

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

IX. MISCELLANEOUS PROJECTS AND CORRESPONDENCE WITH INDUSTRY

E. Expert Witness and Statements to Government Agencies

1. Correspondence and Transcript of Testimony before the Board of Directors of the Federal Home Loan Bank Board, Washington D.C., June, 1975



Federal Home Loan Mortgage Corp.

311 first street, n. w. ■ washington, d. c. 20001 ■ (202) 624-7000

May 2, 1975

Professor James Grasskamp
202A Breese Terrace
Madison, Wisconsin 53705

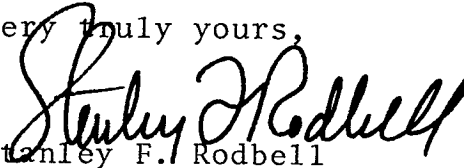
Dear Professor Grasskamp:

I appreciated the time you gave us in the conference call this morning. I am somewhat relieved to now have your expertise involved in the matter of FHLMC's minimum capital requirements.

I am enclosing for your information prior to our visit next week a copy of the FHLMC Eligibility Requirements, a copy of Mid-Atlantic's Application for Waiver and Mid-Atlantic's year-end financials. I will be in touch with you as soon as our travel arrangements are determined.

If you have need of any further information which I may be able to obtain, please do not hesitate to call upon me.

Very truly yours,


Stanley F. Rodbell
Associate General Counsel

SFR/mjm
Enclosures

CC: Robert T. Lasky, Esquire

Cadwalader, Wickersham & Taft

WASHINGTON PARTNERS
H. CLAYTON COOK, JR.
STEPHEN N. SHULMAN

NEW YORK PARTNERS
JACK ADELMAN
JOHN BOYER
PETER MEGARGEE BROWN
WILLIAM N. CLARKE
RODNEY S. DAYAN
DANIEL C. DRAPER
STEVE C. DUNE
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P. JAY FLOCKEN
JOHN F. FRITTS
TERENCE F. GILHEANY
GRANT B. HERING
LEONARD E. KUST
ROBERT C. LAWRENCE III
JAY H. McDOWELL
WILLIAM J. MOSS
HORACE P. MOULTON
JOHN J. O'GRADY III
ROY ALBERT POVELL
GEORGE D. REYCRAFT
HADLEY S. ROE
STUART D. ROOT
JEROME SHELBY
JOHN A. SULLIVAN
JACQUELIN A. SWORDS
RICHARD T. TAYLOR
COURTLAND W. TROUTMAN
JOHN J. WALSH
ARNOLD J. ZURCHER, JR.

1000 Connecticut Avenue

Washington, D. C. 20036

Telephone (202) 659-1700

Cable address Labellum

Telex 12-9146

May 12, 1975

HAROLD W. CONROY
RICHARD N. CROCKETT
HENRY ALLEN MARK
CHARLES W. McCONAUGHY
COUNSEL

ONE WALL STREET
NEW YORK, N. Y. 10005
TELEPHONE: (212) 785-1000

SUITE 5, EATON HOUSE
39 UPPER GROSVENOR STREET
LONDON W1X 0PF, ENGLAND
TELEPHONE: 01-499-6122/3
TELEX: 23248

Dr. James A. Graaskamp
202A Breese Terrace
Madison, Wisconsin 53705

Dear Dr. Graaskamp:

Thank you for your cordial reception in Madison. Stan Rodbell and I are hopeful that our association will prove rewarding both professionally and personally.

I return herewith your copy of the Journal of Risk and Insurance and would ask you in turn to provide us a copy of the Alger Report if you can locate it. For whatever help it might be in making certain we are proceeding in some sort of coordinated direction, I also enclose a copy of a Memorandum which I prepared outlining our discussions and the direction your research will be taking.

Stan and I would appreciate being kept up-to-date as to your progress. If necessary, we would be happy to come again to Madison at whatever point you think it appropriate. If you determine that there is further information which we can supply, please let us know.

By copy of this letter, I am asking that Stan send you a copy of the A. D. Little study.

Again, thank you.

Sincerely yours,

Rob T. Lasky
Robert T. Lasky

cc: Philip R. Brinkerhoff, Esq.
Stanley Rodbell, Esq.

Enclosure

Cadwalader, Wickersham & Taft

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RICHARD T. TAYLOR
COURTLAND W. TROUTMAN
JOHN J. WALSH
ARNOLD J. ZURCHER, JR.

1000 Connecticut Avenue

Washington, D. C. 20036

Telephone (202) 659-4700

Cable address Labellum

Telex: 12-9146

May 13, 1975

HAROLD W. CONROY
RICHARD N. CROCKETT
HENRY ALLEN MARK
CHARLES W. McCONAUGHY
COUNSEL

ONE WALL STREET
NEW YORK, N. Y. 10005
TELEPHONE: (212) 785-1000

SUITE 5, EATON HOUSE
39 UPPER GROSVENOR STREET
LONDON W1X9PF, ENGLAND
TELEPHONE: 01-499-6122/3
TELEX: 23248

Dr. James A. Graaskamp
202A Breese Terrace
Madison, Wisconsin 53705

Dear Dr. Graaskamp:

Opposing counsel has consented to permitting your testimony to be presented at the beginning of the hearing. The hearing begins June 9. Since I assume that the first day will be substantially consumed by procedural issues, your testimony is likely to begin on June 10. I would not anticipate more than two days of testimony, one day of direct testimony and one day of cross-examination.

Accordingly, could you plan to be in Washington by early afternoon on June 8 so that there would be ample time for rehearsal.

Sincerely yours,

Rob Lasky
Robert T. Lasky

cc: Stanley Rodbell, Esq.



Robert T. Lasky
Cadwalader, Wickersham & Taft
1000 Connecticut Ave.
Wash. D.C. 20036

Dear Bob:

Will make reservations to arrive the night of June 7 so I would be available Sunday, afternoon, June 8 for a rehearsal.

A first draft of Prof. James Hickman minimum capital to prevent disaster calculations are enclosed. I am discussing with him further so you may get a revised version shortly. The loss data I am using of \$3500 per claim with a standard error of \$2000 is from a report we did for IMI last winter and for which I have their permission to use in this case. They would prefer that its source remain anonymous but we can identify it if required to do so in cross exam. We are running their new loss tapes this week so that more recent '74-'75 experience can be used since these losses will be a little more severe.

I contacted both CMI and MGIC and they do not compute the standard error in their average loss! MGIC has agreed to do so on '74 ~~3500 per claim~~ experience and is sending their numbers this week. Apparently their average losses are worse than IMI so they would provide a better base for Prof. Hickman's calculations.

However, all of the big three are super-sensitive on whose having the worst experience and have therefore asked me to construct a weighted average loss rate for use in the court room so that no company is held up as having been selected as the worst underwriter, most inefficient claims collector, etc. so I will ponder on the best way of handling that problem.

