on collection of the tax that was refunded when this loss was carried back, and not because the IRS actually intends to disallow the carryback permanently. Depending on the outcome of this matter, additional state income taxes and state interest may become due when a final resolution is reached. As of June 30, 2017, those state taxes and interest would approximate $82.4 million. In addition, there could also be state tax penalties. Our total amount of unrecognized tax benefits as of June 30, 2017 is $140.8 million, which represents the tax benefits generated by the REMIC portfolio included in our tax returns that we have not taken benefit for in our financial statements, including any related interest.

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We filed a petition with the U.S. Tax Court contesting most of the IRS' proposed adjustments reflected in the Notices of Deficiency and the IRS filed an answer to our petition which continued to assert their claim. The case has twice been scheduled for trial and in each instance, the parties jointly filed, and the U.S. Tax Court approved (most recently in February 2016), motions for continuance to postpone the trial date. Also in February 2016, the U.S. Tax Court approved a joint motion to consolidate for trial, briefing and opinion, our case with similar cases of Radian Group, Inc., as successor to Enhance Financial Services Group, Inc., et al. The parties informed the Tax Court in January 2017 that they had reached a basis for settlement of the major issues in the case and in June 2017 that there was only one remaining unresolved secondary issue (a factual determination arising from the 2002-2004 audit that is unrelated to the REMIC matter which the parties continue to work toward resolving). Any agreed settlement terms will ultimately be subject to review by the Joint Committee on Taxation ("JCT") before a settlement can be completed and there is no assurance that a settlement will be completed. Based on information that we currently have regarding the status of our ongoing dispute, we recorded a provision for additional taxes and interest of $27.8 million in the first half of 2017.

Should a settlement not be completed, ongoing litigation to resolve our dispute with the IRS could be lengthy and costly in terms of legal fees and related expenses. We would need to make further adjustments, which could be material, to our tax provision and liabilities if our view of the probability of success in this matter changes, and the ultimate resolution of this matter could have a material negative impact on our effective tax rate, results of operations, cash flows, available assets and statutory capital. In this regard, see Note 15 - "Statutory Information."

The total amount of the unrecognized tax benefits, related to our aforementioned REMIC issue that would affect our effective tax rate is $119.1 million. We recognize interest accrued and penalties related to unrecognized tax benefits in income taxes. As of June 30, 2017 and December 31, 2016, we had accrued $49.9 million and $28.9 million, respectively, for the payment of interest.

Note 12. Loss Reserves

We establish reserves to recognize the estimated liability for losses and loss adjustment expenses ("LAE") related to defaults on insured mortgage loans. Loss reserves are established by estimating the number of loans in our inventory of delinquent loans that will result in a claim payment, which is referred to as the claim rate, and further estimating the amount of the claim payment, which is referred to as claim severity.

Estimation of losses is inherently judgmental. The conditions that affect the claim rate and claim severity include the current and future state of the domestic

economy, including unemployment and the current and future strength of local housing markets; exposure on insured loans; the amount of time between default and claim filing; and curtailments and rescissions. The actual amount of the claim payments may be substantially different than our loss reserve estimates. Our estimates could be adversely affected by several factors, including a deterioration of regional or national economic conditions, including unemployment, leading to a reduction in borrowers' income and thus their ability to make mortgage payments, and a drop in housing values which may affect borrower willingness to continue to make mortgage payments when the value of the home is below the mortgage balance. Changes to our estimates could result in a material impact to our results of operations and capital position, even in a stable economic environment.

The "Losses incurred" section of the table below shows losses incurred on defaults that occurred in the current year and in prior years. The amount of losses incurred relating to defaults that occurred in the current year represents the estimated amount to be ultimately paid on such defaults. The amount of losses incurred relating to defaults that occurred in prior years represents the actual claim rate and severity associated with those defaults resolved in the current year differing from the estimated liability at the prior year-end, as well as a re-estimation of amounts to be ultimately paid on defaults continuing from the end of the prior year. This re-estimation of the claim rate and severity

is the result of our review of current trends in the default inventory, such as percentages of defaults that have resulted in a claim, the amount of the claims relative to the average loan exposure, changes in the relative level of defaults by geography and changes in average loan exposure.

Losses incurred on defaults that occurred in the current year decreased in the first six months of 2017 compared to the same period in 2016, primarily due to a decrease in the estimated claim rate on recently reported defaults and a decrease in the number of new defaults, net of related cures.

For the six months ended June 30, 2017 and 2016 we experienced favorable prior year loss reserve development. This development was, in part, due to the resolution of approximately 48% and 43% of the prior year default inventory during the six months ended June 30, 2017 and 2016, respectively. During the first six months of 2017 and 2016, we experienced improved cure rates on prior year defaults, which were offset in part by an increase in severity on the prior year defaults in both periods.

The “Losses paid” section of the table below shows the breakdown between claims paid on new default notices in the current year and claims paid on defaults from prior years. Until a few years ago, it took, on average, approximately twelve months for a default that is not cured to develop into a paid claim. Over the past several years, the average time

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it takes to receive a claim associated with a default has increased. This is, in part, due to new loss mitigation protocols established by servicers and to changes in some state foreclosure laws that may include, for example, a requirement for additional review and/or mediation processes. It is difficult to estimate how long it may take for current and future defaults that do not cure to develop into paid claims.

During the first six months of 2017 and 2016, our losses paid included amounts paid in connection with disputes concerning our claims paying practices and settlements of coverage on pools of non-performing loans ("NPLs"). The impacts of the settlements were as follows:

- 2017 - Items removed from inventory totaled 1,128 notices with an amount paid of $45 million.
- 2016 - Items removed from inventory totaled 1,273 notices with an amount paid of $51 million.

The liability associated with our estimate of premiums to be refunded on expected claim payments is accrued for separately at June 30, 2017 and December 31, 2016 and approximated $74 million and $85 million, respectively. This liability was included in "Other liabilities" on our consolidated balance sheets.

The following table provides a reconciliation of beginning and ending loss reserves as of and for the six months ended June 30, 2017 and 2016:

	Six months ended June 30,	
(In thousands)	2017	2016
Reserve at beginning of period	$1,438,813	$1,893,402
Less reinsurance recoverable	50,493	44,487
Net reserve at beginning of period	1,388,320	1,848,915
Losses incurred:		
Losses and LAE incurred in respect of default notices received in:		
Current year	158,906	196,543
Prior years [1]	(103,948)	(64,941)
Total losses incurred	54,958	131,602
Losses paid:		
Losses and LAE paid in respect of default notices received in:		
Current year	2,125	1,396
Prior years	298,847	392,007
Reinsurance terminations	—	(4)
Total losses paid	300,972	393,399
Net reserve at end of period	1,142,306	1,587,118
Plus reinsurance recoverables	44,783	45,215
Reserve at end of period	$1,187,089	$1,632,333

(1) A negative number for prior year losses incurred indicates a redundancy of prior year loss reserves. See the following table for more information about prior year loss development.

The prior year development of the reserves in the first six months of 2017 and 2016 is reflected in the following table.

	Six months ended June 30,	
(In millions)	2017	2016
Decrease in estimated claim rate on primary defaults	$ (104)	$ (76)

Increase in estimated severity on primary defaults	2			17		
Change in estimates related to pool reserves, LAE reserves and reinsurance	(2		)	(6		)
Total prior year loss development [1]	$	(104	)	$	(65	)

[1] A negative number for prior year loss development indicates a redundancy of prior year loss reserves.

Default inventory

A rollforward of our primary default inventory for the three and six months ended June 30, 2017 and 2016 appears in the following table. The information concerning new notices and cures is compiled from monthly reports received from loan servicers. The level of new notice and cure activity reported in a particular month can be influenced by, among other things, the date on which a servicer generates its report, the accuracy of the data provided by servicers, the number of business days in a month, transfers of servicing between loan servicers and whether all servicers have provided the reports in a given month.

	Three months ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Default inventory at beginning of period	45,349	55,590	50,282	62,633
New notices	14,463	16,080	29,402	32,811
Cures	(14,708)	(15,640)	(31,836)	(34,693)
Paids (including those charged to a deductible or captive)	(2,573)	(3,195)	(5,208)	(6,568)
Rescissions and denials	(100)	(142)	(195)	(352)
Other items removed from inventory	(1,114)	(135)	(1,128)	(1,273)
Default inventory at end of period	41,317	52,558	41,317	52,558

The decrease in the primary default inventory experienced during 2017 and 2016 was generally across all markets and primarily in book years 2008 and prior. Historically as a default ages it becomes more likely to result in a claim.

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Consecutive months in default

	June 30, 2017		December 31, 2016		June 30, 2016	
3 months or less	10,299	25 %	12,194	24 %	11,547	22 %
4 - 11 months	11,018	27 %	13,450	27 %	12,680	24 %
12 months or more [(1)] [(2)]	20,000	48 %	24,638	49 %	28,331	54 %
Total primary default inventory	41,317	100%	50,282	100%	52,558	100%
Primary claims received inventory included in ending default inventory:	1,258	3 %	1,385	3 %	1,829	3 %

(1) Approximately 46%, 47%, and 49% of the primary default inventory in default for 12 consecutive months or more has been in default for at least 36 consecutive months as of June 30, 2017, December 31, 2016, and June 30, 2016, respectively.

(2) The majority of items removed from our default inventory under NPL settlements during the six months ended June 30, 2017 were in default for 12 consecutive months or more as of December 31, 2016.

The number of months a loan is in the default inventory can differ from the number of payments that the borrower has not made or is considered delinquent. These differences typically result from a borrower making monthly payments that do not result in the loan becoming fully current. The number of payments that a borrower is delinquent is shown in the table below.

Number of payments delinquent

	June 30, 2017		December 31, 2016		June 30, 2016	
3 payments or less	15,858	38 %	18,419	36 %	17,299	33 %
4 - 11 payments	10,560	26 %	12,892	26 %	12,746	24 %
12 payments or more [(1)]	14,899	36 %	18,971	38 %	22,513	43 %
Total primary default inventory	41,317	100%	50,282	100%	52,558	100%

(1) The majority of items removed from our default inventory under NPL settlements during the six months ended June 30, 2017 had 12 or more payments delinquent as of December 31, 2016.

Pool insurance default inventory decreased to 1,511 at June 30, 2017 from 1,883 at December 31, 2016, and 2,024 at June 30, 2016.

Claims paying practices

Our loss reserving methodology incorporates our estimates of future rescissions. A variance between ultimate actual rescission rates and our estimates, as a result of the outcome of litigation, settlements or other factors, could materially affect our losses.

The liability associated with our estimate of premiums to be refunded on expected future rescissions is accrued for separately and is included in "Other liabilities" on our consolidated balance sheets.

For information about discussions and legal proceedings with customers with respect to our claims paying practices see Note 5 – "Litigation and Contingencies."

Note 13. Shareholders' Equity

Change in accounting principle

As described in Note 2 - "New Accounting Pronouncements," during the first quarter of 2017 we adopted the updated guidance of "Improvements to Employee Share-Based Compensation Accounting." The adoption of this guidance

resulted in an immaterial cumulative effect adjustment to our 2017 beginning retained earnings.

2% Notes
As described in Note 3 - "Debt," on March 21, 2017, we issued an irrevocable notice of redemption in respect of our outstanding 2% Notes, with a redemption date of April 21, 2017. Subsequent to our notice of redemption, in April, holders of approximately $202.5 million of the outstanding principal amount exercised their rights to convert their notes into shares of our common stock. As a result, we issued approximately 29.1 million shares of our common stock, of which 18.7 million shares were reissued from our treasury stock and 10.4 million were newly issued shares. The conversions of the notes increased our shareholders' equity by the carrying value of the notes, which included outstanding debt issuance costs, at the time of conversion.

Shareholders Rights Agreement
Our Amended and Restated Rights Agreement dated July 23, 2015 seeks to diminish the risk that our ability to use our NOLs to reduce potential future federal income tax obligations may become substantially limited and to deter certain abusive takeover practices. The benefit of the NOLs would be substantially limited, and the timing of the usage of the NOLs could be substantially delayed, if we were to experience an "ownership change" as defined by Section 382 of the Internal Revenue Code.

Under the Agreement each outstanding share of our Common Stock is accompanied by one Right. The "Distribution Date" occurs on the earlier of ten days after a public announcement that a person has become an "Acquiring Person," or ten business days after a person

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announces or begins a tender offer in which consummation of such offer would result in a person becoming an "Acquiring Person." An "Acquiring Person" is any person that becomes, by itself or together with its affiliates and associates, a beneficial owner of 5% or more of the shares of our Common Stock then outstanding, but excludes, among others, certain exempt and grandfathered persons as defined in the Agreement. The Rights are not exercisable until the Distribution Date. Each Right will initially entitle shareholders to buy one-tenth of one share of our Common Stock at a Purchase Price of $45 per full share (equivalent to $4.50 for each one-tenth share), subject to adjustment. Each exercisable Right (subject to certain limitations) will entitle its holder to purchase, at the Rights' then-current Purchase Price, a number of our shares of Common Stock (or if after the Shares Acquisition Date, we are acquired in a business combination, common shares of the acquiror) having a market value at the time equal to twice the Purchase Price. The Rights will expire on August 1, 2018, or earlier as described in the Agreement. The Rights are redeemable at a price of $0.001 per Right at any time prior to the time a person becomes an Acquiring Person. Other than certain amendments, the Board of Directors may amend the Rights in any respect without the consent of the holders of the Rights.

Note 14. Share-Based Compensation

We have certain share-based compensation plans. Under the fair value method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the service period which generally corresponds to the vesting period. Awards under our plans generally vest over periods ranging from one to three years.

