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August 1, 2011

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Docket No. R-1411

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File Number S7-14-11

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RIN 2590-AA43

Re: Credit Risk Retention proposed rules

Ladies and Gentlemen,

Thank you for the opportunity to comment on the proposed rules to implement the credit risk retention requirements of section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Experian shares the concern that insufficient alignment of the interests of securitizers and/or originators with those of investors may lead to poor quality of underwriting and monitoring of the underlying securitized assets, which may in turn contribute to excessive risk and instability in the financial system, housing markets, and ultimately the economy as a whole. The underwriting and monitoring functions of banks and other financial institutions are central to the value of their economic role: gathering and assessing information for lending opportunities when that information is private or too costly per unit size to be gathered effectively or efficiently by capital markets. Providing the data and analytical tools to help banks and other financial institutions make the best possible underwriting and account management decisions is at the core of Experian's mission.

Experian agrees that partial risk retention requirements as proposed may help better align the interests of the securitizer and/or originator with investors and encourage better underwriting

and monitoring. However, as explained in a subsequent section of this letter, Experian is concerned that the proposed options for partial risk retention structures still provide a “race-to-the-bottom” incentive inherent in the optionality of transferring underwriting risk into a senior/subordinate structure.

Accordingly, Experian proposes a more effective alternative risk retention structure that uses industry-wide loan performance indices to isolate a securitized pool’s specific underwriting risk from the general systematic economic risk that all pools of loans face regardless of underwriting quality. Full retention of this underwriting risk by the securitizer and/or originator and full transfer of the systematic risk to capital markets not only aligns interests perfectly, but creates a virtuous circle of incentives for each securitizer and/or originator towards outperformance in underwriting and monitoring, thus improving the quality of the entire loan population. Experian believes this proposal strikes the right balance between assuaging securitization investor concerns about underwriting quality and maintaining the economic viability of securitizations as a means of financing and risk transfer for securitizers and/or originators. Finding this balance is critical to re-establishing the securitization market, which in turn is a prerequisite to eventually transitioning the mortgage finance system to greater reliance on the private market rather than government-backed entities. Further details, rationale and benefits of this proposed underwriting risk retention structure are expanded in a subsequent section of this letter.

Further, Experian agrees with the principles underlying the proposed rules prohibiting hedging to evade credit risk retention, as well as with the proposed exemption for indices other than those based on underlying assets consisting of too great a proportion of the securitized assets themselves. Indeed, such index-based hedging should be heavily encouraged to the extent that it can be used to isolate and retain a loan pool’s specific underwriting risk separated from systematic economic risk, for the reasons outlined above.

The remainder of this letter is organized into three sections:

- Fundamental misalignment of incentives in the proposed risk retention structures
- Experian’s proposed alternative underwriting risk retention structure
- Responses to specific questions posed in the request for comment to the proposed rules

***Fundamental misalignment of incentives in the proposed risk retention structures: race-to-the-bottom effect of the “underwriting put”***

When the securitizer and/or originator retains the upside on a securitized pool of assets but partially transfers the downside to investors, they have effectively acquired a put on the performance of the pool. To the extent that the pool performance is driven by general economic conditions (unemployment rates, home prices, etc.) beyond the control of the securitizer and/or originator, this put on pool performance can be assessed and priced into the spread by prospective noteholders. However, pool performance is also a function of underwriting and monitoring which is within the control of the securitizer and/or originator, such that the value of the put, unlike a traditional option, can be maximized by the actions of its owner. Risk retention may give the securitizer and/or originator “skin in the game”, but they are still long the underwriting put.