UNIVERSITY OF WISCONSIN-MADISON

GRADUATE SCHOOL OF BUSINESS

1155 Observatory Drive
Madison, Wisconsin 53706



June 12, 1975

MEMORANDUM

TO: Dean Robert H. Bock, School of Business

FROM: Professor James A. Graaskamp

RE: Testimony of Expert Witness

Testimony for the Internal Revenue Service against the Southern Pacific Railroad no longer required as the railroad decided to settle out-of court.

However, I have been asked to testify on behalf of the Federal Home Loan Bank Mortgage Corporation on Monday, June 23. Case involves determination of minimum capital for mortgage guaranty insurance companies, a \$5,000,000 dollar minimum capital requirement being contested by a Mid-Atlantic Guaranty Insurance Company. Request permission to miss summer school classes for Monday, the 23rd. Classes will be covered by teaching assistant, Lynn Woodward.

RECEIVED

JUN 12 1975

School of Business

copy to Paul Graaskamp
RHB

M E M O R A N D U M

May 9, 1975

TO : The Files
FROM: Robert T. Lasky
RE : Expert Testimony -- James A. Graaskamp

Stan Rodbell and I met today in Madison with Dr. Graaskamp and a University of Wisconsin colleague. In broad terms, we decided upon the following approach to justification of the \$5 million capital requirement:

1. Based upon data to be furnished by Dr. Graaskamp, Dr. Graaskamp's colleague (who is primarily expert in questions of actuarial and risk analysis) will attempt to analyze the minimum capital requirements from a purely statistical, insurance risk standpoint. The data furnished will initially be based upon the recent experience of private mortgage insurers. This study will let us examine the probability of an insolvency occurring at various levels of capital and is premised upon the assumption that, as the number of insured loans grows, the behavior of the loans becomes more stable causing a decrease in the probability of insolvency. (The generally accepted European measurement of an unacceptable probability of insolvency is one chance in 200). A very preliminary analysis suggests that this type of analysis will produce a \$2 million minimum requirement at the one chance in 200 level.

Dr. Graaskamp's colleague will prepare a Memorandum showing the results of this analysis and has agreed, if necessary, to do a second analysis if we wish to change the assumptions upon which the first analysis was based. However, his time is limited and, other than the above, can promise only to come to Washington for one day to testify as to his results.

It should be noted that this type of analysis assumes that the incidence of one loss is completely unrelated to another. If there is a relationship between losses such as one would expect in a general economic downturn, then capital requirements should be higher than shown as a result of this type of study. If we can obtain data showing the degree of correlation between mortgage foreclosures and economic activity, we may then be able to justify assuming some degree of correlation in this area.

This type of study also does not evaluate the potential of insurer insolvency which might result from unsatisfactory investment results, a problem which some p.m.i. companies have already encountered.

2. Dr. Graaskamp's schedule is very tight and he is unavailable to us after June 15. We will therefore have to arrange for his testimony to be taken out of order.

He will prepare an economic "density model" which will enable us to predict the results of operations of p.m.i. companies during the first five years of existence making various assumptions as to claim levels, expenses, etc. and

to relate this performance to various levels of capitalization. A second aspect of the density model will also take into consideration the performance of the insurer's investments.

3. Dr. Graaskamp will examine the claim that the risks inherent in low capitalization can in fact be eliminated by a reduction in the permissible ratio of insurance risk outstanding to policy holders' surplus. We are hopeful of showing that for a start-up insurer a low ratio (such as 10 to 1) produces a situation that it is not possible to generate sufficient income to cover expenses. If such is the case, lowering the ratio does not serve any useful purpose from the standpoint of insurer viability.

4. We will attempt to obtain data from the Federal Home Loan Bank Board which will enable Dr. Graaskamp to relate some measure of economic activity with foreclosure rates. Hopefully, this data is available by SMSA and for each quarter. The appropriate Bank Board person should contact Dr. Graaskamp.



R.T.L.

See pages 9 → 15
for reference
To Graaskamp
testimony —

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL HOME LOAN MORTGAGE CORPORATION

In Re: Application of Mid Atlantic
Mortgage Insurance, Inc. for Waiver
of the Five Million Dollar Minimum
Capital Requirement Established by
Section 130.1 of the Eligibility
Requirements for Mortgage Insurers

No. MC 75-48

DECISION OF THE BOARD OF DIRECTORS

I. Introduction

This matter comes before the Board of Directors of the Federal Home Loan Mortgage Corporation (Mortgage Corporation) on the application of Mid Atlantic Mortgage Insurance, Inc. (Mid Atlantic) for approval as an eligible private mortgage insurer under section 110 of the Eligibility Requirements for Private Mortgage Insurers (Eligibility Requirements) and on Mid Atlantic's application for waiver of the \$5 million minimum capital requirement established in section 130.1 of said Requirements. Following denial of these applications and a subsequent request for reconsideration, Mid Atlantic asked for a hearing. This request was granted by the Mortgage Corporation in Resolution No. MC 75-15, dated April 16, 1975.

The hearing commenced on June 9, 1975 and concluded on June 24, 1975. Thereafter, the parties submitted proposed findings of fact and conclusions of law to the Presiding Officer, who issued his Report and Recommendation on October 6, 1975. In reaching this Decision, the Board of Directors has considered the hearing record, and the Report and Recommendation of the Presiding Officer (Presiding Officer's Report), as well as the exceptions filed thereto by Mid Atlantic (which, to a considerable extent, incorporate Mid Atlantic's proposed findings of fact and conclusions of law) and by the Mortgage Corporation.

The Board of Directors has considered this matter de novo, and has arrived at its own conclusions independently of those reached in the Presiding Officer's Report, and without consultation or discussion with any attorney or official of the Mortgage Corporation. The Board of Directors hereby adopts the findings and recommendations of the Presiding Officer's Report only to the extent that they are consistent with this Decision.^{1/}

At the outset, the Board of Directors rejects categorically and without qualification all allegations by Mid Atlantic to the effect that the Presiding Officer was too ill to prepare the Presiding Officer's Report or that the Presiding Officer was motivated by a malicious intent to injure Mid Atlantic, or that the Presiding Officer should have been disqualified by virtue of his alleged close business and personal ties to former Chairmen of the Board who presently are executives of other private mortgage insurers which allegedly are anxious to drive Mid Atlantic from the market. (See letter of October 8, 1975 to Messrs. Marston and Perry from the President and Chief Executive Officer of Mid Atlantic). The Board of Directors has the utmost faith in the ability and integrity of the Presiding Officer. The Board of Directors further notes that not a shred of evidence has been put forth by Mid Atlantic to support the allegations that the Presiding Officer lacks ability or integrity, or that he in fact had any close business or personal ties to any competitor of Mid Atlantic or that the Presiding Officer was prejudiced in any way against Mid Atlantic.

II. Questions Presented

The dispute between Mid Atlantic and the Mortgage Corporation essentially involves three issues: (1) whether or not the Mortgage Corporation may legally establish minimum capitalization

^{1/} The Board of Directors finds merit in Exception No. 1 of the Mortgage Corporation's Proposed Exceptions to the Presiding Officer's Report and notes that Resolution MC 75-14, dated April 10, 1975, granted Mid Atlantic's request for a reconsideration of the previous denial of its application.

requirements for private mortgage insurers before it qualifies them; (2) whether or not the \$5 million minimum capitalization requirement is reasonable; and (3) whether or not this requirement should be waived for Mid Atlantic.