The number of shares granted to employees and the weighted average fair value per share during the periods presented were (shares in thousands):

	Six months ended June 30,			
	2017		2016	
	Shares Granted	Weighted Average Share Fair Value	Shares Granted	Weighted Average Share Fair Value
RSUs subject to performance conditions	1,237	$ 10.41	1,257	$ 5.66
RSUs subject only to service conditions	395	10.41	433	5.67

Note 15. Statutory Information

Statutory Capital Requirements

The insurance laws of 16 jurisdictions, including Wisconsin, our domiciliary state, require a mortgage insurer to maintain a minimum amount of statutory capital relative to the risk in force (or a similar measure) in order for the mortgage insurer to continue to write new business. We refer to these requirements as the "State Capital Requirements." While they vary among jurisdictions, the most common State Capital Requirements allow for a maximum risk-to-capital ratio of 25 to 1. A risk-to-capital ratio will increase if (i) the percentage decrease in capital exceeds the percentage decrease in insured risk, or (ii) the percentage increase in capital is less than the percentage increase in insured risk. Wisconsin does not regulate capital by using a risk-to-capital measure but instead requires a minimum policyholder position ("MPP"). The "policyholder position" of a mortgage insurer is its net worth or surplus, contingency reserve and a portion of the reserves for unearned premiums.

At June 30, 2017, MGIC's risk-to-capital ratio was 10.2 to 1, below the maximum allowed by the jurisdictions with State Capital Requirements, and its policyholder position was $1.8 billion above the required MPP of $1.1 billion. In calculating our risk-to-capital ratio and MPP, we are allowed full credit for the risk ceded under our reinsurance transactions with a group of unaffiliated reinsurers. It is possible that under the revised State Capital Requirements discussed below, MGIC will not be allowed full credit for the risk ceded to the reinsurers. If MGIC is not allowed an

agreed level of credit under either the State Capital Requirements or the financial requirements of the PMIERs, MGIC may terminate the reinsurance transactions, without penalty. At this time, we expect MGIC to continue to comply with the current State Capital Requirements; however, you should read the rest of these financial statement footnotes for information about matters that could negatively affect such compliance.

At June 30, 2017, the risk-to-capital ratio of our combined insurance operations (which includes a reinsurance affiliate) was 11.3 to 1. Reinsurance agreements with an affiliate permit MGIC to write insurance with a higher coverage percentage than it could on its own under certain state-specific requirements. A higher risk-to-capital ratio on a combined basis may indicate that, in order for MGIC to continue to utilize reinsurance agreements with its affiliate, additional capital contributions to the reinsurance affiliate could be needed.

We ask the Commissioner of Insurance of the State of Wisconsin (the “OCI”) not to object before MGIC pays dividends. In the second quarter of 2017, MGIC paid a $30 million dividend to our holding company. MGIC is subject to statutory regulations as to payment of dividends. The maximum amount of dividends that MGIC may pay in any

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twelve-month period without regulatory approval by the OCI is the lesser of adjusted statutory net income or 10% of statutory policyholders' surplus as of the preceding calendar year end. Adjusted statutory net income is defined for this purpose to be the greater of statutory net income, net of realized investment gains, for the calendar year preceding the date of the dividend or statutory net income, net of realized investment gains, for the three calendar years preceding the date of the dividend less dividends paid within the first two of the preceding three calendar years. The OCI recognizes only statutory accounting practices prescribed or permitted by the State of Wisconsin for determining and reporting the financial condition and results of operations of an insurance company. The OCI has adopted certain prescribed accounting practices that differ from those found in other states. Specifically, Wisconsin domiciled companies record changes in the contingency reserves through the income statement as changes in underwriting deductions. As a result, in periods in which MGIC is increasing contingency reserves, statutory net income is lowered. For the year ended December 31, 2016, MGIC's statutory net income was reduced by $490 million to account for the increase in contingency reserves.

The NAIC previously announced that it plans to revise the minimum capital and surplus requirements for mortgage insurers that are provided for in its Mortgage Guaranty Insurance Model Act. In May 2016, a working group of state regulators released an exposure draft of a risk-based capital framework to establish capital requirements for mortgage insurers, although no date has been established by which the NAIC must propose revisions to the capital requirements. We are currently evaluating the impact of the framework contained in the exposure draft, including the potential impact of certain items that have not yet been completely addressed by the framework which include: the treatment of ceded risk, minimum capital floors, and action level triggers.

While MGIC currently meets the State Capital Requirements of Wisconsin and all other jurisdictions, it could be prevented from writing new business in the future in all jurisdictions if it fails to meet the State Capital Requirements of Wisconsin, or it could be prevented from writing new business in another jurisdiction if it fails to meet the State Capital Requirements of that jurisdiction, and in each case MGIC does not obtain a waiver of such requirements. It is possible that regulatory action by one or more jurisdictions, including those that do not have specific State Capital Requirements, may prevent MGIC from continuing to write new insurance in such jurisdictions.

If we are unable to write business in all jurisdictions, lenders may be unwilling to procure insurance from us anywhere. In addition, a lender's assessment of the future ability of our insurance operations to meet the State Capital Requirements or the PMIERs may affect its willingness to procure insurance from us. A possible future failure by MGIC to meet the State Capital Requirements or the PMIERs will not necessarily mean that MGIC lacks sufficient resources to pay claims on its insurance liabilities. While we believe MGIC has sufficient claims paying resources to meet its claim obligations on its insurance in force on a timely basis, you should read the rest of these financial statement footnotes for information about matters that could negatively affect MGIC's claims paying resources.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Introduction

The following is management’s discussion and analysis of the financial condition and results of operations of MGIC Investment Corporation for the second quarter and first six months of 2017. As used below, “we” and “our” refer to MGIC Investment Corporation’s consolidated operations. This form 10-Q should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our Annual Report on Form 10-K for the year ended December 31, 2016. See the “Glossary of terms and acronyms” for definitions and descriptions of terms used throughout this MD&A.

Forward Looking and Other Statements

As discussed under “Forward Looking Statements and Risk Factors” below, actual results may differ materially from the results contemplated by forward looking statements. We are not undertaking any obligation to update any forward looking statements or other statements we may make in the following discussion or elsewhere in this document even though these statements may be affected by events or circumstances occurring after the forward looking statements or other statements were made. Therefore no reader of this document should rely on these statements being current as of any time other than the time at which this document was filed with the Securities and Exchange Commission.

Through our subsidiary MGIC, we are a leading provider of PMI in the United States, as measured by $187.3 billion of primary IIF at June 30, 2017.

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Overview

Summary Financial Results of MGIC Investment Corporation

(In millions, except per share data, unaudited)	Three Months Ended June 30,			Six Months Ended June 30,		
	2017	2016	% Change	2017	2016	% Change
Selected statement of operations data						
Total revenues	$263.3	$263.5	—	$524.2	$522.1	—
Losses incurred, net	27.3	46.6	(41)	55.0	131.6	(58)
Loss on debt extinguishment	0.1	1.9	N/M	0.1	15.3	N/M
Income before tax	180.6	165.2	9	354.6	268.9	32
Provision for income taxes	62.0	56.0	11	146.2	90.5	62
Net income	118.6	109.2	9	208.4	178.4	17
Diluted income per share	$0.31	$0.26	19	$0.55	$0.43	28
Non-GAAP Financial Measures [1]						
Adjusted pre-tax operating income	$180.7	$166.3	9	$354.8	$280.3	27
Adjusted net operating income	119.3	110.0	8	236.4	186.2	27
Adjusted net operating income per diluted share	$0.31	$0.26	19	$0.62	$0.44	41

[1] See "Explanation and Reconciliation of our use of Non-GAAP Financial Measures."

SUMMARY OF SECOND QUARTER AND YEAR TO DATE 2017 RESULTS

Comparative quarterly results

We recorded second quarter 2017 net income of $118.6 million, or $0.31 per diluted share. Net income increased by $9.4 million compared with net income of $109.2 million in the prior year, primarily due to lower losses incurred, net. In addition to the increase in net income, our diluted weighted average shares outstanding decreased from the prior year, resulting in a 19% increase in diluted income per share.

Adjusted net operating income for the second quarter 2017 was $119.3 million (Q2 2016: $110.0 million) and adjusted net operating income per diluted share was $0.31 (Q2 2016: $0.26). The 8% increase in adjusted net operating income was driven primarily by lower losses incurred, net. In addition to the increase in adjusted net operating income, our diluted weighted average shares outstanding decreased from the prior year, resulting in a 19% increase in adjusted net operating income per diluted share.

The decrease in our diluted weighted average shares during the three months ended June 30, 2017 was primarily due to the repayment at maturity of our 5% Notes on May 1, 2017.

Losses incurred, net were $27.3 million, down 41% compared to the prior year. New delinquency notices in the second quarter were 10% lower than the prior year and the claim rate applied to the new notices was approximately 11%, down from approximately 13% in the prior year. Our estimated claim rate on new notices reflects the current economic environment and anticipated cure activity on the notices received.

The increase in our provision for income taxes in the second quarter of 2017 as compared to the same period in the prior year was primarily due to an increase in our income before tax.

In June 2017, MGIC paid a dividend of $30 million to our holding company and we expect to continue to pay quarterly dividends through the remainder of the year.

Comparative year to date results

We recorded net income of $208.4 million, or $0.55 per diluted share during the first six months 2017. Net income increased by $30.0 million compared with net income of $178.4 million in the same period of 2016, primarily due to lower losses incurred, net and lower losses from debt extinguishment activity in the current year period, partially offset by an increase in our effective tax rate due to an additional provision related to our IRS litigation recorded in the first half of 2017. In addition to the increase in net income, our diluted weighted average shares outstanding decreased from the prior year, resulting in a 28% increase in diluted income per share.

Adjusted net operating income for the first six months of 2017 was $236.4 million (2016: $186.2 million) and adjusted net operating income per diluted share was $0.62 (2016: $0.44). The 27% increase in adjusted net operating income was driven primarily by lower losses incurred, net. In addition to the increase in adjusted net operating income, our weighted average shares outstanding decreased from the prior year, resulting in a 41% increase in adjusted net operating income per diluted share.

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The decrease in our diluted weighted average shares during the six months ended June 30, 2017 was primarily due to the repayment at maturity of our 5% Notes on May 1, 2017.

Losses incurred, net were $55.0 million down 58% compared to the prior year. New delinquency notices in the first half of 2017 were 10% lower than the prior year and the claim rate applied to the new notices was approximately 11%, down from approximately 13% in the prior year.

Loss on debt extinguishment in the prior year reflects the repurchases of a portion of our outstanding debt at amounts above our carrying value for our 5% Notes and above fair value of the liability component for our 9% Debentures.

The increase in our provision for income taxes for the first six months of 2017 as compared to the prior year was the result of an increase in our income before tax and an additional provision recorded for the expected settlement of our IRS litigation as more fully described in Note 11 - "Income Taxes" to our consolidated financial statements. Excluding the additional provision and interest related to our IRS litigation, the effective tax rate was approximately 33.4% in the first six months of 2017, compared to 33.5% in the prior year period.

See "Consolidated Results of Operations" below for additional discussion of our results for the three and six months ended June 30, 2017 compared to the respective prior year periods.

CAPITAL

The following debt transactions were completed during the second quarter of 2017:

- 2% Notes - In April, holders of approximately $202.5 million of the outstanding principal amount of the notes exercised their rights to convert their notes to shares of our common stock and we issued approximately 29.1 million shares of our common stock, which included newly issued shares and the reissuance of treasury stock. The remaining $5.1 million of outstanding principal amount of the notes was redeemed for cash. The conversions and cash redemptions eliminated our debt obligation for the 2% Notes and the conversions increased our shareholders' equity by the carrying value of the converted notes, including outstanding debt issuance costs. The notes redeemed for cash eliminated approximately 0.7 million potentially dilutive shares. These shares had previously been included in our calculation of diluted weighted average shares and diluted EPS up to the date of the notes redemption.
- 5% Notes - On May 1, 2017, our 5% Notes matured and were repaid with $145 million of holding company cash. The repayment of our 5% Notes eliminated approximately 10.8 million potentially dilutive shares. These shares were included in our calculation of diluted

weighted average shares and diluted EPS up to the date of the notes repayment.

- Revolving credit facility - In March, we borrowed $150 million on our revolving credit facility to fund, as necessary, the redemption price of our 2% Notes. In April, we repaid the amount borrowed because most holders of our 2% Notes elected to convert their notes.

The above debt transactions allowed us to lower our long-term debt to shareholders' equity ratio. As of June 30, 2017, our ratio of long-term debt to shareholders' equity was approximately 28%, down from approximately 47% as of December 31, 2016. While the repayment at maturity of our 5% Notes, partial redemption of our 2% Notes, and the repayment of the amount borrowed on our revolving credit facility reduced the cash and investments at our holding company during the second quarter, we expect to provide additional liquidity to our holding company during 2017 through quarterly dividends from MGIC.

GSEs

We must comply with the PMIERs to be eligible to insure loans purchased by the GSEs. The PMIERs include financial requirements, as well as business, quality control and certain transaction approval requirements. The financial requirements of the PMIERs require a mortgage insurer's Available Assets to equal or exceed its Minimum

Required Assets. Based on our interpretation of the PMIERs, as of June 30, 2017, MGIC's Available Assets totaled approximately $4.7 billion, an excess of approximately $815 million over its Minimum Required Assets of approximately $3.8 billion. MGIC is in compliance with the PMIERs and eligible to insure loans purchased by the GSEs.