The put is obvious in case of a “horizontal” first-loss risk retention: because the retained interest does not bear risk beyond its exhaustion point, the cost of increasing that risk is incrementally

free and attractive if riskier mortgages are commensurately more profitable. The put is more subtle in a “vertical” pro-rata risk retention: it is struck at zero with respect to the first-loss tranche – and therefore even more valuable in proportional terms, though reduced pro-rata by the retained slice – so long as the securitizer and/or originator is able to capture the incremental profitability, e.g. through higher upfront fees or points to the borrower (if other means such as gain on sale, higher servicing fees, etc. are prevented). So long as the outcomes are asymmetric to the securitizer and/or originator, the incentive to skew the positive outcomes with riskier mortgages remains in place. Thus, horizontal or vertical risk retention may decrease the value of the put by moving the strike out or reducing the quantity, but cannot eliminate it unless the size of retention is large enough to render the value of the put immaterial. It is worth noting that 5% is considerably less than the loss suffered during the recent financial crisis on many RMBS pools and certain segments of the GSE’s portfolios, so the optionality embedded in the risk retention structures is by no means deeply “out-of-the-money”.

In option terms, the securitizer and/or originator partly controls the volatility of the underlying asset by choosing its composition, and may seek to maximize the option value by increasing that volatility. In practice, this may take the straightforward form of composing a pool so as to maximize the difference between the portfolio yield and the expected cost of financing via the securitization structure. In an efficient market, investors should price the incremental cost of this underwriting put into the spread required to sell the notes, based on some expectation of adverse pool composition. This of course increases the securitization’s overall cost of financing, forcing the securitizer and/or originator to seek even higher yielding, riskier mortgages in order to make the economics of the deal work. The expected outcome of such a race to the bottom is the worst possible pool of assets that meets (or appears to meet) the selection criteria for the deal.

If investors cannot rely on risk retention to eliminate the incentive of the securitizer and/or originator to favor higher yielding assets without fully-aligned consideration of quality and risk, they are forced to attempt to evaluate and mitigate against poor quality of origination by performing loan-level due diligence themselves. Enhanced transparency and disclosure is unquestionably better for markets, but the potentially duplicative process of essentially re-underwriting loans clearly adds costs that erode the relative financial attractiveness of securitizations, and may not even be effective at mitigating poor quality originations. Even with full disclosure of loan-level underwriting data and strong contractual and procedural assurances that originated loans meet underwriting criteria, poorer than expected performance may result from a variety of less tangible factors not reflected in quantifiable loan-level characteristics or underwriting criteria, such as:

- origination channel, marketing and selection approach;
- product offerings susceptible to adverse selection;
- customer goodwill and depth of banking relationship; and,
- mortgage servicing techniques and intensity.

It is also worth noting that while risk retention may shift a substantial portion of the credit risk of securitized assets from investors to the securitizer and/or originator, it obviously does not make the credit risk disappear. Even if the retention of a horizontal or vertical layer of credit risk improves the alignment of interests and provides some incentives for better underwriting and monitoring, the retained credit risk will contain significant systematic economic risks that may be correlated to the systematic risks inherent in financial institutions’ portfolios. This in turn

exacerbates the already problematic exposure to systematic economic risk faced by the FDIC or other government-backed resolution mechanisms (another embedded put option, on the value of a financial institution's asset portfolio, struck at the point where capital is depleted). It is not at all clear that the value of better aligned underwriting incentives outweighs the harm of shifting significant systematic economic risks out of capital markets and into the banking system.

### ***Underwriting Risk Retention***

Mortgage finance reform presents fundamentally challenging tensions for regulators seeking to simultaneously balance and optimize concerns of macro-prudential regulation, investor protection, economic efficiency, and consumer welfare. On the one hand, we want mortgage loans to be widely accessible, especially to consumers traditionally underserved by the financial system. On the other hand, we do not want loans which are too risky to be underwritten. We want banks to retain more of their risk to promote accountability, but we do not want the capital requirements of holding this risk on bank balance sheets to make mortgage rates too expensive. And fundamentally we face the fact that the mortgage market significantly exceeds the financial sector's potential capacity for both funding and capital, so capital markets (whether accessed directly through securitizations or indirectly through Government Sponsored Entities) are a necessary source of finance and risk transfer for the mortgage market. The root cause of these conflicting objectives is that loans bundle multiple types of risk and financing needs that are each appropriate to different participant in the financial system.

Every loan bundles two "bets":

- **Underwriting risk** – that the loan was underwritten well and will perform as expected (at a pool-level) given macroeconomic conditions and the performance of the overall loan population; and
- **Systematic economic risk** – that economic conditions do not worsen and adversely impact pool performance for all loans, whether underwritten well or not.