III. Background

Mid Atlantic is a wholly-owned subsidiary of MIDAMI Corporation, with its office in Silver Spring, Maryland, and has been in business since March 13, 1973, when it was incorporated with authorized capital slightly in excess of \$500,000 (Presiding Officer's Report, p. 4). Mid Atlantic's capital has never exceeded \$900,000 and Mid Atlantic has operated at a loss since it began operations (Presiding Officer's Report, p. 4). However, the Board of Directors recognizes that Mid Atlantic takes the position that its losses were caused, in part, by its inability to obtain Mortgage Corporation eligibility. While the Board of Directors, as noted infra, believes that the minimum capital requirement is valid and proper in all respects, it is reluctant to reject an applicant for approval as an eligible private mortgage insurer on the basis of said applicant's inability to operate at a profit in a situation where the applicant's operating losses are alleged to have been caused, at least in part, by any previous decision of the Mortgage Corporation regarding its eligibility (no matter how proper such decision may have been). Accordingly, the Board of Directors, in reaching its Decision, has given no weight to the evidence respecting Mid Atlantic's operating losses.

IV. The Mortgage Corporation's Statutory Authority to Establish Minimum Capital Requirements

The Board of Directors has concluded that the Mortgage Corporation's authority to establish the \$5 million minimum capital requirement at issue herein is clear, and that the Mortgage Corporation's authority is not circumscribed by the lower minimum capital requirements imposed by various State laws. The

Board of Directors' conclusion in this matter is supported by the wording of the Mortgage Corporation's enabling statute, Title III of the Emergency Home Finance Act of 1970, 12 U.S.C. 1451-1459, which permits the Mortgage Corporation to purchase conventional mortgages having a loan-to-value ratio exceeding 80% if the unpaid principle balance of the mortgage over 80% is guaranteed or insured by "a qualified insurer as determined by the [Mortgage] Corporation." 12 U.S.C. 1454(a)(2). It is clear that this language indicates a Congressional intent to give the Mortgage Corporation broad discretion to establish qualifications, including minimum capital requirements, for private mortgage insurers which insure mortgages purchased by it. The statute further provides that the Mortgage Corporation's secondary market operations "shall be confined so far as practicable to residential mortgages which are deemed by the [Mortgage] Corporation to be of such quality, type, and class as to meet generally the purchase standards imposed by private institutional mortgage investors." 12 U.S.C. 1454(a)(1). The Board of Directors, for reasons discussed elsewhere in this Decision, has concluded that institutional investors generally would not find acceptable residential mortgages insured by a private mortgage insurance company which had less than \$5 million in capital. The Board of Directors' conclusion in this regard is supported by language in the legislative history of Title III, which indicates a Congressional intent to authorize the Mortgage Corporation to allow participation by private mortgage insurance companies in the Mortgage Corporation's secondary market operations "under terms and conditions that require sound and ethical practices." 1970 U.S. Code Cong. and Admin. News 3537 (1970). This statement does not indicate any Congressional concern that the Mortgage Corporation's secondary market activities be restricted in any way by the requirements of State law. As discussed in detail subsequently in this Decision, the Mortgage Corporation's secondary market activities might well be throttled

if the securities which it was attempting to sell were supported by private mortgage insurance written by companies with inadequate capitalization. A Congressional intent to hamstring the Mortgage Corporation's secondary market activities will not be lightly inferred.

Finally, if there were doubt remaining on the extent of the Mortgage Corporation's authority in this area, it would be resolved by the specific Congressional directive that the "powers and functions of the [Mortgage Corporation] and its Board of Directors shall be exercisable, and the provisions of this chapter shall be applicable and effective, without regard to any other law. . . ." 12 U.S.C. 1459. The word "law" is defined elsewhere to include "any law of the United States or of any State (including any rule of law or equity)." 12 U.S.C. 1451(c). This language, in the Board of Directors' view, is dispositive of the argument that the Mortgage Corporation is not completely free to set its own minimum capital requirements, and is bound by the law or practice of any State in this regard. The only restriction on the authority of the Mortgage Corporation to set such a requirement is that it not act in an arbitrary and capricious manner and we now turn to this issue.

V. The Reasonableness of
the \$5 Million Minimum
Capital Requirement

For practical business reasons, the Mortgage Corporation is not free to set whatever minimum capital requirement it believes might be appropriate. Rather, the amount of said requirement is dictated largely by the Mortgage Corporation's need to have its securities find a ready acceptance in the capital market. Accordingly, the Board of Directors believes that the minimum capital requirements set by various State laws are not germane to the reasonableness of

the Mortgage Corporation's standard, since State authorities are not primarily concerned with selling debt obligations to private institutional investors, as is the Mortgage Corporation.^{2/}

The Mortgage Corporation was organized with relatively little capital (\$100,000,000) in relation to its needs, which are in the billions (Tr. 8-22).^{3/} Accordingly, the Mortgage Corporation is not in a position simply to buy mortgages and hold them in its own portfolio (Tr. 8-70). In order to fulfill its role as a prime supplier of capital to help satisfy, to the extent possible, the nation's housing needs, the Mortgage Corporation is forced to turn to the capital markets. To raise substantial amounts of capital, the Mortgage Corporation must convince institutional investors, and the Wall Street investment bankers upon whom they rely for advice, that the Mortgage Corporation securities are of unquestionable quality. For these private institutional investors or Wall Street investment bankers even to question the Mortgage Corporation's securities would probably be fatal to the Mortgage Corporation's hopes of raising large volumes of capital at favorable interest rates, or raising an adequate amount of capital at any price (Tr. 8-10, 40, 43, 48-51, 70).

Uncontradicted testimony at the hearing established that Wall Street investment bankers, when considering the purchase of securities such as those to be issued by the Mortgage Corporation or advising their clients to purchase such securities, look primarily

2/ Statutory authority for the Mortgage Corporation to borrow funds in the capital market is set forth specifically at 12 U.S.C. 1455(a), which authorizes the Mortgage Corporation, "upon such terms and conditions as it may prescribe, to borrow, to give security, to pay interest or other return, and to issue notes, debentures, bonds, or other obligations, or other securities. . . . The legislative history indicates that Congress intended to make the Mortgage Corporation "as much as possible [a] selle[r] as well as [a] purchase[r] of mortgages" and further intended that "the basic funds to be used [by the Mortgage Corporation] to purchase mortgages would be raised in the capital market . . ." 1970 U.S. Code Cong. and Admin. News 3496, 3497.