If MGIC ceases to be eligible to insure loans purchased by one or both of the GSEs, it would significantly reduce the volume of our new business writings. Factors that may negatively impact MGIC's ability to continue to comply with the financial requirements of the PMIERs include the following:

- The GSEs could make the PMIERs more onerous in the future; in this regard, the PMIERs provide that the factors that determine Minimum Required Assets will be updated every two years and may be updated more frequently to reflect changes in macroeconomic conditions or loan performance. The GSEs have informed us that they currently do not expect any updates to be effective before the fourth quarter of 2018 and we expect the GSEs will provide notice 180 days prior to the effective date of such updates. The GSEs may amend the PMIERs at any time.
- The GSEs may reduce the amount of credit they allow under the PMIERs for the risk ceded under our quota share reinsurance transactions. The GSEs' ongoing approval of those transactions is subject to several conditions and the transactions will be reviewed under the PMIERs at

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least annually by the GSEs. For more information about the transactions, see Note 4 - "Reinsurance" to our consolidated financial statements.

- Our future operating results may be negatively impacted by the matters discussed in our risk factors. Such matters could decrease our revenues, increase our losses or require the use of assets, thereby creating a shortfall in Available Assets.
- Should capital be needed by MGIC in the future, capital contributions from our holding company may not be available due to competing demands on holding company resources, including for repayment of debt.

While on an overall basis, the amount of Available Assets MGIC must hold in order to continue to insure loans purchased by the GSEs increased under the PMIERs over what state regulation currently requires, our reinsurance transactions mitigate the negative effect of the PMIERs on our returns. In this regard, see the second bullet point above.

State Regulations

The insurance laws of 16 jurisdictions, including Wisconsin, MGIC's domiciliary state, require a mortgage insurer to maintain a minimum amount of statutory capital relative to its risk in force (or a similar measure) in order for the mortgage insurer to continue to write new business. We refer to these requirements as the "State Capital Requirements." While they vary among jurisdictions, the most common State Capital Requirements allow for a maximum risk-to-capital ratio of 25 to 1. A risk-to-capital ratio will increase if (i) the percentage decrease in capital exceeds the percentage decrease in insured risk, or (ii) the percentage increase in capital is less than the percentage increase in insured risk. Wisconsin does not regulate capital by using a risk-to-capital measure but instead requires an MPP.

At June 30, 2017, MGIC's risk-to-capital ratio was 10.2 to 1, below the maximum allowed by the jurisdictions with State Capital Requirements, and its policyholder position was $1.8 billion above the required MPP of $1.1 billion. In calculating our risk-to-capital ratio and MPP, we are allowed full credit for the risk ceded under our reinsurance transactions with a group of unaffiliated reinsurers. It is possible that under the revised State Capital Requirements discussed below, MGIC will not be allowed full credit for the risk ceded to the reinsurers. If MGIC is not allowed an agreed level of credit under either the State Capital Requirements or the PMIERs, MGIC may terminate the reinsurance transactions, without penalty. At this time, we expect MGIC to continue to comply with the current State Capital Requirements; however, refer to our risk factor titled "State capital requirements may prevent us from continuing to write new insurance on an uninterrupted basis" for more information about matters that could negatively affect such compliance.

The NAIC plans to revise the minimum capital and surplus requirements for mortgage insurers that are provided for in its Mortgage Guaranty Insurance Model Act. In May 2016, a working group of state regulators released an exposure draft of a risk-based capital framework to establish capital requirements for mortgage insurers, although no date has been established by which the NAIC must propose revisions to the capital requirements. We continue to evaluate the impact of the framework contained in the exposure draft, including the potential impact of certain items that have not yet been completely addressed by the framework which include: the treatment of ceded risk, minimum capital floors, and action level triggers. Currently we believe that the PMIERs contain the more restrictive capital requirements in most circumstances.

GSE REFORM

The FHFA has been the conservator of the GSEs since 2008 and has the authority to control and direct their operations. The increased role that the federal government has assumed in the residential housing finance system through the GSE conservatorship may increase the likelihood that the business practices of the GSEs change in ways that have a material adverse effect on us and that the charters of the GSEs are changed by new federal legislation. In the past, members of Congress have introduced several bills intended to change the business practices of the GSEs and

the FHA; however, no legislation has been enacted. The Administration has indicated that the conservatorship of the GSEs should end; however, it is unclear whether and when that would occur and how that would impact us. As a result of the matters referred to above, it is uncertain what role the GSEs, FHA and private capital, including private mortgage insurance, will play in the residential housing finance system in the future or the impact of any such changes on our business. In addition, the timing of the impact of any resulting changes on our business is uncertain. Most meaningful changes would require Congressional action to implement and it is difficult to estimate when Congressional action would be final and how long any associated phase-in period may last.

For additional information about the business practices of the GSEs, see our risk factor titled "Changes in the business practices of the GSEs, federal legislation that changes their charters or a restructuring of the GSEs could reduce our revenues or increase our losses."

LOAN MODIFICATIONS AND OTHER SIMILAR PROGRAMS

The federal government, including through the U.S. Department of the Treasury and the GSEs, and several lenders have modification and refinance programs to make loans more affordable to borrowers with the goal of reducing the number of foreclosures. These programs have included HAMP, which expired at the end of 2016, and HARP, which is scheduled to expire at the end of September 2017. The

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GSEs have introduced the "Flex Modification" program to replace HAMP effective in October 2017. Until it becomes effective, loan servicers must still evaluate borrowers for other GSE modification programs.
During 2016 and the first half of 2017, we were notified of modifications that cured delinquencies that had they become paid claims would have resulted in approximately $0.5 billion and $0.2 billion, respectively, of estimated claim payments. These levels are down from a high of $3.2 billion in 2010.

We cannot determine the total benefit we may derive from loan modification programs, particularly given the uncertainty around the re-default rates for defaulted loans that have been modified. Our loss reserves do not account for potential re-defaults of current loans.

As shown in the following table, as of June 30, 2017 approximately 18% of our primary RIF has been modified.

Policy year	HARP Modifications [1]		HAMP & Other Modifications	
2003 and prior	11.1	%	38.3	%
2004	18.8	%	38.7	%
2005	25.4	%	37.9	%
2006	28.7	%	37.4	%
2007	39.7	%	30.2	%
2008	54.5	%	17.9	%
2009	32.6	%	4.5	%
2010 - Q2 2017	—	%	0.2	%
Total	9.3	%	8.2	%

[1] Includes proprietary programs that are substantially the same as HARP.

As of June 30, 2017 based on loan count, the loans associated with 97.8% of HARP modifications and 78.1% of HAMP and other modifications were current.

FACTORS AFFECTING OUR RESULTS
Our results of operations are affected by:

Premiums written and earned
Premiums written and earned in a year are influenced by:

- NIW, which increases IIF, is the aggregate principal amount of the mortgages that are insured during a period. Many factors affect NIW, including the volume of low down payment home mortgage originations and competition to provide credit enhancement on those mortgages, including competition from the FHA, the VA, other mortgage insurers, GSE programs that may reduce or eliminate the demand for mortgage insurance and other alternatives to mortgage insurance. NIW does not include loans previously insured by us that are modified, such as loans modified under HARP.

- Cancellations, which reduce IIF. Cancellations due to refinancings are affected by the level of current mortgage interest rates compared to the mortgage coupon rates throughout the in force book, current home values compared to values when the loans in the in force book were insured and the terms on which mortgage credit is available. Home price appreciation can give homeowners the right to cancel mortgage insurance on their loans if sufficient home equity is achieved. Cancellations also result from policy rescissions, which require us to return any premiums received on the rescinded policies and claim payments, which require us to return any premium received on the related policies from the date of default on the insured loans. Cancellations of single premium policies, which are generally non-refundable, results in immediate recognition of any remaining unearned premium.

- Premium rates, which are affected by product type, competitive pressures, the risk characteristics of the insured loans and the percentage of coverage on the insured loans. The substantial majority of our monthly and annual mortgage insurance premiums are under premium plans for which, for the first ten years of the policy, the amount of premium is determined by multiplying the initial premium rate by the original loan balance; thereafter, the premium resets and a lower premium rate is used for the remaining life of the policy. However, for loans that have utilized HARP, the initial ten-year period resets as of the date of the HARP transaction. The remainder of our monthly and annual premiums are under premium plans for which premiums are determined by a fixed percentage of the loan's amortizing balance over the life of the policy.

- Premiums ceded, net of a profit commission, under reinsurance agreements. See Note 4 - "Reinsurance" to our consolidated financial statements for a discussion of our reinsurance agreements.

Premiums are generated by the insurance that is in force during all or a portion of the period. A change in the average IIF in the current period compared to an earlier period is a factor that will increase (when the average in force is higher) or reduce (when it is lower) premiums written and earned in the current period, although this effect may be enhanced (or mitigated) by differences in the average premium rate between the two periods as well as by premiums that are returned or expected to be returned in connection with claim payments and rescissions, and premiums ceded under reinsurance agreements. Also, NIW and cancellations during a period will generally have a greater effect on premiums written and earned in subsequent periods than in the period in which these events occur.

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Investment income

Our investment portfolio is composed principally of investment grade fixed income securities. The principal factors that influence investment income are the size of the portfolio and its yield. As measured by amortized cost (which excludes changes in fair value, such as from changes in interest rates), the size of the investment portfolio is mainly a function of cash generated from (or used in) operations, such as NPW, investment income, net claim payments and expenses, and cash provided by (or used for) non-operating activities, such as debt or stock issuances or repurchases.

Losses incurred

Losses incurred are the current expense that reflects estimated payments that will ultimately be made as a result of delinquencies on insured loans. As explained under "Critical Accounting Policies" in our 10-K MD&A, except in the case of a premium deficiency reserve, we recognize an estimate of this expense only for delinquent loans. The level of new delinquencies has historically followed a seasonal pattern, with new delinquencies in the first part of the year lower than new delinquencies in the latter part of the year, though this pattern can be affected by the state of the economy and local housing markets. Losses incurred are generally affected by:

- The state of the economy, including unemployment and housing values, each of which affects the likelihood that loans will become delinquent and whether loans that are delinquent cure their delinquency.

- The product mix of the in force book, with loans having higher risk characteristics generally resulting in higher delinquencies and claims.

- The size of loans insured, with higher average loan amounts tending to increase losses incurred.

- The percentage of coverage on insured loans, with deeper average coverage tending to increase incurred losses.

- The rate at which we rescind policies or curtail claims. Our estimated loss reserves incorporate our estimates of future rescissions of policies and curtailments of claims, and reversals of rescissions and curtailments. We collectively refer to such rescissions and denials as "rescissions" and variations of this term. We call reductions to or denials of claims "curtailments."

- The distribution of claims over the life of a book. Historically, the first few years after loans are originated are a period of relatively low claims, with claims increasing substantially for several years subsequent and then declining, although persistency, the condition of the economy, including unemployment and housing prices, and other factors can affect this pattern. For example, a weak economy or housing value declines can lead to

claims from older books increasing, continuing at stable levels or experiencing a lower rate of decline. See further information under "Mortgage Insurance Earnings and Cash Flow Cycle" below.

- Losses ceded under reinsurance agreements. See Note 4 - "Reinsurance" to our consolidated financial statements for a discussion of our reinsurance agreements.

Underwriting and other expenses

The majority of our operating expenses are fixed, with some variability due to contract underwriting volume. Contract underwriting generates fee income included in "Other revenue." Underwriting and other expenses are net of any ceding commission associated with our reinsurance agreements. See Note 4 - "Reinsurance" to our consolidated financial statements for a discussion of our reinsurance agreements.

Interest expense

Interest expense reflects the interest associated with our outstanding debt obligations. For information about our outstanding debt obligations, see Note 3 - "Debt" to our consolidated financial statements and under "Liquidity and Capital Resources" below.

Other

Certain activities that we do not consider being part of our fundamental operating activities, may also impact our results of operations and are described below.

Net realized investment gains (losses)

Realized gains and losses are a function of the difference between the amount received on the sale of a security and the security's cost basis, as well as any "other than temporary" impairments ("OTTI") recognized in earnings. The amount received on the sale of fixed income securities is affected by the coupon rate of the security compared to the yield of comparable securities at the time of sale.

Loss on debt extinguishment

At times, we may undertake activities to enhance our capital position, improve our debt profile and/or reduce potential dilution from our outstanding convertible debt. Extinguishing our outstanding debt obligations early through these discretionary activities may result in losses primarily driven by the payment of consideration in excess of our carrying value and the write off of unamortized debt issuance costs on the extinguished portion of the debt.

Refer to "Explanation and reconciliation of our use of Non-GAAP financial measures" below to understand how these items impact our evaluation of our core financial performance.

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MORTGAGE INSURANCE EARNINGS AND CASH FLOW CYCLE

In general, the majority of any underwriting profit that a book generates occurs in the early years of the book, with the largest portion of any underwriting profit realized in the first year following the year the book was written. Subsequent years of a book generally result in either less underwriting profit or in underwriting losses. This pattern of results typically occurs because relatively few of the claims that a book will ultimately experience typically occur in the first few years of the book, when premium revenue is highest, while subsequent years are affected by declining premium revenue, as the number of insured loans decreases (primarily due to loan prepayments) and increasing losses. The typical pattern is also a function of premium rates generally resetting to lower levels after ten years.

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EXPLANATION AND RECONCILIATION OF OUR USE OF NON-GAAP FINANCIAL MEASURES

Non-GAAP financial measures
We believe that use of the Non-GAAP measures of adjusted pre-tax operating income (loss), adjusted net operating income (loss) and adjusted net operating income (loss) per diluted share facilitate the evaluation of the company's core financial performance thereby providing relevant information to investors. These measures are not recognized in accordance with GAAP and should not be viewed as alternatives to GAAP measures of performance.