3/ "Tr." references are to the transcript of the hearings before the Presiding Officer.

to the equity behind the debt security. Ideally, the bankers would prefer a one to one equity to debt ratio (Tr. 8-30-32). Needless to say, this ideal cannot be achieved by the Mortgage Corporation, since the latter was chartered by Congress with capitalization of \$100,000,000 and hopes to raise billions of dollars in the capital market. To New York investment bankers, accustomed to dealing in hundreds of millions or even billions of dollars, a company with \$1 million of equity is, by comparison, microscopic and any attempts by the Mortgage Corporation to market securities which are guaranteed in part by private mortgage insurers with \$1 million equity capital or less would be doomed to failure (Tr. 8-26, 46-47, 73-74, 99-100). In fact, if the Mortgage Corporation were concerned solely with the marketability of its securities, it would set a minimum capital requirement of \$20-25 million for private mortgage insurers (Tr. 8-54, 59-60). The Mortgage Corporation has concluded, however, that while a \$20-25 million requirement would make these securities more attractive, it might at this time unduly hinder access to the market by new private mortgage insurers. Hence, \$5 million is a compromise figure, which, the Mortgage Corporation believes, will permit expansion in the number of private mortgage insurers while at the same time convincing institutional investors and their investment advisors that the Mortgage Corporation's securities constitute a safe and stable investment (Tr. 8-60, 100). 4/

Unchallenged testimony further established that investment bankers, whose support is vital to the Mortgage Corporation's ability to raise funds, will not take the time to analyze the strength of each private mortgage insurer qualified by the Mortgage Corporation but will examine closely the minimum capitalization established as a prerequisite to qualification

4/ The guaranteed mortgage certificates currently marketed by the Mortgage Corporation are guaranteed by the Mortgage Corporation itself and the strength of the private mortgage insurers who are in effect underwriting a portion of the securities is not a factor in their marketability. However, when the Mortgage Corporation markets securities which lack a Mortgage Corporation guarantee, the capitalization of the qualified private mortgage insurers is crucial to acceptance of the securities (Tr. 8-34-35, 45-46, 126).

(Tr. 8-34-35, 52, 130-131).5/ These bankers must be satisfied, without reservation, of the strength of the private mortgage insurance behind the securities. Without ready access to the capital markets, the Mortgage Corporation will be hampered seriously in carrying out its statutory goal of stabilizing the flow of funds into residential housing by transferring large sums of money from areas of capital surplus to areas where shortages of capital exist and by attracting funds to residential housing which traditionally have been invested elsewhere (Tr. 7-105, 8-62-66, 9-34-35).

In light of all the foregoing factors, the Board of Directors has concluded that the Mortgage Corporation's \$5 million minimum capital requirement is wholly reasonable and appropriate.6/

5/ Needless to say, the unwillingness of the investment community to analyze the strengths and weaknesses of private mortgage insurers on an individual basis substantially undermines Mid Atlantic's argument that its own, somewhat unique, assets justify its inclusion as a qualified insurer. These arguments will be discussed in detail infra.

6/ The Presiding Officer apparently relied, in reaching his recommendations, on what he believed was a "concession" by Mid Atlantic that a minimum capital requirement of \$2 million, as the State of California imposed, was reasonable and further found that Mid Atlantic had never come close to meeting even this California standard (Presiding Officer's Report, p.6). Mid Atlantic has pointed out (Exceptions to Presiding Officer's Report, No. 5) that its alleged "acceptance" of the California standard was made only in the context of its offer to reach a compromise and settlement with the Mortgage Corporation (see Mid Atlantic Exhibit No. 43). It is not without significance that Mid Atlantic's President acknowledged during the hearing that California's \$2 million minimum was "not an arbitrary requirement in California" (Tr. 5-28) but the matter is sufficiently ambiguous that the Board of Directors has determined to reject the Presiding Officer's finding that Mid Atlantic conceded the reasonableness of California's standard. The record is similarly ambiguous on the issue of whether or not the Maryland Savings Share Insurance Corporation (MSSIC) has adopted the \$5 million minimum capital requirement set by the Mortgage Corporation (see Presiding Officer's Report, p. 6, footnote 3) and the Board of Directors declines to adopt as its own the Presiding Officer's finding that the MSSIC has established a \$5 million minimum capital requirement (see Mid Atlantic Exceptions to Presiding Officer's Report, No. 7). The Board of Directors, however, believes that the record does support the Presiding Officer's finding (Presiding Officer's Report, p. 6, footnote 3) that the Federal National Mortgage Association (FNMA) has, since 1972, required that private mortgage insurers which do business with it be capitalized at no less than \$5 million. FNMA's policy in this regard is set forth in a letter from its Assistant General Counsel dated June 16, 1975 (Mortgage Corporation Exhibit No. 16). The Board believes that the FNMA policy set forth in said letter supports the Mortgage Corporation's minimum capital requirement.

* In reaching its conclusion on this point, the Board of Directors has given weight to the testimony of Dr. James Graaskamp * of the University of Wisconsin, whose expertise in the field of private mortgage insurance is unchallenged.^{7/} Dr. Graaskamp's testimony supported the position of the Mortgage Corporation that \$5 million was a reasonable minimum capital requirement; specifically, Dr. Graaskamp testified that a private mortgage insurer with only \$1 million in capital would be considerably less likely to survive under present adverse economic circumstances than a private mortgage insurer with \$5 million in capitalization (Tr. 10-40-58). Dr. Graaskamp also testified that, were the decision his to make, he would establish a minimum capital requirement of \$10 million for newly organized companies seeking to enter the private mortgage insurance field, so that the new insurers would have a sufficient cushion from their capitalization and from their investment income to protect them from the losses and mistakes inherent in the early months of their operations (Tr. 10-99, 150).

The Board of Directors believes that the failure of even one Mortgage Corporation-qualified private mortgage insurer could be catastrophic in its effect on the marketability of the Mortgage Corporation's securities. This conclusion is supported by the testimony of Stuart Coven, Chief Operating Officer of Suburban Savings and Loan Association, Wayne, New Jersey (Suburban), which

^{7/} The Board of Directors rejects without reservation the suggestion by Mid Atlantic (Mid Atlantic Exceptions to the Presiding Officer's Report, No. 17) that Dr. Graaskamp's testimony was motivated by his prejudice on behalf of existing private mortgage insurers. Without attempting to answer in detail all of Mid Atlantic's unsubstantiated allegations, the Board of Directors notes that Dr. Graaskamp's unchallenged testimony established, inter alia, that many prominent figures in the private mortgage insurance industry consider him "persona non grata", that no more than two percent of his total consultant fees for the previous year represented billings to that industry, and that he was philosophically opposed to fragmentation of the insurance industry among many very small companies (Tr. 10-141, 142, 144-146). In sum, the Board of Directors finds that the record clearly establishes Dr. Graaskamp's independence and integrity.

is active in the field of secondary markets for residential mortgages (Tr. 9-40, 41). Mr. Coven testified that he would not deal with a private mortgage insurer which lacked capitalization of at least \$10 million, in order to eliminate any doubt by Suburban's secondary mortgage customers about the soundness of the insurer (Tr. 9-8, 9, 14). Mr. Coven further stated, without substantial refutation, that in his opinion mortgages backed by a private mortgage insurer the size of Mid Atlantic would be unmarketable, even if Mid Atlantic were qualified by the Mortgage Corporation (Tr. 9-15, 16, 23). Moreover, he would not do business with a \$1 million insurer (regardless of how much confidence he had in the strength of that particular insurer) because such insurer's lack of adequate capitalization would almost surely make it impossible for Suburban to sell the mortgages. As Mr. Coven succinctly put it: ". . . I think our function is to sell our loans, not the PMI Companies." (Tr. 9-23).

VI. Mid Atlantic's Request
For Waiver of the Minimum
Capital Requirement

In support of its application to the Mortgage Corporation to waive its minimum requirement, Mid Atlantic has raised several arguments, which the Board of Directors will discuss in turn.

1. Mid Atlantic's quality approach: Mid Atlantic has indicated that it intends to pursue a highly critical underwriting policy and will insure only those mortgages which are virtually free from risk. This policy, Mid Atlantic argues, will assure its continued growth and vitality. The Board of Directors cannot agree that this policy will guarantee Mid Atlantic's success. In this regard, the Board of Directors was favorably impressed by the testimony of Dr. Graaskamp, who noted that it was unrealistic for a new private mortgage insurer to pursue a policy of insuring only the highest-quality mortgages, since mortgage insurers who consistently refuse to underwrite marginal loans provide little in the way of service for savings and loan associations and other mortgage

originators. These lenders occasionally, for business reasons, accept loans which involve a certain amount of risk and they look to private mortgage insurance for dispersion of such risks (Tr. 10-84). The Board of Directors agrees with Dr. Graaskamp that a newly organized private mortgage insurer using such a highly discriminating approach would find it difficult to break into the market, since established insurers already are willing to underwrite a certain amount of marginal loans for their customers (Tr. 10-86, 87).^{8/}

The Board of Directors rejects Mid Atlantic's contention (Exceptions to Presiding Officer's Report, No. 21) that the Mortgage Corporation has no legitimate reason to be concerned with Mid Atlantic's ability to attract customers. As noted above, the failure of even one Mortgage Corporation-qualified private mortgage insurer could be disastrous for the entire industry and the success and stability of every qualified private mortgage insurer is the concern of the Mortgage Corporation.

2. The Maryland Insurance Guarantee Association: Mid Atlantic has asserted that its relatively low capitalization may not validly be construed as an indication of lack of strength and stability because it is a member of the Maryland Insurance Guarantee Association (MIGA). The latter was created by the State of Maryland in 1971 in order to provide a mechanism for satisfying claims against insolvent insurers. MIGA has no funds of its own to satisfy claims against insolvent insurance companies; in the event of an insolvency, MIGA is authorized to assess all member companies in similar lines of insurance up to 2% of their premium

^{8/} Dr. Graaskamp testified without contradiction that most of the newly organized private mortgage insurers initially made their entry into the industry because of their willingness to provide insurance on loans which established insurers had turned down (Tr. 10-119).

volume for current and successive years until claims against the insolvent company are paid in full (Tr. 7-5-7). See Maryland Code Annotated, Art. 48A, Sections 504-519 (Supp. 1974). Generally, it is to be expected that a delay of 90 days following a judicial declaration of insolvency would ensue before MIGA would be in a position to pay claims against it (Tr. 7-15-22). ^{9/} Mid Atlantic has argued that its membership in MIGA provides a considerable degree of protection, over and above its own equity, to those who deal with it. For the following reasons, the Board of Directors has concluded that it has no alternative but to reject this argument.

At the hearing in this matter, considerable testimony was elicited from Mr. Murray K. Josephson, a member of the staff of the Maryland Attorney General, who was thoroughly familiar with MIGA's legal status. In general, Mr. Josephson testified that MIGA would pay claims in a situation in which the claimant was a resident of Maryland and that the Mortgage Corporation would not qualify as a Maryland resident since its situs is in the District of Columbia (Tr. 7-19). Of course, purchasers of insured mortgages from the Mortgage Corporation would similarly not qualify for MIGA protection in the event of Mid Atlantic's insolvency, unless said purchasers happened to be residents of Maryland.

In the alternative, MIGA will pay claims regardless of the residence of the claimant if the property from which the claim arises is "permanently located" in Maryland. However, Mr. Josephson testified, under Maryland law the insured property

^{9/} The testimony of Ronald D. Struck, an employee of the Mortgage Corporation, established that the 90 day (or longer) delay between the judicial declaration of an insolvency of a MIGA member and the payment of a claim by MIGA, coupled with the lack of interest paid to the holder of a mortgage during that period, would have a substantial and adverse impact upon the Corporation's sales of mortgage or mortgage related securities (Tr. 10-156-158).

in this event would not be the physical property on which the mortgage was originally granted, but rather the mortgage itself, which, of course, is portable and would not qualify for MIGA protection if it were transferred out of State. Specifically, if a mortgage on Maryland property were sold to an out-of-State resident, the situs of the "property" (that is the debt represented by the mortgage) would be deemed to be the residence of the purchaser. Accordingly, such property would no longer be located in Maryland and MIGA would have no responsibility to pay any claim made upon it which resulted from the insolvency of a private mortgage insurer (Tr. 7-19-21).

It necessarily follows that mortgages insured by a Maryland private mortgage insurer but purchased by an out-of-State entity such as the Mortgage Corporation, or a customer of the Mortgage Corporation, would lack MIGA protection, unless the Mortgage Corporation's customer chanced to be a Maryland resident. Accordingly, the Board of Directors concludes that the protection afforded by MIGA is largely illusory as far as the Mortgage Corporation is concerned.

Mr. Josephson has served for five years as counsel to the Maryland Insurance Commissioner; he participated in drafting MIGA's enabling legislation and his qualifications as an expert on this aspect of Maryland law were unchallenged (Tr. 7-3). The Board of Directors has placed great weight on his testimony, and we reject as wholly without merit Mid Atlantic's assertion that MIGA provides meaningful protection to non-Maryland residents or to property located outside the State of Maryland. The only evidence introduced by Mid Atlantic in support of this contention was its Exhibit No. 48, a document prepared by Mid Atlantic's President, who was not qualified as an expert in Maryland insurance law, as was Mr. Josephson.

3. Mid Atlantic's regional approach: Mid Atlantic proposes to limit its business to the State of Maryland and other areas in and around the District of Columbia. At present, however, Mid Atlantic is licensed to do business only in Maryland (Tr. 1-49, 148). Mid Atlantic has asserted that its localized approach will enable it to attract new business and service its customers more efficiently than a non-local insurer could do. For the reasons set forth below, the Board of Directors has concluded that Mid Atlantic's regional approach does not justify approval of its application for waiver of the minimum capital requirement. Dr. Graaskamp testified, persuasively in the opinion of the Board of Directors, that the Maryland area did not provide the necessary geographic diversity to allow for adequate risk spreading for private mortgage insurers, since any number of unforeseen economic consequences could adversely affect the Maryland economy and create serious problems for a private mortgage insurer whose policies were limited solely to Maryland property (Tr. 10-72-74). Dr. Graaskamp's testimony further establishes that no one can predict accurately the long-term stability of a geographically concentrated market area (Tr. 10-68, 69). The Board of Directors concludes, therefore, that the continuing vitality and growth of Mid Atlantic cannot be presumed from Mid Atlantic's policy of concentrating its activities in the Maryland area, notwithstanding that area's recent favorable claims and foreclosure history.