Adjusted pre-tax operating income (loss) is defined as GAAP income (loss) before tax, excluding the effects of net realized investment gains (losses), gain (loss) on debt extinguishment, net impairment losses recognized in income (loss) and infrequent or unusual non-operating items where applicable.

Adjusted net operating income (loss) is defined as GAAP net income (loss) excluding the after-tax effects of net realized investment gains (losses), gain (loss) on debt extinguishment, net impairment losses recognized in income (loss), and infrequent or unusual non-operating items where applicable. The amounts of adjustments to GAAP income (loss) before tax are generally tax effected using a federal statutory tax rate of 35%.

Adjusted net operating income (loss) per diluted share is calculated in a manner consistent with the accounting standard regarding earnings per share by dividing (i) adjusted net operating income (loss) after making adjustments for interest expense on convertible debt, whenever the impact is dilutive by (ii) diluted weighted average common shares outstanding, which reflects share dilution from unvested restricted stock units and from convertible debt when dilutive under the “if-converted” method.

Although pretax operating income (loss) and net operating income (loss) exclude certain items that have occurred in the past and are expected to occur in the future, the excluded items are: (1) not viewed as part of the operating performance of our primary activities; or (2) impacted by both discretionary and other economic factors and are not necessarily indicative of operating trends. These adjustments, along with the reasons for their treatment, are described below. Other companies may calculate these measures differently, and, therefore, their measures may not be comparable to those used by us.

(1) Net realized investment gains (losses). The recognition of net realized investment gains or losses can vary significantly across periods as the timing of individual

securities sales is highly discretionary and is influenced by such factors as market opportunities, our tax and capital profile, and overall market cycles.

Trends in the profitability of our fundamental operating activities can be more clearly identified without the fluctuations of these realized gains and losses.

(2) Gains and losses on debt extinguishment. Gains and losses on debt extinguishment result from discretionary activities that are undertaken to enhance our capital position, improve our debt profile, and/or reduce potential dilution from our outstanding convertible debt.

(3) 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, individual issuer performance, and general economic conditions.

(4) Infrequent or unusual non-operating items. In 2017, this adjustment reflects income tax expense related to our IRS dispute, which is related to past transactions which are non-recurring in nature and are not part of our primary operating activities.

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Non-GAAP Reconciliations
Reconciliation of Income before tax / Net income to Adjusted pre-tax operating income / Adjusted net operating income

	Three Months Ended June 30,					
	2017			2016		
(In thousands, except per share amounts)	Pre-tax	Tax provision (benefit)	Net (after-tax)	Pre-tax	Tax provision (benefit)	Net (after-tax)
Income before tax / Net income	$180,616	$61,994	$118,622	$165,239	$56,018	$109,221
Adjustments:						
Additional income tax provision related to IRS litigation	—	(559)	559	—	(152)	152
Net realized investment losses (gains)	42	15	27	(836)	(293)	(543)
Loss on debt extinguishment	65	23	42	1,868	654	1,214
Adjusted pre-tax operating income / Adjusted net operating income	$180,723	$61,473	$119,250	$166,271	$56,227	$110,044

Reconciliation of Net income per diluted share to Adjusted net operating income per diluted share

	2017	2016
Weighted average diluted shares outstanding	394,470	446,139
Net income per diluted share	$0.31	$0.26
Additional income tax provision related to IRS litigation	—	—
Net realized investment losses (gains)	—	—
Loss on debt extinguishment	—	—
Adjusted net operating income per diluted share	$0.31	$0.26

Reconciliation of Income before tax / Net income to Adjusted pre-tax operating income / Adjusted net operating income

	Six Months Ended June 30,					
	2017			2016		
(In thousands, except per share amounts)	Pre-tax	Tax provision (benefit)	Net (after-tax)	Pre-tax	Tax provision (benefit)	Net (after-tax)
Income before tax / Net income	$354,573	$146,153	$208,420	$268,927	$90,515	$178,412
Adjustments:						
Additional income tax provision related to IRS litigation	—	(27,783)	27,783	—	(341)	341
Net realized investment losses (gains)	164	57	107	(3,892)	(1,362)	(2,530)
Loss on debt extinguishment	65	23	42	15,308	5,358	9,950
Adjusted pre-tax operating income / Adjusted net operating income	$354,802	$118,450	$236,352	$280,343	$94,170	$186,173

Reconciliation of Net income per diluted share to Adjusted net operating income per diluted share

	2017	2016
Weighted average diluted shares outstanding	398,302	450,354

Net income per diluted share	$0.55	$0.43
Additional income tax provision related to IRS litigation	0.07	—
Net realized investment losses (gains)	—	(0.01)
Loss on debt extinguishment	—	0.02
Adjusted net operating income per diluted share	$0.62	$0.44

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Mortgage Insurance Portfolio

NEW INSURANCE WRITTEN
According to Inside Mortgage Finance and GSE estimates, total mortgage originations for the second quarter and first six months of 2017 decreased from the respective prior year periods due to a decline in refinance originations that was somewhat offset by an increase in purchase originations. Total mortgage originations in the second quarter of 2017 are estimated to have been higher than the first quarter primarily due to seasonal factors. PMI market share of total mortgage originations is generally influenced by the mix of purchase and refinance originations as PMI market share is 3-4 times higher for purchase originations than refinance originations. PMI market share is also impacted by the market share of total originations for FHA, VA, and USDA.

NIW for the second quarter of 2017 was $12.9 billion (Q2 2016: $12.6 billion) and for the first half of 2017 was $22.2 billion (YTD 2016: $20.9 billion) and continued to have what we believe are favorable risk characteristics (see tables 01 and 02). The percentage of purchase mortgages insured increased in the three and six months ended June 30, 2017 compared to the same periods of the prior year because the level of refinance transactions declined as mortgage interest rates in the current year were generally higher than those in the latter half of 2016, and the prior year periods experienced declining mortgage interest rates (see table 04).

01 PRIMARY NIW BY FICO SCORE IN BILLIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
740 and greater	58.9%	58.1%	58.9%	56.7%
700-739	26.0%	25.6%	26.0%	25.9%
660-699	11.9%	13.0%	11.9%	13.7%
659 and less	3.2 %	3.3 %	3.2 %	3.7 %

02 LOAN-TO-VALUE % OF PRIMARY NIW

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
95.01% and above	9.7 %	5.4 %	9.0 %	5.1 %
90.01% to 95.00%	48.1%	49.7%	47.7%	50.1%
85.01% to 90.00%	29.9%	31.4%	30.1%	31.8%
80.01% to 85%	12.3%	13.5%	13.2%	13.0%

03 POLICY PAYMENT TYPE % OF PRIMARY NIW

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Monthly premiums	81.7%	78.5%	82.3%	78.3%
Single premiums	18.0%	21.2%	17.4%	21.4%
Annual premiums	0.3 %	0.3 %	0.3 %	0.3 %

04 TYPE OF MORTGAGE % OF PRIMARY NIW

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016

Purchases	91.3%	83.1%	87.9%	82.7%
Refinances	8.7 %	16.9%	12.1%	17.3%

INSURANCE AND RISK IN FORCE (see table 05)

The amount of our IIF and RIF is impacted by the amount of NIW and cancellations of primary IIF during the period. Cancellation activity is primarily due to refinancing activity, but is also impacted by rescissions, cancellations due to claim payment, and policies cancelled when borrowers achieve the required amount of home equity. Refinancing activity has historically been affected by the level of mortgage interest rates and the level of home price appreciation. Cancellations generally move inversely to the change in the direction of interest rates, although they generally lag a change in direction.

Persistency

Our persistency was 77.8% at June 30, 2017 compared to 76.9% at December 31, 2016 and 79.6% at June 30, 2016. Since 2000, our year-end persistency ranged from a high of 84.7% at December 31, 2009 to a low of 47.1% at December 31, 2003. With the current and expected level of mortgage interest rates we expect a low level of refinance activity and that our persistency will trend higher during 2017 from the level experienced at the end of 2016.

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05 INSURANCE AND RISK IN FORCE IN BILLIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
(In billions)	2017	2016	2017	2016
NIW	$12.9	$12.6	$22.2	$20.9
Cancellations	(9.1)	(10.1)	(16.9)	(17.9)
Increase in primary IIF	$3.8	$2.5	$5.3	$3.0

(In billions)	As of June 30, 2017	June 30, 2016
Direct primary IIF	$187.3	$177.5
Direct primary RIF	$48.5	$46.2

CREDIT PROFILE OF OUR PRIMARY RIF (see table 06)

Our total primary RIF written after 2008 as a percentage of total primary RIF has been steadily increasing. Our 2009 and later books possess significantly improved credit characteristics when compared to our 2005-2008 books. The loans we insured beginning in 2009, on average, have substantially higher FICO scores and lower LTVs than those insured in 2005-2008. The credit profile of our RIF has also benefited from programs such as HARP. HARP allows borrowers who are not delinquent, but who may not otherwise be able to refinance their loans under the current GSE underwriting standards, due to, for example, the current LTV exceeding 100%, to refinance and lower their note rate. Loans associated with 97.8% of all of our HARP modifications were current as of June 30, 2017. The aggregate of our 2009-2017 book years and our HARP modifications accounted for approximately 83% of our total primary RIF at June 30, 2017 (see table 06).

06 PRIMARY RIF IN BILLIONS

	June 30, 2017		December 31, 2016		June 30, 2016	
Policy Year	RIF	% of RIF	RIF	% of RIF	RIF	% of RIF
2009+	$35,996	74 %	$33,368	71 %	$30,762	66 %
2005 - 2008 (HARP)	4,169	8 %	4,489	9 %	4,913	11 %
Other years (HARP)	354	1 %	396	1 %	455	1 %
Subtotal	40,519	83 %	38,253	81 %	36,130	78 %
Other years (Non-HARP)	1,292	3 %	1,475	3 %	1,686	4 %
2005- 2008 (Non-HARP)	6,660	14 %	7,467	16 %	8,419	18 %
Subtotal	7,952	17 %	8,942	19 %	10,105	22 %
Total Primary RIF	$48,471	100 %	$47,195	100 %	$46,235	100 %

Pool insurance

MGIC has written no new pool insurance since 2009, however, for a variety of reasons, including responding to capital market alternatives to PMI and customer demands, MGIC may write pool risk in the future. Our direct pool risk in force was $506 million ($239 million on pool policies with aggregate loss limits and $267 million on pool policies without aggregate loss limits) at June 30, 2017 compared to $547 million ($244 million on pool policies with aggregate loss limits and $303 million on pool policies without aggregate loss limits) at December 31, 2016. If claim payments associated with a specific pool reach the aggregate loss limit, the remaining IIF within the pool would be cancelled and any remaining defaults under the pool would be removed from our default inventory.

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Consolidated Results of Operations

The following section of the MD&A provides a comparative discussion of MGIC Investment Corporation's Consolidated Results of Operations for the three and six months ended June 30, 2017 and 2016.

Revenues

	Three Months Ended June 30,			Six Months Ended June 30,		
(In millions)	2017	2016	% Change	2017	2016	% Change
Net premiums written	$245.8	$250.0	(2)	$482.5	$481.3	—
Net premiums earned	$231.1	$231.5	—	$460.2	$452.8	2
Investment income, net of expenses	29.7	27.2	9	59.2	55.1	7
Net realized investment (losses) gains	—	0.8	N/M	(0.2)	3.9	N/M
Other revenue	2.5	4.0	(38)	4.9	10.4	(53)
Total revenues	$263.3	$263.5	—	$524.1	$522.2	—

NET PREMIUMS WRITTEN AND EARNED

Comparative quarterly results

NPW declined 2% due to lower premium rates on our IIF and a decrease in premiums from single premium policies. NPE declined marginally due to lower premiums from our IIF during the period, mostly offset by declines in ceded premiums and premium refunds when compared to the prior year.

Comparative year to date results

NPW was relatively consistent with the prior year reflecting lower premium rates on our IIF and a decrease in premiums from single premium policies, mostly offset by a decline in ceded premiums. NPE increased 2% due to declines in premium refunds and ceded premiums, offset in part by a decrease in premiums from our IIF during the period compared to the prior year.

See "Overview - Factors Affecting Our Results" above for additional factors that influenced the amount of net premiums written and earned during the period.

Premium Yield (see table 07)

Premium yield (NPE divided by average IIF) decreased from the prior year periods to 49.9 and 50.0 basis points for Q2 and YTD 2017, respectively, (Q2 2016: 52.5 basis points, YTD 2016: 51.6 basis points) and is influenced by a number of key drivers, which have a varying impact from period to period.

The decline in our premium yield compared to the respective prior year periods reflects:

- A larger percentage of our earned premiums generated from IIF book years with lower premium rates due to a decline in premium rates in recent periods and a portion of our book years undergoing premium rate resets on their ten-year anniversary, as well as less of a positive impact from acceleration of premium recognition upon cancellation of single premium policies; offset in part by,
- less of an adverse impact from premium refunds and reinsurance, each primarily due to lower claim activity.

The following table reconciles our premium yield for the three and six months ended June 30, 2017 from the respective prior year periods.

07 PREMIUM YIELD IN BASIS POINTS

	Three Months	Six Months

	Ended	Ended
Premium yield - June 30, 2016	52.5	51.6
Reconciliation:		
Change in premium rates	(3.6)	(3.6)
Change in premium refunds and accruals	0.7	1.4
Single premium policy persistency	(0.5)	(0.4)
Reinsurance	0.8	1.0
Premium yield - June 30, 2017	49.9	50.0

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Reinsurance agreements (see tables 08 and 09)
Our reinsurance affects various lines of our statements of operations and therefore we believe it should be analyzed by reviewing its total effect on our pre-tax income, described as follows.

- We cede a fixed percentage of premiums on insurance covered by the agreements.