The Board of Directors similarly rejects as without merit Mid Atlantic's contention that a locally-oriented private mortgage insurer will be able to exercise greater control over

claims (see Dr. Graaskamp's testimony at Tr. 10-87-90).^{10/}

4. The Arthur D. Little study: Mid Atlantic has made much of a voluminous study of the private mortgage insurance industry by the firm of Arthur D. Little, Inc., which was sponsored, in part, by the Mortgage Corporation itself. In its Exceptions to the Report and Recommendation of the Presiding Officer (see Exception No. 34), Mid Atlantic advanced four major arguments based on the Arthur D. Little study (Little study): First, Mid Atlantic argues that the Little study praised MIGA as "one of the best" guarantee acts. The Board of Directors takes no position on the efficacy of MIGA in general, but notes that expert testimony, virtually unchallenged, developed at the hearing showed conclusively that MIGA would afford little or no protection to the Mortgage Corporation and those who purchased mortgages from it (see supra, pp. 12-15). The effectiveness of MIGA in other circumstances is not at issue herein. Second, Mid Atlantic contends that the Little study concluded that the 25 to 1 underwriting ratio followed by Mid Atlantic was a "sufficient limitation on capital to protect the solidity of private mortgage insurance companies. . . ." In that context, the Board of Directors notes that the conclusions in the Little study regarding the safety of the 25 to 1 underwriting ratio were based entirely on simulations

^{10/} Mid Atlantic argued before the Presiding Officer that the Mortgage Corporation had discriminated against it, in that it had granted qualification to other private mortgage insurers which had less than \$5 million capitalization. In this regard, the Board has fully considered Exception No. 13 filed by Mid Atlantic together with section 6 of the Presiding Officer's Report and Recommendation. The Board herewith adopts section 6 of said Report as its own and incorporates said section 6 herein by reference. Regarding the Mortgage Corporation's approval of Ticor Mortgage Insurance Company of Georgia (Ticor-Georgia) as a qualified mortgage insurer, the Board of Directors rejects as unfounded Mid Atlantic's allegations that said approval was improper because at the time of said approval Ticor-Georgia was a "shell" corporation organized to evade California law. The Board of Directors has concluded that Mortgage Corporation Exhibit No. 38 establishes that Ticor-Georgia was not permitted to underwrite any policies until it was adequately staffed and that no violation of California law was involved.

involving private mortgage insurers with more than \$20 million in capital; that aspect of the Little study is, therefore, scarcely germane to Mid Atlantic's position (Tr. 6-168,169, 7-84-85). In any event, the \$5 million minimum capital requirement is not based entirely on the Mortgage Corporation's concern that an insurer capitalized at less than that amount would fail, but principally on the Mortgage Corporation's conclusion that the Wall Street investment bankers and institutional investors to whom it must look for billions of dollars in capital will refuse to deal in Mortgage Corporation securities unless the mortgage insurance supporting these securities is written by insurers capitalized at no less than \$5 million. 11/ The latter point, in the opinion of the Board of Directors, is dispositive of Mid Atlantic's third argument, namely, that the Little study illustrates that Mid Atlantic would not fail, but would be "extremely successful in just a few years." Mid Atlantic's fourth argument deals with investment strategy, a matter not at issue herein.12/

For the foregoing reasons, the Board of Directors finds that there is no merit to any of Mid Atlantic's contentions in support of its application for waiver of the \$5 million minimum capital requirement, and hereby rejects said application for waiver.

11/ The Board finds merit in Exception No. 3(c) of the Exceptions to the Presiding Officer's Report filed by Mid Atlantic and notes that the statement at page 5, footnote 2 of the Presiding Officer's Report to the effect that the Mortgage Corporation has purchased relatively few mortgages with a loan-to-value ratio greater than 80% is erroneous. In fact, as Mid Atlantic's exceptions note, approximately 2/3 of the loans purchased by the Mortgage Corporation are supported in part by private mortgage insurance. The Board of Directors views this error in the Presiding Officer's Report to be inadvertent and without significance.

12/ It is undisputed that the Little study was prepared with no "relevance to the [Mortgage] Corporation's marketing activities" (Tr. 8-121).

VII. Competition in the Private
Mortgage Insurance Industry

For the reasons set forth below, the Board of Directors rejects the suggestion that the Mortgage Corporation's \$5 million capital entry requirement constitutes an illegitimate and anti-competitive barrier to the entrance of new firms to compete in the private mortgage insurance industry. Evidence developed at the hearing indicates that the market share of the four largest mortgage insurance firms in the country declined from 1970 to 1973 and that, since adoption of the Eligibility Requirements in 1971 by the Mortgage Corporation, four additional unaffiliated insurers have received Mortgage Corporation qualification (Mortgage Corporation Exhibits 27, 29, Tr. 8-164, 170). The entry of these four companies represents a 50% increase in the number of competitors in the private mortgage insurance field. While the four largest companies in this field in 1973 still held 91.04% of the market, their share of the market had shrunk approximately 4.5% since 1971 (Mortgage Corporation Exhibit 29, Tr. 8-170). These facts indicate that there is a trend in the private mortgage insurance industry toward greater competition. In any event, the pattern of entry into the private mortgage insurance industry following the adoption of the Mortgage Corporation's Eligibility Requirements indicates that these requirements do not constitute a substantial barrier to entry or hindrance to competition in this industry (Mortgage Corporation Exhibit 27, Tr. 8-164-168).

The Board of Directors welcomes new firms into this field, and believes that it is in the interest of the industry, as well as in the public interest, that competition in the private mortgage insurance industry be increased. The Board of Directors must, however, be concerned with the financial stability and health of private mortgage insurers, whose strength and vitality is essential

to the task of the Mortgage Corporation in raising funds to satisfy the nation's housing needs. While the Board of Directors believes that healthy competition is in the public interest, it must adhere to the view that Mortgage Corporation eligibility should be limited to qualified firms, and that the \$5 million capital requirement is a reasonable prerequisite to Mortgage Corporation qualification. Evidence developed in this cause clearly establishes that the \$5 million minimum capital requirement for Mortgage Corporation qualification was established and continues to be enforced solely to enable the Mortgage Corporation to fulfill its mission, and not to prevent increased competition in the private mortgage insurance industry. See supra, pp. 7-8, for discussion of the fact that the \$5 million requirement was the lowest possible figure, consistent with the Mortgage Corporation's commitment to raise vast sums of money from private institutional investors.

VIII. Order

For the reasons set forth in the Decision, the Board of Directors hereby orders that the application by Mid Atlantic for approval as an eligible private mortgage insurer under section 110 of the Mortgage Corporation's Eligibility Requirements be denied; and the Board of Directors further orders that the application by Mid Atlantic for waiver of the minimum capital requirement of section 130.1 of the said Eligibility Requirements be denied.

Dated: November 18, 1975

By Direction of the Board of Directors
of the Federal Home Loan Mortgage
Corporation


J. J. Finn
Secretary

FEDERAL HOME LOAN MORTGAGE CORPORATION

No. MC 75-48

DATE: November 18, 1975

WHEREAS, the Board of Directors of the Federal Home Loan Mortgage Corporation (Mortgage Corporation) has adopted Eligibility Requirements for Private Mortgage Insurers which provide that the Board shall determine whether and under what terms and conditions a mortgage insurer would be deemed an eligible mortgage insurer for the purposes of Section 305(a)(2) of the Federal Home Loan Mortgage Corporation Act; and

WHEREAS, the Board of Directors considered an application for a waiver from the minimum capital requirements of Section 130.1 of said Eligibility Requirements and an application for approval as an eligible private mortgage insurer pursuant to Section 110 of the said Eligibility Requirements, both of which were submitted by Mid-Atlantic Mortgage Insurance, Inc. (Mid-Atlantic); and

WHEREAS, by Resolution MC 75-13, dated March 13, 1975, the Board of Directors denied the said application for waiver and application for approval; and

WHEREAS, Mid-Atlantic requested the Board of Directors to reconsider its action reflected by Resolution MC 75-13, dated March 13, 1975; and

WHEREAS, the Board of Directors reconsidered its denial of March 13, 1975, and by Resolution MC 75-14, dated April 10, 1975, again denied said application for waiver and application for approval; and

WHEREAS, Mid-Atlantic Mortgage Insurance, Inc. by letter dated April 10, 1975, requested, pursuant to Sections 110 and 190 of said Eligibility Requirements, that a hearing be conducted pursuant to Section 210 of said Eligibility Requirements with regard to the denial of the application for approval pursuant to and the denial of the application for waiver of said Eligibility Requirements; and

WHEREAS, pursuant to Section 210 of said Eligibility Requirements, the Board of Directors granted the request for hearing and designated a presiding officer to conduct such hearing; and

WHEREAS, said hearing commenced on June 9, 1975, and concluded on June 24, 1975; and

WHEREAS, on October 6, 1975, the presiding officer certified to the Board of Directors the entire record of the hearing, including his recommended decision; and

FEDERAL HOME LOAN MORTGAGE CORPORATION

NO. MC 75-48

PAGE TWO

WHEREAS, the Board of Directors has considered the entire record in this matter, including all exceptions filed by the parties to the presiding officer's recommended decision; and

WHEREAS, the Board of Directors has determined to deny the applications of Mid-Atlantic for approval as an eligible private mortgage insurer under Section 110 of the Eligibility Requirements for Private Mortgage Insurers and for waiver of the \$5 million minimum capital requirement established by Section 130.1 of said Requirements; and

WHEREAS, the Board of Directors has directed that a written Decision be drafted setting forth the reasons for the denial by the Board of Directors of the aforesaid applications of Mid-Atlantic:

NOW, THEREFORE, BE IT RESOLVED, that the aforesaid Decision be, and it hereby is, approved and adopted by the Board of Directors, and the release of said Decision is hereby authorized; and

IT IS FURTHER RESOLVED, that the Secretary of the Mortgage Corporation be, and he hereby is, directed to serve said Decision upon counsel for Mid-Atlantic and the Mortgage Corporation.

By the Board of Directors


J. S. Finn
Secretary



Federal Home Loan Mortgage Corp.

311 first street, n. w. ■ washington, d. c. 20001 ■ (202) 624-7000

July 7, 1975

Dr. James A. Graaskamp
Landmark Research
202A Breese Terrace
Madison, Wisconsin 53705

Dear Jim:

Enclosed please find our check in payment of your invoice dated June 25, 1975. I have already paid James Hickman and will pay the other billings when available.

I would like to thank you again for your work and help on this matter. I hope to play with our new toy after I get some time available.

Very truly yours,

A handwritten signature in cursive script, appearing to read 'Stan'. The ink is dark and the strokes are fluid.

Stanley F. Rodbell
Associate General Counsel

SFR:blp

Enclosure

Cadwalader, Wickersham & Taft

*1000 Connecticut Avenue
Washington, D. C. 20036*

Telephone: (202) 659-4700

August 18, 1975

WASHINGTON PARTNERS
H. CLAYTON COOK, JR.
ROBERT T. LASKY
STEPHEN N. SHULMAN

NEW YORK PARTNERS
JACK ADELMAN
JOHN BOYER
PETER MEGARGEE BROWN
WILLIAM N. CLARKE
RODNEY S. DAYAN
DANIEL C. DRAPER
STEVE C. DUNE
DAVID W. FEENEY
P. JAY FLOCKEN
JOHN F. FRITTS
TERENCE F. GILHEANY
STEPHEN P. GOTTLIEB
GRANT B. HERING
LEONARD E. KUST
ROBERT C. LAWRENCE III
JAY H. MCDOWELL
WILLIAM J. MOSS
HORACE P. MOULTON
JOHN J. O'GRADY III
ROY ALBERT POVELL
GEORGE D. REYCRRAFT
HADLEY S. ROE
HAVEN C. ROOSEVELT
STUART D. ROOT
JEROME SHELBY
JOHN A. SULLIVAN
JACQUELIN A. SWORDS
RICHARD T. TAYLOR
COURTLAND W. TROUTMAN
JOHN J. WALSH
ARNOLD J. ZURCHER, JR.

HAROLD W. CONROY
RICHARD N. CROCKETT
HENRY ALLEN MARK
CHARLES W. McCONAUGHY
COUNSEL

ONE WALL STREET
NEW YORK, N.Y. 10005
TELEPHONE: (212) 763-1000
CABLE ADDRESS: LABELLUM
TELEX: 12 0146

DOWGATE HILL HOUSE
DOWGATE HILL
LONDON EC4R 2SU, ENGLAND
TELEPHONE: 01-236-6378/9

Dr. James A. Graaskamp
202A Breese Terrace
Madison, Wisconsin 53705

Dear Jim:

I want to thank you personally for appearing as a witness at the hearing. I assume the Corporation has already thanked you as well in a more tangible and useful manner.

In anticipation of the possibility of further litigation, the Corporation would like to retain you to make some refinements to the density model already prepared. When you testified concerning the model, you indicated that certain assumptions had been made which favored the \$1 million capitalized insurer. The Corporation would like to revise the program for the model to eliminate these assumptions and instead employ a program which more accurately reflects the experience of a typical private mortgage insurer. With the model so revised, we would then appreciate computer runs similar to those utilized at the hearing.

Specifically, I would think that the following modifications to the program would be appropriate.