- We receive the benefit of a profit commission through a reduction in the premiums we cede. The profit commission varies directly and inversely with the level of losses on a "dollar for dollar" basis and is eliminated at levels of losses that we do not expect to occur. As a result, lower levels of losses result in a higher profit commission and less benefit from ceded losses; higher levels of losses result in more benefit from ceded losses and a lower profit commission (or for levels of losses we do not expect, its elimination).

- We receive the benefit of a ceding commission through a reduction in underwriting expenses equal to 20% of premiums ceded (before the effect of the profit commission).

- We cede a fixed percentage of losses incurred on insurance covered by the agreements.

The effects described above result in a net cost of the reinsurance, with respect to a covered loan, of 6% (but can be lower if losses are materially higher than we expect). This cost is derived by dividing the reduction in our pre-tax net income from such loans with reinsurance by our direct (that is, without reinsurance) premiums from such loan. Although the net cost of the reinsurance is generally constant at 6%, the effect of the reinsurance on the various components of pre-tax income discussed above will vary from period to period, depending on the level of ceded losses.

The amount of our NIW subject to our QSR Transactions (see table 08) will vary from period to period due to loan level exclusion terms. For example, our 2017 QSR Transaction excludes NIW with amortization terms of 20 years or less, but allows higher limits on debt-to-income and loan levels than our 2015 QSR Transaction. In addition, the QSR Transactions contain coverage thresholds that may be triggered depending on the mix of our risk written during the period.

The following table provides additional information related to our reinsurance agreements for 2017 and 2016.
08 QUOTA SHARE REINSURANCE

	As of and For the Six Months Ended June 30,	
($ in thousands, unless otherwise stated)	2017	2016
NIW subject to quota share reinsurance agreements	87 %	90 %
IIF subject to quota share reinsurance agreements	78 %	75 %
Statements of operations:		
Ceded premiums written, net	$57,812	$61,627
% of direct premiums written	11 %	11 %
Ceded premiums earned, net	$57,812	$61,627
% of direct premiums earned	11 %	12 %
Profit commission	$63,442	$55,982
Ceding commissions	$24,251	$23,522
Ceded losses incurred	$9,111	$14,583

Mortgage insurance portfolio:		
Ceded RIF (in millions)	$11,286	$10,313

09 CAPTIVE REINSURANCE

	As of and For the Six Months Ended June 30,	
($ in thousands)	2017	2016
IIF subject to captive reinsurance agreements	1 %	2 %
Statements of operations:		
Ceded premiums written	$2,519	$4,630
% of direct premiums written	0.5 %	0.8 %
Ceded premiums earned	$2,542	$4,679
% of direct premiums earned	0.5 %	0.9 %

INVESTMENT INCOME

Comparative quarterly and year to date results

Net investment income in the second quarter of 2017 was $29.7 million, up from $27.2 million in the prior year period. Net investment income in the first six months of 2017 was $59.2 million, up from $55.1 million in the prior year period. The increase in investment income in both periods was due to an increase in the average balance of the investment portfolio along with higher investment yields (see chart 10) over the periods.

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10 PORTFOLIO DURATION IN YEARS
INVESTMENT YIELD % OF AVERAGE INVESTMENT PORTFOLIO ASSETS

NET REALIZED INVESTMENT (LOSSES) GAINS
Comparative quarterly and year to date results
Net realized losses for the second quarter and first six months of 2017 were immaterial to our consolidated financial statements in both periods, whereas we recorded net realized gains of $0.8 million and $3.9 million for the second quarter and first six months of 2016, respectively.

The net unrealized gains (losses) position of our investment portfolio (see chart 11) as of June 30, 2017 and December 31, 2016 is as follows.
11 NET UNREALIZED INVESTMENT GAINS (LOSSES) IN MILLIONS

OTHER REVENUE
Comparative quarterly results
Other revenue for the second quarter of 2017 was $2.5 million, down from $4.0 million in the prior year primarily due to a decline in contract underwriting fees.

Comparative year to date results
Other revenue for the first six months of 2017 was $4.9 million, down from $10.4 million in the prior year period. Contract underwriting fees were lower in the current year and the prior year included approximately $4 million of gains recognized upon the substantial liquidation of our Australian operations resulting from changes in foreign currency exchange rates.

Losses and expenses

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	2017	2016	2017	2016
Losses incurred, net	$27.3	$46.6	$55.0	$131.6
Amortization of deferred policy acquisition costs	2.6	2.2	4.8	4.2
Other underwriting and operating expenses, net	38.5	35.3	79.3	75.1
Interest expense	14.2	12.2	30.5	26.9
Loss on debt extinguishment	0.1	1.9	0.1	15.3
Total losses and expenses	$82.7	$98.2	$169.7	$253.1

LOSSES INCURRED, NET
As discussed in “Critical Accounting Policies” in our 10-K MD&A and consistent with industry practices, we establish loss reserves for future claims only for loans that are currently delinquent. The terms “delinquent” and “default” are used interchangeably by us. We consider a loan in default when it is two or more payments past due. Loss reserves are established based on estimating the number of loans in our default inventory that will result in a claim payment, which is referred to as the claim rate, and further estimating the amount of the claim payment, which is referred to as claim severity.

Estimation of losses is inherently judgmental. The conditions that affect the claim rate and claim severity include the current and future state of the domestic economy, including unemployment, and the current and future strength of

local housing markets. The actual amount of the claim payments may be substantially different than our loss reserve estimates. Our estimates could be adversely affected by several factors, including a deterioration of regional or national economic conditions, including unemployment, leading to a reduction in borrower income and thus their ability to make mortgage payments, and a drop in housing values that could result in, among other things, greater losses on loans, and may affect borrower willingness to continue to make mortgage payments when the value of the home is below the mortgage balance. Historically, losses incurred have followed a seasonal trend in which the second half of the year has weaker credit performance than the first half, with higher new notice activity and a lower cure rate. Our estimates are also affected by any agreements we enter into regarding our claims paying practices, such as the settlement agreements discussed in Note 5 – "Litigation and Contingencies" to our consolidated financial statements. Changes to our estimates could result in a material impact to our consolidated results of operations and capital position, even in a stable economic environment.

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Losses incurred, net (see table 12)

Comparative quarterly results

Losses incurred, net in the second quarter of 2017 decreased 41% to $27 million compared to $47 million in the prior year. The decrease was due to a decrease in losses and LAE incurred on defaults reported in the current year, offset in part, by a lower amount of favorable development on prior year defaults. Losses incurred on current year defaults declined due to a 10% reduction in new notices received and a lower claim rate on new notices (see chart 14). Favorable development on prior year defaults occurred in the second quarter of 2017 and 2016 due to a lower claim rate on those defaults, offset in part, by increases in our severity assumption (see table 16).

Comparative year to date results

Losses incurred, net in the first six months of 2017 decreased 58% to $55 million compared to $132 million in the prior year. The decrease was due to a decrease in losses and LAE incurred on defaults reported in the current year and higher favorable development on prior year defaults. Losses incurred on current year defaults declined due to a 10% reduction in new notices received and a lower claim rate on new notices (see chart 14). Favorable development on prior year defaults occurred in both the 2017 and 2016 period due to a lower claim rate on those defaults, offset in part, by increases in our severity assumption. The increases in our severity assumption generally reflect a rising trend in our average claim paid (see table 16).

12 COMPOSITION OF LOSSES INCURRED
$ IN MILLIONS

	Three Months Ended June 30,			Six Months Ended June 30,		
	2017	2016	% Change	2017	2016	% Change
Current year / New notices	$78.5	$104.1	(25)	$158.9	$196.5	(19)
Prior year reserve development	(51.2)	(57.5)	(11)	(103.9)	(64.9)	60
Losses incurred, net	$27.3	$46.6	(41)	$55.0	$131.6	(58)

Loss Ratio (see chart 13)

The loss ratio is the ratio, expressed as a percentage, of the sum of incurred losses and loss adjustment expenses to net premiums earned. The decline in the loss ratio in the three and six months ended June 30, 2017 compared to the respective prior year periods was primarily due to a lower level of losses incurred, net.

13 LOSS RATIO

New Notice Claim Rate (see chart 14)

- Q2 2017: ~11% compared to Q2 2016: ~13%
- YTD 2017: ~11% compared to YTD 2016: ~13%

- The new notice claim rate for the second quarter of 2017 increased from that in the first quarter (Q1 2017: ~10.5%) which is directionally consistent with the seasonal pattern in which we experience better cure rates early in the year. The quarterly new notice claim rate during 2016 generally ranged from 12% to 13% and we expect our new notice claim rates during 2017 to be lower than the comparable 2016 rates.
- New notice activity continues to be primarily driven by loans insured in 2008 and prior (see chart 15), which continue to experience a cycle whereby many loans default, cure, and re-default. This cycle, along with the duration that defaults may ultimately remain in our notice inventory, results in significant judgment in establishing the estimated claim rate.

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14 PRIMARY NEW NOTICES IN VOLUME
NEW NOTICE CLAIM RATE [1][2] %

(1) Claim rate is the approximate quarterly rate.
(2) Claim rate is the approximate year-to-date rate.

15 NEW NOTICES FROM BOOK YEARS 2008 AND PRIOR IN VOLUME
PREVIOUSLY DELINQUENT %

Claims Severity (see table 16)
Factors that impact claim severity include the exposure on the loan (the unpaid principal balance of the loan times our insurance coverage percentage), the amount of time between default and claim filing (which impacts the amount of interest and expenses) and curtailments. All else being equal, the longer the period between default and claim filing, the greater the severity. The majority of loans from 2005-2008 (which represent the majority of loans in the delinquent inventory) are covered by master policy terms that, except under certain circumstances, do not limit the number of years that an insured can include interest when filing a claim if they comply with their obligations under the terms of the master policy.

Changes in our severity estimates resulted in unfavorable development on defaults that occurred in prior years in each of the six months ended June 30, 2017 and 2016, with a higher amount of unfavorable development in the 2016 period. As shown in the following table, the average paid claim, expressed as a percentage of our exposure, following periods of stability increased resulting in a higher severity estimates.

16 CLAIMS SEVERITY TREND
Note: Table excludes material settlements[1].

Period	Average exposure on claim paid	Average claim paid	% Paid to exposure		Average number of missed payments at claim received date
Q2 2017	$ 44,747	$49,105	109.7	%	35
Q1 2017	$ 44,238	$49,110	111.0	%	35
Q4 2016	43,200	48,297	111.8	%	35
Q3 2016	43,747	48,050	109.8	%	34
Q2 2016	43,709	47,953	109.7	%	35
Q1 2016	44,094	49,281	111.8	%	34
Q4 2015	44,342	49,134	110.8	%	35
Q3 2015	44,159	48,156	109.1	%	33
Q2 2015	44,683	48,587	108.7	%	34
Q1 2015	44,403	47,366	106.7	%	33

(1) Settlements include amounts paid in settlement disputes for claims paying practices and NPL settlements.

In considering the potential sensitivity of the factors underlying our estimate of loss reserves, it is possible that even a relatively small change in our estimated claim rate or severity could have a material impact on reserves and, correspondingly, on our consolidated results of operations even in a stable economic environment. For example, as of June 30, 2017, assuming all other factors remain constant, a $1,000 increase/decrease in the average severity reserve

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factor would change the reserve amount by approximately +/- $22 million. A 1 percentage point increase/decrease in the average claim rate reserve factor would change the reserve amount by approximately +/- $23 million.

See Note 12 – "Loss Reserves" to our consolidated financial statements for a discussion of our losses incurred and claims paying practices (including curtailments).

Net losses and LAE paid
Net losses and LAE paid in the three months ended June 30, 2017 compared to the prior year were relatively unchanged due to losses paid in the current year period under settlement agreements offsetting the decline in losses paid on our primary and pool RIF. Net losses and LAE paid in the six months ended June 30, 2017 declined 24% due to lower claim activity on our primary and pool business and a reduction in losses paid under settlement agreements. The credit profile of our RIF continues to improve and we believe paid claims will continue to decline in 2017 compared to 2016.

The following table presents our net losses and LAE paid for the three and six months ended June 30, 2017 and 2016.
Net Losses and LAE Paid

	Three Months Ended June 30,		Six Months Ended June 30,	
(In millions)	2017	2016	2017	2016
Total primary (excluding settlements)	$126	$153	$256	$319
Claims paying practices and NPL settlements[1]	45	4	45	51
Pool [2]	4	14	6	28
Direct losses paid	175	171	307	398
Reinsurance	(6)	(4)	(15)	(14)
Net losses paid	169	167	292	384
LAE	4	5	9	10
Net losses and LAE paid	$173	$172	301	$394

(1) See Note 12 - "Loss Reserves" for additional information on our settlements of disputes for claims paying practices and NPL settlements.
(2) The three and six months ended June 30, 2016 includes $11 million and $21 million, respectively, paid under the terms of the settlement with Freddie Mac. The final payment under this settlement was made on December 1, 2016.

Primary claims paid for the top 15 jurisdictions (based on 2017 losses paid) and all other jurisdictions for the three and six months ended June 30, 2017 and 2016 appears in the following table.
Paid Losses by Jurisdiction

	Three Months Ended June 30,		Six Months Ended June 30,	
(In millions)	2017	2016	2017	2016
New Jersey	$18	$15	35	$ 31
Florida	14	24	30	50
New York	11	8	21	16
Illinois	7	12	15	23
Pennsylvania	6	7	14	14
Maryland	7	7	14	16

Puerto Rico	5	4	10	8
California	6	6	10	13
Ohio	4	5	8	10
Massachusetts	4	3	8	7
Connecticut	3	3	6	7
Georgia	2	3	6	7
Indiana	3	2	5	5
Virginia	2	3	5	8
Washington	2	5	5	9
All other jurisdictions	32	46	64	95
Total primary (excluding settlements)	$126	$153	256	319

The primary average claim paid can vary materially from period to period based upon a variety of factors, including the local market conditions, average loan amount, average coverage percentage, the amount of time between default and claim filing, and our loss mitigation efforts on loans for which claims are paid.