1. The model assumed that each insurer wrote at capacity from the commencement of operations. I suggest the model be modified to reflect the normal level of business buildup. To my knowledge, no recently organized mortgage

Dr. James A. Graaskamp
August 18, 1975
Page Two

insurer has reached capacity even during the first several years of operations. I leave to you the selection of the appropriate levels of business generated, which I assume will represent a composite of the results achieved by several insurers.

2. The model assumed that claims occurred equally in each quarter. However, especially with the increasing level of 95's, I understand that claims will bunch in the earlier years. Again, could you modify the model to reflect a composite of the actual experience of a typical mortgage insurer.

3. You anticipated that the second quarter 1975 claims experience would show an increased level of claims as opposed to the first quarter of 1975. Could you modify the model to reflect second quarter experience. I assume the appropriate modification would be to base claims data on the aggregate results for the first six months of this year.

While I can think of no further, helpful modifications to the model, please let me know if you have any suggestions. I would also appreciate receiving an estimate of the approximate cost of the modifications and some idea of approximately when the completed computer runs would be available.

Again, thank you.

Sincerely yours,



Robert T. Lasky

UNIVERSITY OF WISCONSIN-MADISON

GRADUATE SCHOOL OF BUSINESS

1155 Observatory Drive
Madison, Wisconsin 53706



December 26, 1975

MEMORANDUM

TO: David Dykstal

FROM: James A. Graaskamp

RE: Further Modification of Guaranty Model

Robert Lasky has asked us to add another feature. Rather than a fixed ratio of liability to capital of 25-1 (which is then multiplied by 5 to show liability as 20% of mortgage balance in the model for a factor of 125), he would like the ratio to be an input variable and conditional on policy holder surplus in any quarter. For example:

Policy Holder Surplus Range	Ratio of Maximum Liability to Policy Holder Surplus Including Contingency Reserve
\$2 million or less	15:1
2 - 2.5 m	17:1
2.5 - 3 m	20:1
3 - 3.5 m	21:1
3.5 - 4 m	22:1
4 - 4.5 m	23:1
4.5 - 5 m	24:1
5 m or more	25:1

I am sure I sent Bob Knitter or the computer center a new deposit for Landmark Research but in case I didn't, I have enclosed a \$100 check for deposit to Landmark Research, Inc.

check enclosed separately

Cadwalader, Wickersham & Taft

WASHINGTON PARTNERS
H. CLAYTON COOK, JR.
ROBERT T. LASKY
STEPHEN N. SHULMAN

NEW YORK PARTNERS
JACK ADELMAN
JOHN BOYER
PETER MEGARGEE BROWN
WILLIAM N. CLARKE
RODNEY S. DAYAN
DANIEL C. DRAPER
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JOHN F. FRITTS
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WILLIAM J. MOSS
HORACE P. MOULTON
JOHN J. O'GRADY III
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GEORGE D. REYCRAFT
HADLEY S. ROE
HAVEN C. ROOSEVELT
STUART D. ROOT
JEROME SHELBY
JOHN A. SULLIVAN
JACQUELIN A. SWORDS
RICHARD T. TAYLOR
COURTLAND W. TROUTMAN
JOHN J. WALSH
ARNOLD J. ZURCHER, JR.

*1000 Connecticut Avenue
Washington, D. C. 20036*

Telephone: (202) 659-4700

August 25, 1975

HAROLD W. CONROY
RICHARD N. CROCKETT
HENRY ALLEN MARK
CHARLES W. McCONAUGHY
COUNSEL

ONE WALL STREET
NEW YORK, N.Y. 10005
TELEPHONE: (212) 785-1000
CABLE ADDRESS: LABELLUM
TELEX: 12-9146

DOWGATE HILL HOUSE
DOWGATE HILL
LONDON EC4R 2SU, ENGLAND
TELEPHONE: 01-236-6378/9

Dr. James A. Graaskamp
202A Breese Terrace
Madison, Wisconsin 53705

Dear Jim:

Thank you for your prompt reply. Both the time schedule and the budget you propose are acceptable. This letter thus constitutes your authorization to undertake the project.

As to using the material for an article, I would think that the Corporation would have no objection after the completion of the litigation. However, completion may be several years hence and there is always the possibility of litigation raising similar issues instituted by other non-approved private mortgage insurers. I would like to postpone the decision on the use of the materials for academic purposes until the situation can be better evaluated.

Sincerely yours,



Robert T. Lasky

Cadwalader, Wickersham & Taft

*Eleven Dupont Circle
Washington, D. C. 20036*

Telephone: (202) 387-8100

October 29, 1975

WASHINGTON PARTNERS
H. CLAYTON COOK, JR.
ROBERT T. LASKY
STEPHEN N. SHULMAN

NEW YORK PARTNERS
JACK ADELMAN
JOHN BOYER
PETER MEGARGEE BROWN
WILLIAM N. CLARKE
RODNEY S. DAYAN
DANIEL C. DRAPER
STEVE C. DUNE
DAVID W. FEENEY
P. JAY FLOCKEN
JOHN F. FRITTS
TERENCE F. GILHEANY
STEPHEN P. GOTTLIEB
GRANT B. HERING
LEONARD E. KUST
ROBERT C. LAWRENCE III
JAY H. McDOWELL
WILLIAM J. MOSS
HORACE P. MOULTON
JOHN J. O'GRADY III
ROY ALBERT POVELL
GEORGE D. REYCRRAFT
HADLEY S. ROE
HAVEN C. ROOSEVELT
STUART D. ROOT
JEROME SHELBY
JOHN A. SULLIVAN
JACQUELIN A. SWORDS
RICHARD T. TAYLOR
COURTLAND W. TROUTMAN
JOHN J. WALSH
ARNOLD J. ZURCHER, JR.

DONALD I. BAKER
SPECIAL COUNSEL

HAROLD W. CONROY
RICHARD N. CROCKETT
HENRY ALLEN MARK
CHARLES W. McCONAUGHY
COUNSEL

ONE WALL STREET
NEW YORK, N. Y. 10005
TELEPHONE: (212) 785-1000
CABLE ADDRESS: LABELLUM
TELEX: 12-9148

DOWGATE HILL HOUSE
DOWGATE HILL
LONDON EC4R 2SY, ENGLAND
TELEPHONE: 01-236-6378/9
TELEX: 885935

Dr. James A. Graaskamp
Landmark Research, Inc.
202A Breese Terrace
Madison, Wisconsin 53705

Dear Jim:

As you will hopefully recall, I wrote you on August 18, 1975 to retain Landmark to perform additional work on private mortgage insurance capital requirements. Your August 22 reply accepting the project suggested a completion date of the end of October "at the very latest."

The additional work has now become a matter of some urgency. Another private mortgage insurer with less than \$5 million in capital has applied for a waiver. Your work would be extremely helpful in evaluating this application. I would appreciate a collect telephone call as to when we might have the results of the new computer runs. If at all possible, results by November 10 would be most desirable.

It will presumably come as no surprise that the Hearing Officer recommended that Mid Atlantic's waiver request be denied and that his recommended decision placed considerable emphasis upon your testimony.

Sincerely yours,



Robert T. Lasky