The primary average claim paid for the top 5 states (based on 2017 losses paid) for the three and six months ended June 30, 2017 and 2016 appears in the following table.

Primary Average Claim Paid

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
New Jersey	$85,846	$77,922	$86,363	$81,898
Florida	64,355	59,824	65,712	62,039
New York	79,821	69,563	82,911	67,408
Illinois	43,363	48,778	46,506	48,586
Pennsylvania	42,146	44,040	44,581	43,224
All other jurisdictions	41,465	41,779	40,714	42,546
All jurisdictions	49,105	47,953	49,108	48,635

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Note: Jurisdictions in italics in the table above are those that predominately use a judicial foreclosure process, which generally increases the amount of time it takes for a foreclosure to be completed.

The primary average exposure of our primary RIF at June 30, 2017, December 31, 2016 and June 30, 2016 and for the top 5 jurisdictions (based on 2017 losses paid) appears in the following table.

Primary Average Exposure

	June 30, 2017	December 31, 2016	June 30, 2016
New Jersey	$63,785	$ 63,351	$62,795
Florida	50,286	49,908	49,650
New York	52,373	52,006	51,623
Illinois	41,162	40,696	40,707
Pennsylvania	45,031	44,213	43,675
All other jurisdictions	48,036	47,038	46,272
All jurisdictions	48,163	47,276	46,604

Loss reserves

Our primary default rate at June 30, 2017 was 4.11% (YE 2016: 5.04%, June 30, 2016: 5.30%). Our primary default inventory was 41,317 loans at June 30, 2017, representing a decrease of 18% from December 31, 2016 and 21% from June 30, 2016. The reduction in our primary default inventory is the result of the total number of defaulted loans: (1) that have cured; (2) for which claim payments have been made; or (3) that have resulted in rescission, claim denial, or removal from inventory due to settlements, collectively exceeding the total number of new defaults on insured loans. In recent periods we have experienced improved cure rates and the overall mix of our default inventory, as represented by the number of missed payments, has improved compared to the prior years. As of June 30, 2017, the percentage of our default inventory that has 12 or more missed payments was 36% (YE 2016: 38%, June 30, 2016: 43%). Generally, the fewer missed payments a defaulted loan has the lower the likelihood it will result in a claim. We expect our default inventory to continue to decline in 2017 from 2016 levels; however, the pace of decline is expected to moderate as our more recent books naturally season.

The gross reserves at June 30, 2017, December 31, 2016 and June 30, 2016 appear in the table below.

Gross Reserves	June 30, 2017	December 31, 2016	June 30, 2016
Primary:			
Direct loss reserves (in millions)	$1,093	$1,334	$1,483
IBNR and LAE	72	79	91
Total primary loss reserves	$1,165	$1,413	$1,574
Ending default inventory	41,317	50,282	52,558
Percentage of loans delinquent (default rate)	4.11 %	5.04 %	5.30 %
Average total primary loss reserves per default	$28,206	$28,104	$29,939
Primary claims received inventory included in ending default inventory	1,258	1,385	1,829
Pool[1]:			
Direct loss reserves (in millions):			
With aggregate loss limits	$15	$18	$29
Without aggregate loss limits	6	7	8

Reserve related to Freddie Mac Settlement[2]	—	—	21
Total pool direct loss reserves	$21	$25	$58
Ending default inventory:			
With aggregate loss limits	1,124	1,382	1,492
Without aggregate loss limits	387	501	532
Total pool ending default inventory	1,511	1,883	2,024
Pool claims received inventory included in ending default inventory	63	72	95
Other gross reserves (in millions)	$1	$1	$—

(1) Since a number of our pool policies include aggregate loss limits and/or deductibles, we do not disclose an average direct reserve per default for our pool business.

(2) See our Form 8-K filed with the Securities and Exchange Commission on November 30, 2012 for a discussion of our settlement with Freddie Mac regarding a pool policy. As of December 31, 2016 we had completed our obligation under this settlement agreement.

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The primary default inventory for the top 15 jurisdictions (based on 2017 losses paid) at June 30, 2017, December 31, 2016 and June 30, 2016 appears in the following table.

Primary Default Inventory by Jurisdiction

	June 30, 2017	December 31, 2016	June 30, 2016
New Jersey	2,003	2,586	2,878
Florida	3,311	4,150	4,626
New York	2,587	3,171	3,377
Illinois	2,195	2,649	2,748
Pennsylvania	2,488	2,984	3,003
Maryland	1,098	1,312	1,344
Puerto Rico	1,614	1,844	2,012
California	1,371	1,590	1,660
Ohio	2,096	2,614	2,726
Massachusetts	867	1,108	1,192
Connecticut	577	690	698
Georgia	1,577	1,853	1,864
Indiana	1,246	1,532	1,593
Virginia	705	885	932
Washington	589	754	851
All other jurisdictions	16,993	20,560	21,054
Total primary default inventory	41,317	50,282	52,558

Note: Jurisdictions in italics in the table above are those that predominately use a judicial foreclosure process, which generally increases the amount of time it takes for a foreclosure to be completed.

The primary default inventory by policy year at June 30, 2017, December 31, 2016 and June 30, 2016 appears in the following table.

Primary Default Inventory by Policy Year

	June 30, 2017	December 31, 2016	June 30, 2016
Policy year:			
2004 and prior	9,016	11,116	12,134
2005	4,739	5,826	6,479
2006	7,476	9,267	9,928
2007	12,642	15,816	16,564
2008	3,352	4,140	4,376
2009	319	421	424
2010	178	222	214
2011	203	246	242
2012	327	364	332
2013	581	686	595
2014	1,044	1,142	846
2015	947	814	405
2016	469	222	19
2017	24	—	—
Total primary default inventory	41,317	50,282	52,558

Our results of operations continue to be negatively impacted by the mortgage insurance we wrote during 2005 through 2008 (see chart 17). Although uncertainty remains with respect to the ultimate losses we may experience on those

books of business, as we continue to write new insurance on high-quality mortgages, those books have become a smaller percentage of our total portfolio, and we expect this trend to continue. Our 2005 through 2008 books of business represented approximately 23% and 25% of our total primary RIF at June 30, 2017 and December 31, 2016, respectively. Approximately 38% of the remaining primary RIF on our 2005-2008 books of business benefited from HARP as of June 30, 2017 and December 31, 2016.

17 DEFAULT INVENTORY MIX BY BOOK YEAR
% OF TOTAL INVENTORY

On our primary business, the highest claim frequency years have typically been the third and fourth year after the year of loan origination. However, the pattern of claim frequency can be affected by many factors, including persistency and deteriorating economic conditions. Low persistency can accelerate the period in the life of a book during which the highest claim frequency occurs. Deteriorating economic conditions can result in increasing claims following a period of declining claims. As of June 30, 2017, 50% of our primary RIF was written subsequent to December 31, 2014, 61% of our primary RIF was written subsequent to December 31, 2013, and 67% of our primary RIF was written subsequent to December 31, 2012.

UNDERWRITING AND OTHER EXPENSES, NET

Comparative quarterly and year to date results

Underwriting and other expenses includes items such as employee compensation costs, fees for professional services, depreciation and maintenance expense, and premium taxes, and are reported net of ceding commissions.

Underwriting and other expenses, net for the three and six months ended June 30, 2017 were $38.5 million and $79.3 million, respectively, up from $35.3 million and $75.1 million

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in the respective prior year periods. The increases were due to higher depreciation and compensation expenses.

Underwriting expense ratio (see chart 18). The underwriting expense ratio is the ratio, expressed as a percentage, of the underwriting and operating expenses, net and amortization of DAC of our combined insurance operations (which excludes underwriting and operating expenses of our non-insurance operations) to NPW. The underwriting expense ratio in the each of the three and six months ended June 30, 2017 increased compared to the respective prior year periods. The increase in the ratio in both periods was primarily due to higher depreciation and compensation expenses in the current year periods; however the three months ended June 30, 2017 was also impacted by lower NPW.
18 UNDERWRITING EXPENSE RATIO

INTEREST EXPENSE
Comparative quarterly and year to date results
Interest expense for the three and six months ended June 30, 2017 was $14.2 million and $30.5 million, respectively, up from $12.2 million and $26.9 million in the respective prior year periods. The increases were due to interest expense incurred on our 5.75% Notes and revolving credit facility, which offset the reduction in interest expense from the maturity of our 5% Notes and elimination of our 2% Notes through conversion and partial redemption during the quarter.

See Note 3 - "Debt" for debt transaction activity in 2017 pertaining to our 2% and 5% Notes and revolving credit facility that will impact the comparability of our interest expense in 2017 relative to 2016.

LOSS ON DEBT EXTINGUISHMENT
Comparative quarterly and year to date results
Loss on debt extinguishment of $1.9 million and $15.3 million for the three and six months ended June 30, 2016, respectively, reflects our repurchase of a portion of our 5% Notes at amounts above our carrying value and MGIC's purchase of a portion of our 9% Debentures at an amount above fair value, with each transaction resulting in losses. These transactions repositioned the maturity profile of our debt and reduced potentially dilutive shares at the time of their execution.

PROVISION FOR INCOME TAXES AND EFFECTIVE TAX RATE

	Three Months Ended June 30,			Six Months Ended June 30,		
(In millions, except rate)	2017	2016	% Change	2017	2016	% Change
Income before tax	$180.6	$165.2	9 %	$354.6	$268.9	32 %
Provision for income taxes	$62.0	$56.0	11 %	$146.2	$90.5	62 %
Effective tax rate	34.3 %	33.9 %	N/M	41.2 %	33.7 %	N/M

The difference between our statutory tax rate of 35% and our effective tax rate of 34.3% and 33.9% for the respective three months ended June 30, 2017 and 2016 was primarily due to the benefits of tax preferenced securities. The difference between our statutory rate of 35% and our effective tax rate of 41.2% for the six months ended June 30, 2017 is due to the $27.8 million additional provision recorded for the expected settlement of our IRS litigation more than offsetting benefits of tax preferenced securities. The difference between our statutory tax rate of 35% and our effective tax rate of 33.7% for the six months ended June 30, 2016 was primarily due to the benefits of tax preferenced securities.

See Note 11 – "Income Taxes" to our consolidated financial statements for a discussion of our tax position.

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Balance Sheet Review

Total assets and total liabilities
As of June 30, 2017, total assets were $5.6 billion and total liabilities were $2.6 billion. Compared to year-end 2016, this represented a decrease of $134.4 million in total assets and of $580.6 million in total liabilities.

The following sections mainly focus on our cash and cash equivalents and deferred income taxes, net, as these reflect the major developments in our assets and loss reserves and debt as these reflect the major developments in our liabilities since December 31, 2016.

ASSETS
Cash and cash equivalents - The decrease in our cash and cash equivalents reflects the repayment at maturity of our 5% Notes and redemption of a portion of our 2% Notes, offset in large part, by cash flows generated from our operating activities.

Deferred income taxes, net - The decrease in our deferred income taxes, net was primarily due to the utilization of federal net operating loss carryforwards as we generated net income during the first half of 2017.

As of June 30, 2017, our deferred tax asset was $481.4 million. A decrease in the federal statutory rate will result in a one-time reduction in the amount at which our deferred tax asset is recorded, thereby reducing our net income and book value; however, such a decrease will also reduce our effective tax rate in future periods, thereby increasing net income. We estimate that every 1 percentage point reduction in the federal statutory rate would result in a one-time reduction in our deferred tax asset of $13.4 million.

Investment portfolio
Our overall investment portfolio asset allocation (see table 19) and modified duration, remained relatively unchanged compared to December 31, 2016. Our lower level of invested assets (as measured by amortized cost) was offset by an increase in their fair values during the first half of 2017.

19 FIXED INCOME SECURITY RATINGS [(1)]
% OF FIXED INCOME SECURITIES AT FAIR VALUE

	Security Ratings			
Period	AAA	AA	A	BBB
June 30, 2017	23%	28%	35%	14%
December 31, 2016	25%	28%	32%	15%
June 30, 2016	23%	30%	32%	15%

(1) Ratings are provided by one or more of: Moody's, Standard & Poor's and Fitch Ratings. If three ratings are available, the middle rating is utilized; otherwise the lowest rating is utilized.

LIABILITIES
Loss reserves - Our loss reserves can be split into two parts: (1) reserves representing estimates of losses and settlement expenses on known delinquencies and (2) IBNR. Our gross liability for both is reduced by reinsurance balances recoverable on our estimated losses and settlement expenses to calculate a net reserve balance. The net reserve balance decreased by 18% to $1.14 billion as of June 30, 2017, from $1.39 billion as of December 31, 2016. Reinsurance balances recoverable on our estimated losses and settlement expenses were $44.8 million and $50.5 million as of June 30, 2017 and December 31, 2016, respectively. The overall decrease in our loss reserves during the first half of 2017 was due to a higher level of losses paid ($301.0 million) relative to losses incurred ($55.0 million).

Debt - The decrease in our consolidated debt was due to the elimination of our 2% Notes in April through a combination of conversions and cash redemptions and repayment of our 5% Notes on May 1, 2017 with holding company cash. See Note 3 - "Debt" for further information on our 2017 debt transactions and remaining outstanding obligations.

Total shareholders' equity

As of June 30, 2017, total shareholders' equity amounted to $3.0 billion, an increase of $446.2 million compared to December 31, 2016. The increase in our total shareholders' equity was due to net income in the first half of 2017, issuance of common stock to holders of our 2% Notes that elected to convert their notes during the second quarter, and an increase in the fair value of our investment portfolio during the first half of 2017.

As described in Note 3 - "Debt", approximately $202.5 million of principal outstanding on our 2% Notes was converted to shares of common stock in April. This debt conversion resulted in an increase to our shareholders' equity for the carrying value of the notes, which included outstanding debt issuance costs, at the time of conversion.

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Liquidity and Capital Resources

Consolidated Cash Flow Analysis

We have three primary types of cash flows: (1) operating cash flows, which consist mainly of cash generated by our insurance operations and income earned on our investment portfolio, less amounts paid for claims, interest expense and operating expenses, (2) investing cash flows related to the purchase, sale and maturity of investments and (3) financing cash flows generally from activities that impact our capital structure, such as changes in debt and shares outstanding. The following table summarizes our consolidated cash flows from operating, investing and financing activities:

	Six Months Ended June 30,	
(In thousands)	2017	2016
Total cash provided by (used in):		
Operating activities	125,556	54,993
Investing activities	5,419	261,043
Financing activities	(158,477)	(196,182)
(Decrease) increase in cash and cash equivalents	$(27,502)	$119,854

Net cash provided by operating activities for the six months ended June 30, 2017 increased compared to the same period of 2016 primarily due to a lower level of losses paid, net, offset in part by increases in payments for interest and other expenses and a decrease in premiums collected.

Net cash from investing activities for the six months ended June 30, 2017 decreased when compared to the same period of 2016, primarily due to an increase in the percentage of proceeds from the maturity and sales of fixed income securities that were reinvested, a decrease in unsettled investment purchase activity, and an increase in amounts spent on property and equipment.

Net cash used in financing activities for the six months ended June 30, 2017 includes the repayment at maturity of our 5% Notes and redemption of a portion of our 2% Notes, as well as, expenses paid to establish the revolving credit facility and cash remittance of withholding taxes paid by employees through shares withheld upon vesting of restricted stock units.

Net cash used by financing activities for the six months ended June 30, 2016 includes the repurchase of a portion of our 5% Notes and MGIC's purchase of a portion of our 9% Debentures and cash remittance of withholding taxes paid by employees through shares withheld upon vesting of restricted stock units. These cash uses were offset, in part,

by a borrowing from the FHLB.

Capitalization

DEBT AT OUR HOLDING COMPANY AND HOLDING COMPANY LIQUIDITY

Debt - holding company (see charts 20 and 21)

The 5.75% Notes and 9% Debentures are obligations of our holding company, MGIC Investment Corporation, and not of its subsidiaries. As of June 30, 2017, our holding company's debt obligations were $814.5 million in aggregate principal. In April 2017, prior to the redemption date of the 2% Notes, holders of approximately $202.5 million of the outstanding principal exercised their rights to convert their notes into shares of our common stock and we repaid the outstanding amount borrowed under our credit facility plus interest incurred. The remaining $5.1 million of our 2% Notes that did not convert were redeemed with holding company cash. The conversion of our 2% Notes into shares of our common stock, along with the cash redemption, eliminated our debt obligation. Our 5% Notes matured on May 1, 2017 and we repaid the $145 million of outstanding principal with holding company cash.

20HOLDING COMPANY DEBT IN MILLIONS

June 30, 2017 December 31, 2016

* MGIC owns approximately $132.7 million of our 9% Debentures, which are eliminated in consolidation, but they remain outstanding obligations owed by our holding company to MGIC.

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21 REMAINING TIME TO MATURITY OF HOLDING COMPANY DEBT IN MILLIONS
June 30, 2017 December 31, 2016

Liquidity analysis - holding company
As of June 30, 2017, we had approximately $149 million in cash and investments at our holding company. These resources are maintained primarily to service our debt interest expense, pay debt maturities, repurchase outstanding debt obligations from time to time, and to settle intercompany obligations. We may also use available holding company cash to repurchase shares of our common stock. While these assets are held, we generate investment income that serves to offset a portion of our interest expense. In addition to investment income, the payment of dividends from our insurance subsidiaries and/or raising capital in the public markets are the principal sources of holding company cash inflow. MGIC is the principal source of dividend-paying capacity, which is restricted by insurance regulation. The ability to raise capital in the public markets is subject to prevailing market conditions, investor demand for the securities to be issued, and our deemed creditworthiness.

In the second quarter of 2017, our holding company cash and investments decreased by $302 million, to $149 million as of June 30, 2017. Cash outflows during the quarter at our holding company included a $150 million repayment of our revolving credit facility, $150 million to repay or redeem outstanding debt obligations, $24 million of interest payments (of which $6 million was paid to MGIC), and $10 million to settle investment transactions. Cash inflows during the quarter included $30 million of dividends received from MGIC and other inflows of $2 million. We expect MGIC to continue to pay quarterly dividends. We ask the OCI not to object before MGIC pays dividends.

The net unrealized losses on our holding company investment portfolio were approximately $1 million at June 30, 2017 and the portfolio had a modified duration of

approximately 2.7 years.

We may from time to time continue to seek to acquire our debt obligations through cash purchases and/or exchanges for other securities. We may also from time to time seek to acquire our common stock through cash purchases, including with funds provided by debt. We may make such acquisitions in open market purchases, privately negotiated acquisitions or other transactions. The amounts involved may be material.

Subject to certain limitations and restrictions, holders of each of the 9% Debentures may convert their notes into shares of our common stock at their option prior to certain dates under the terms of their issuance, in which case our corresponding obligation will be eliminated.

See Note 7 – "Debt" to our consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2016 for additional information about our convertible debt, including our option to defer interest on our 9% Debentures. Any deferred interest compounds at the stated rate of 9%. The description in Note 7 - "Debt" to our consolidated financial statements in our Annual Report on Form 10-K is qualified in its entirety by the terms of the notes and debentures.

Although not anticipated in the near term, we may also contribute funds to our insurance operations to comply with the PMIERs or the State Capital Requirements. See "Overview - Capital" above for a discussion of these requirements. See discussion of our non-insurance contract underwriting services in Note 5 – "Litigation and Contingencies" to our consolidated financial statements.

DEBT AT SUBSIDIARIES

MGIC is a member of the FHLB, which provides MGIC access to an additional source of liquidity via a secured lending facility. MGIC has $155.0 million of debt outstanding in the form of a fixed rate advance from the FHLB. Interest on the Advance is payable monthly at an annual rate, fixed for the term of the Advance, of 1.91%. The principal of the Advance matures on February 10, 2023. MGIC may prepay the Advance at any time. Such prepayment would be below par if interest rates have risen after the Advance was originated, or above par if interest rates have declined. The Advance is secured by eligible collateral whose fair value must be maintained at 102% of the outstanding principal balance. MGIC provided eligible collateral from its investment portfolio.

Capital Adequacy

PMIERs

We operate under the PMIERs of the GSEs that became effective December 31, 2015. The revisions to the PMIERS since then have had no impact on our calculation of Available Assets or Minimum Required Assets, or our operations. The GSEs may further amend the PMIERs at any time, and they have broad discretion to interpret the requirements, which could impact the calculation of our Available Assets and/or Minimum Required Assets. The

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PMIERS provide that the factors that determine Minimum Required Assets will be updated every two years and may be updated more frequently to reflect changes in macroeconomic conditions or loan performance. The GSEs have informed us that they currently do not expect any updates to such factors to be effective before the fourth quarter of 2018 and we expect the GSEs will provide notice 180 days prior to the effective date of such updates.

As of June 30, 2017, MGIC's Available Assets under PMIERs totaled approximately $4.7 billion, an excess of approximately $815 million over its Minimum Required Assets of approximately $3.8 billion; and MGIC is in compliance with the requirements of the PMIERs and eligible to insure loans purchased by the GSEs. Our excess Available Assets allow MGIC to remain in compliance with the PMIERs financial requirements, including, we believe, to the extent they are modified further in the next scheduled review; and will also allow us flexibility to participate in additional business opportunities as they may arise. Our QSR Transactions provided an aggregate of approximately $764 million of PMIERs capital credit as of June 30, 2017.

We plan to continuously comply with the PMIERs through our operational activities or through the contribution of funds from our holding company, subject to demands on the holding company's resources, as outlined above.

RISK-TO-CAPITAL

We compute our risk-to-capital ratio on a separate company statutory basis, as well as on a combined insurance operation basis. The risk-to-capital ratio is our net RIF divided by our policyholders' position. Our net RIF includes both primary and pool risk in force, and excludes risk on policies that are currently in default and for which loss reserves have been established, and those covered by reinsurance. The risk amount includes pools of loans with contractual aggregate loss limits and without these limits. Policyholders' position consists primarily of statutory policyholders' surplus (which increases as a result of statutory net income and decreases as a result of statutory net loss and dividends paid), plus the statutory contingency reserve, and a portion of the reserves for unearned premiums. The statutory contingency reserve is reported as a liability on the statutory balance sheet. A mortgage insurance company is required to make annual additions to the contingency reserve of approximately 50% of net earned premiums. These contributions must generally be maintained for a period of ten years. However, with regulatory approval a mortgage insurance company may make early withdrawals from the contingency reserve when incurred losses exceed 35% of net earned premiums in a

calendar year.

MGIC's separate company risk-to-capital calculation appears in the table below.

(In millions, except ratio)	June 30, 2017	December 31, 2016
RIF - net [1]	$29,925	$ 28,668
Statutory policyholders' surplus	1,518	1,505
Statutory contingency reserve	1,413	1,181
Statutory policyholders' position	$2,931	$ 2,686
Risk-to-capital	10.2:1	10.7:1

(1) RIF – net, as shown in the table above is net of reinsurance and exposure on policies currently in default for which loss reserves have been established.

Our combined insurance companies' risk-to-capital calculation appears in the table below.

(In millions, except ratio)	June 30, 2017	December 31, 2016
RIF - net [1]	$35,585	$ 34,465
Statutory policyholders' surplus	1,520	1,507
Statutory contingency reserve	1,623	1,360

Statutory policyholders' position	$3,143	$ 2,867
Risk-to-capital	11.3:1	12.0:1

(1) RIF – net, as shown in the table above, is net of reinsurance and exposure on policies currently in default ($2.2 billion at June 30, 2017 and $2.6 billion at December 31, 2016) for which loss reserves have been established.

The reductions in MGIC's and our combined insurance companies' risk-to-capital in the first six months of 2017 were primarily due to an increase in statutory policyholders' position due to an increase in statutory contingency reserves, partially offset by an increase in net RIF in both calculations. Our RIF, net of reinsurance, increased in the first six months of 2017, due to an increase in our IIF. Our risk-to-capital ratio will decrease if the percentage increase in capital exceeds the percentage increase in insured risk.

For additional information regarding regulatory capital see Note 15 – "Statutory Information" to our consolidated financial statements as well as our risk factor titled "State Capital requirements may prevent us from continuing to write new insurance on an uninterrupted basis."

Financial Strength Ratings

The financial strength of MGIC, our principal mortgage insurance subsidiary, is as follows:

Rating Agency	Rating	Outlook
Moody's Investor Services	Baa3	Stable
Standard and Poor's Rating Services'	BBB+	Stable

For further information about the importance of MGIC's ratings, see our risk factor titled "Competition or changes in our relationships with our customers could reduce our revenues, reduce our premium yields and / or increase our losses."

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Contractual Obligations

At June 30, 2017, the approximate future payments under our contractual obligations of the type described in the table below are as follows:

Contractual Obligations

	Payments due by period				
(In millions)	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt obligations	$2,078.2	$51.4	$102.5	$101.1	$1,823.2
Operating lease obligations	2.6	0.7	1.4	0.5	—
Tax obligations	53.0	53.0	—	—	—
Purchase obligations	18.0	14.0	4.0	—	—
Pension, SERP and other post-retirement plans	287.1	22.7	52.4	57.0	155.0
Other long-term liabilities	1,187.1	557.9	474.9	154.3	—
Total	$3,626.0	$699.7	$635.2	$312.9	$1,978.2

Our long-term debt obligations as of June 30, 2017 include their related interest and are discussed in Note 3 - "Debt" to our consolidated financial statements and under "Liquidity and Capital Resources" above. Our operating lease obligations include operating leases on certain office space, data processing equipment and autos, as discussed in Note 16 – "Leases" to our consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2016. Tax obligations primarily relate to our current dispute with the IRS, as discussed in Note 11 – "Income Taxes." Purchase obligations consist primarily of agreements to purchase items related to our ongoing infrastructure projects and information technology investments in the normal course of business. See Note 11 – "Benefit Plans" to our consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2016 for a discussion of expected benefit payments under our benefit plans.

Our other long-term liabilities represent the loss reserves established to recognize the liability for losses and LAE related to existing defaults on insured mortgage loans. The timing of the future claim payments associated with the established loss reserves was determined primarily based on two key assumptions: the length of time it takes for a notice of default to develop into a received claim and the length of time it takes for a received claim to be ultimately paid. The future claim payment periods are estimated based on historical experience, and could emerge significantly different than this estimate. Due to the uncertainty regarding how certain factors, such as loss mitigation protocols established by servicers and changes in some state foreclosure laws that may include, for example, a requirement for additional review and/or mediation process, will affect our future paid claims it is difficult to estimate the amount and timing of future claim payments. See Note 12 – "Loss Reserves" to our consolidated financial statements. In accordance with GAAP for the mortgage insurance industry, we establish loss reserves only for loans in default. Because our reserving method does not take account of the impact of future losses that could occur from loans that are not delinquent, our obligation for ultimate losses that we expect to occur under our policies in force at any period end is not reflected in our consolidated financial statements or in the table above.

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Forward Looking Statements and Risk Factors

General: Our business, results of operations, and financial condition could be affected by the risk factors referred to under "Location of Risk Factors" below. These risk factors are an integral part of Management's Discussion and Analysis.

These factors may also cause actual results to differ materially from the results contemplated by forward looking statements that we may make. Forward looking statements consist of statements which relate to matters other than historical fact. Among others, statements that include words such as we "believe," "anticipate" or "expect," or words of similar import, are forward looking statements. We are not undertaking any obligation to update any forward looking statements we may make even though these statements may be affected by events or circumstances occurring after the forward looking statements were made. Therefore no reader of this document should rely on these statements being current as of any time other than the time at which this document was filed with the Securities and Exchange Commission.

Location of Risk Factors: The risk factors are in Item 1 A of our Annual Report on Form 10-K for the year ended December 31, 2016, as supplemented by Part II, Item 1 A of our Quarterly Report on Form 10-Q for the Quarter ended March 31, 2017, and by Part II, Item 1 A of this Quarterly Report on Form 10-Q. The risk factors in the 10-K, as supplemented by these 10 Qs and through updating of various statistical and other information, are reproduced in Exhibit 99 to this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our investment portfolio is essentially a fixed income portfolio and is exposed to market risk. Important drivers of the market risk are credit spread risk and interest rate risk.

Credit spread risk is the risk that we will incur a loss due to adverse changes in credit spreads. Credit spread is the additional yield on fixed income securities above the risk-free rate (typically referenced as the yield on U.S. Treasury securities) that market participants require to compensate them for assuming credit, liquidity and/or prepayment risks.

We manage credit risk via our investment policy guidelines which primarily place our investments in investment grade securities and limit the amount of our credit exposure to any one issue, issuer and type of instrument. Guideline and investment portfolio detail is available in "Business – Section C, Investment Portfolio" in Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2016.

Interest rate risk is the risk that we will incur a loss due to adverse changes in interest rates relative to the characteristics of our interest bearing assets.

One of the measures used to quantify this exposure is modified duration. Modified duration measures the price sensitivity of the assets to the changes in spreads. At June 30, 2017, the modified duration of our fixed income investment portfolio was 4.6 years, which means that an instantaneous parallel shift in the yield curve of 100 basis points would result in a change of 4.6% in the fair value of our fixed income portfolio. For an upward shift in the yield curve, the fair value of our portfolio would decrease and for a downward shift in the yield curve, the fair value would increase. See Note 7 – "Investments" to our consolidated financial statements for additional disclosure surrounding our investment portfolio.

Item 4. Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our

principal executive officer and principal financial officer concluded that such controls and procedures were effective as of the end of such period. There was no change in our internal control over financial reporting that occurred during the second quarter of 2017 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1 A. Risk Factors

With the exception of the changes described and set forth below, there have been no material changes in our risk factors from the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as supplemented by Part II, Item I A of our Quarterly Report on Form 10-Q for the Quarter ended March 31, 2017. The risk factors in the 10-K, as supplemented by that 10-Q and this 10-Q, and through updating of various statistical and other information, are reproduced in their entirety in Exhibit 99 to this Quarterly Report on Form 10-Q.

Competition or changes in our relationships with our customers could reduce our revenues, reduce our premium yields and / or increase our losses.

Our private mortgage insurance competitors include:

- Arch Mortgage Insurance Company,
- Essent Guaranty, Inc.,
- Genworth Mortgage Insurance Corporation,
- National Mortgage Insurance Corporation, and
- Radian Guaranty Inc.

The private mortgage insurance industry is highly competitive and is expected to remain so. We believe that we currently compete with other private mortgage insurers based on pricing, underwriting requirements, financial strength (including based on credit or financial strength ratings), customer relationships, name recognition, reputation, the strength of our management team and field organization, the ancillary products and services provided to lenders (including contract underwriting services), the depth of our databases covering insured loans and the effective use of technology and innovation in the delivery and servicing of our mortgage insurance products.

Much of the competition in the industry has centered on pricing practices which, in the last few years included: (i) reductions in standard filed rates on borrower-paid policies, (ii) use by certain competitors of a spectrum of filed rates to allow for formulaic, risk-based pricing (commonly referred to as "black-box" pricing); and (iii) use of customized rates (discounted from published rates) on lender-paid, single premium policies. The willingness of mortgage insurers to offer reduced pricing (through filed or customized rates) has been met with an increased demand from various lenders for reduced rate products. There can be no assurance that pricing competition will not intensify

further, which could result in a decrease in our new insurance written and/or returns.

In 2016 and the first half of 2017, approximately 5% and 4%, respectively, of our new insurance written was for loans for which one lender was the original insured. Our relationships with our customers could be adversely affected by a variety of factors, including if our premium rates are higher than those of our competitors, our underwriting requirements result in our declining to insure some of the loans originated by our customers, or our insurance rescissions and curtailments affect the customer.

Certain of our competitors have access to capital at a lower cost of capital than we do (including, as a result of off-shore reinsurance vehicles, which are also tax-advantaged). As a result, they may be better positioned to compete outside of traditional mortgage insurance, including if the GSEs pursue alternative forms of credit enhancement. In addition, because of their tax advantages, certain competitors may be able to achieve higher after-tax rates of return on their NIW compared to us, which could allow them to leverage reduced pricing to gain market share.

Substantially all of our insurance written since 2008 has been for loans purchased by Fannie Mae and Freddie Mac (the "GSEs"). The current private mortgage insurer eligibility requirements ("PMIERs") of the GSEs require a mortgage insurer to maintain a minimum amount of assets to support its insured risk, as discussed in our risk factor titled "We may not continue to meet the GSEs' private mortgage insurer eligibility requirements and our returns may decrease as we are required to maintain more capital in order to maintain our eligibility." The PMIERs do not require an insurer to maintain minimum financial strength ratings; however, our financial strength ratings can affect us in the following ways:

- A downgrade in our financial strength ratings could result in increased scrutiny of our financial condition by the GSEs and/or our customers, potentially resulting in a decrease in the amount of our new insurance written.

- Our ability to participate in the non-GSE mortgage market (which has been limited since the financial crisis, but may grow in the future), could depend on our ability to maintain and improve our investment grade ratings for our mortgage insurance subsidiaries. We could be competitively disadvantaged with some market participants because the financial strength ratings of our insurance subsidiaries are lower than those of some competitors. MGIC's financial strength rating from Moody’s is Baa3 (with a stable outlook) and from Standard & Poor’s is BBB+ (with a stable outlook).
- Financial strength ratings may also play a greater role if the GSEs no longer operate in their current capacities,

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for example, due to legislative or regulatory action. In addition, although the PMIERs do not require minimum financial strength ratings, the GSEs consider financial strength ratings to be important when utilizing forms of credit enhancement other than traditional mortgage insurance, as discussed in our risk factor titled "The amount of insurance we write could be adversely affected if lenders and investors select alternatives to private mortgage insurance." If we are unable to compete effectively in the current or any future markets as a result of the financial strength ratings assigned to our insurance subsidiaries, our future new insurance written could be negatively affected.

The amount of insurance we write could be adversely affected if lenders and investors select alternatives to private mortgage insurance.

Alternatives to private mortgage insurance include:

- lenders using FHA, VA and other government mortgage insurance programs,
- investors using risk mitigation and credit risk transfer techniques other than private mortgage insurance,
- lenders and other investors holding mortgages in portfolio and self-insuring, and
- lenders originating mortgages using piggyback structures to avoid private mortgage insurance, such as a first mortgage with an 80% loan-to-value ratio and a second mortgage with a 10%, 15% or 20% loan-to-value ratio (referred to as 80-10-10, 80-15-5 or 80-20 loans, respectively) rather than a first mortgage with a 90%, 95% or 100% loan-to-value ratio that has private mortgage insurance.

The GSEs (and other investors) have used alternative forms of credit enhancement other than private mortgage insurance, such as obtaining insurance from non-mortgage insurers, engaging in credit-linked note transactions executed in the capital markets, or using other forms of debt issuances or securitizations that transfer credit risk directly to other investors; using other risk mitigation techniques in conjunction with reduced levels of private mortgage insurance coverage; or accepting credit risk without credit enhancement. Although the alternative forms of credit enhancement used by the GSEs in the past several years have not displaced primary mortgage insurance, the forms continue to evolve.

The FHA's share of the low down payment residential mortgages that were subject to FHA, VA, USDA or primary private mortgage insurance was an estimated 38.9% in the first quarter of 2017, 35.5% in 2016, and 39.3% in 2015. In the past ten years, the FHA’s share has been as low as 17.1% in 2007 and as high as 68.7% in 2009. Factors that influence the FHA’s market share include relative rates and fees, underwriting guidelines and loan limits of the FHA, VA, private mortgage insurers and the GSEs; lenders' perceptions of legal risks under FHA versus GSE programs; flexibility for the FHA to establish new products as a result

of federal legislation and programs; returns expected to be obtained by lenders for Ginnie Mae securitization of FHA-insured loans compared to those obtained from selling loans to Fannie Mae or Freddie Mac for securitization; and differences in policy terms, such as the ability of a borrower to cancel insurance coverage under certain circumstances. We cannot predict how the factors that affect the FHA’s share of new insurance written will change in the future.

The VA's share of the low down payment residential mortgages that were subject to FHA, VA, USDA or primary private mortgage insurance was an estimated 27.2% in the first quarter of 2017, 26.6% in 2016, and 23.9% in 2015. The VA’s market share in the first quarter of 2017 was its highest in the past ten years and its lowest market share in the past ten years was 5.4% in 2007. We believe that the VA’s market share has generally been increasing because the VA offers 100% LTV loans and charges a one-time funding fee that can be included in the loan amount but no additional monthly expense, and because of an increase in the number of borrowers who are eligible for the VA’s program.

We may not continue to meet the GSEs’ private mortgage insurer eligibility requirements and our returns may decrease as we are required to maintain more capital in order to maintain our eligibility.

We must comply with the PMIERs to be eligible to insure loans purchased by the GSEs. The PMIERs include financial requirements, as well as business, quality control and certain transaction approval requirements. The financial requirements of the PMIERs require a mortgage insurer’s “Available Assets” (generally only the most liquid assets of an insurer) to equal or exceed its “Minimum Required Assets” (which are based on an insurer’s book and are calculated from tables of factors with several risk dimensions and are subject to a floor amount). Based on our

interpretation of the PMIERs, as of June 30, 2017, MGIC's Available Assets totaled $4.7 billion, or $0.8 billion in excess of its Minimum Required Assets. MGIC is in compliance with the PMIERs and eligible to insure loans purchased by the GSEs.

If MGIC ceases to be eligible to insure loans purchased by one or both of the GSEs, it would significantly reduce the volume of our new business writings. Factors that may negatively impact MGIC's ability to continue to comply with the financial requirements of the PMIERs include the following:

- The GSEs could make the PMIERs more onerous in the future; in this regard, the PMIERs provide that the factors that determine Minimum Required Assets will be updated every two years and may be updated more frequently to reflect changes in macroeconomic conditions or loan performance. The GSEs have informed us that they currently do not expect any updates to be effective before the fourth quarter of 2018 and we expect the GSEs will provide notice 180 days

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prior to the effective date of such updates. The GSEs may amend the PMIERs at any time.

- The GSEs may reduce the amount of credit they allow under the PMIERs for the risk ceded under our quota share reinsurance transactions. The GSEs' ongoing approval of those transactions is subject to several conditions and the transactions will be reviewed under the PMIERs at least annually by the GSEs. For more information about the transactions, see our risk factor titled "The mix of business we write affects our Minimum Required Assets under the PMIERs, our premium yields and the likelihood of losses occurring."
- Our future operating results may be negatively impacted by the matters discussed in the rest of these risk factors. Such matters could decrease our revenues, increase our losses or require the use of assets, thereby creating a shortfall in Available Assets.
- Should capital be needed by MGIC in the future, capital contributions from our holding company may not be available due to competing demands on holding company resources, including for repayment of debt.

While on an overall basis, the amount of Available Assets MGIC must hold in order to continue to insure GSE loans increased under the PMIERs over what state regulation currently requires, our reinsurance transactions mitigate the negative effect of the PMIERs on our returns. In this regard, see the second bullet point above.

Item 6. Exhibits

The accompanying Index to Exhibits is incorporated by reference in answer to this portion of this Item, and except as otherwise indicated in the next sentence, the Exhibits listed in such Index are filed as part of this Form 10-Q. Exhibit 32 is not filed as part of this Form 10-Q but accompanies this Form 10-Q.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, on August 4, 2017.

MGIC INVESTMENT CORPORATION

/s/ Timothy J. Mattke
Timothy J. Mattke
Executive Vice President and
Chief Financial Officer

/s/ Julie K. Sperber
Julie K. Sperber
Vice President, Controller and Chief Accounting Officer

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INDEX TO EXHIBITS
(Part II, Item 6)

Exhibit Number	Description of Exhibit
3.2	Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2 to the Company's Form 8-K filed July 28, 2017)
12	Ratio of Earnings to Fixed Charges
31.1	Certification of CEO under Section 302 of Sarbanes-Oxley Act of 2002
31.2	Certification of CFO under Section 302 of Sarbanes-Oxley Act of 2002
32	Certification of CEO and CFO under Section 906 of Sarbanes-Oxley Act of 2002 (as indicated in Item 6 of Part II, this Exhibit is not being "filed")
99	Risk Factors included in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2016, as supplemented by Part II, Item 1A of our Quarterly Report on Form 10-Q for the quarters ended March 31, 2017 and June 30, 2017, and through updating of various statistical and other information
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document