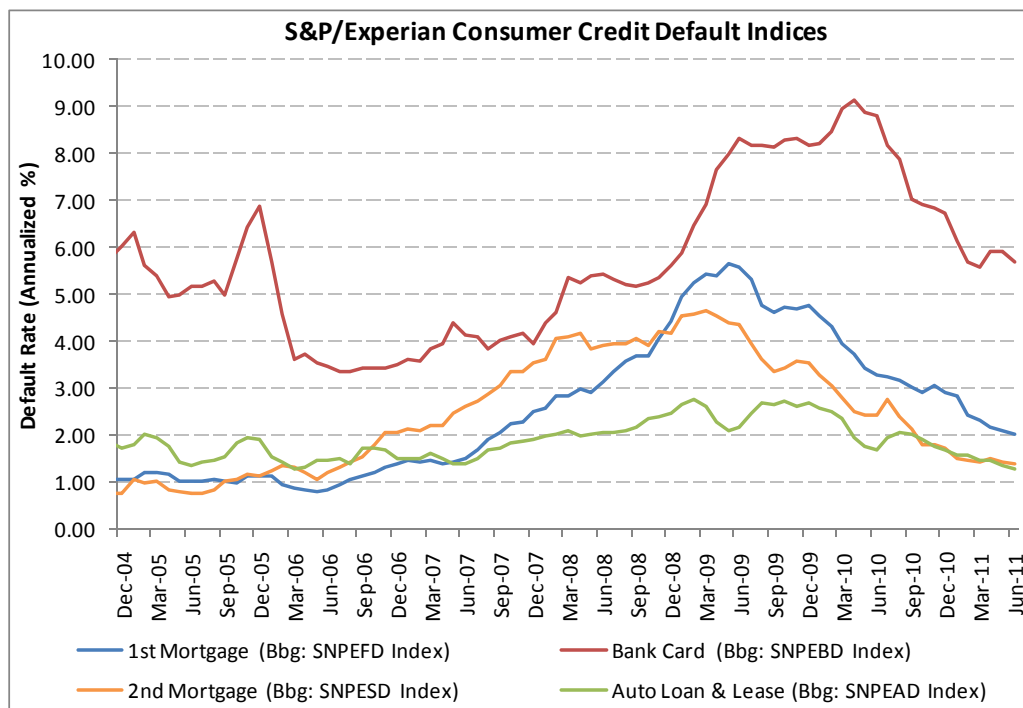
Underwriting risk is obviously most appropriately borne by the securitizer and/or originator, both for accountability and alignment of interests, as well as market efficiency. Capital markets are more efficient bearers of risk than financial institutions when information is transparent and widely available at low cost, and the unit size of homogenous or equivalent exposures provides sufficient depth for liquid markets. While the underwriting risk inherent in consumer loans is not appropriate for capital markets, their systematic economic risk is exactly the type of risk that should be transferred to capital markets. So the conundrum is that these two bundled risks optimally reside with different participants in the financial system.

Fortunately, the underwriting risk and systematic economic risk in a pool of loans can be unbundled using indices representing the performance of a broad market basket of loans in the corresponding category. The family of S&P/Experian Consumer Credit Default Indices<sup>1</sup> (see

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<sup>1</sup> The S&P/Experian Consumer Credit Default Indices measure the balance-weighted proportion of consumer credit accounts in the U.S. that go into default for the first time each month. The indices are calculated from data representing a consistent random sample of consumers, extracted from Experian's consumer credit database as of the archival date on the last Saturday of each month, and published on the third Tuesday of the following month. Default is defined as 90 days past due or worse status (including write-off, bankruptcy, foreclosure or repossession), except for open-end revolving bank card products for which default is defined as 180 days past due

chart below) is one example of such indices; other indices may also be appropriate depending on how loan performance metrics are defined, robustness of calculation methodology and data sources, frequency and timeliness publication, etc. The difference between the index and pool loss rates is underwriting risk; the index primarily reflects systematic economic risk<sup>2</sup>.



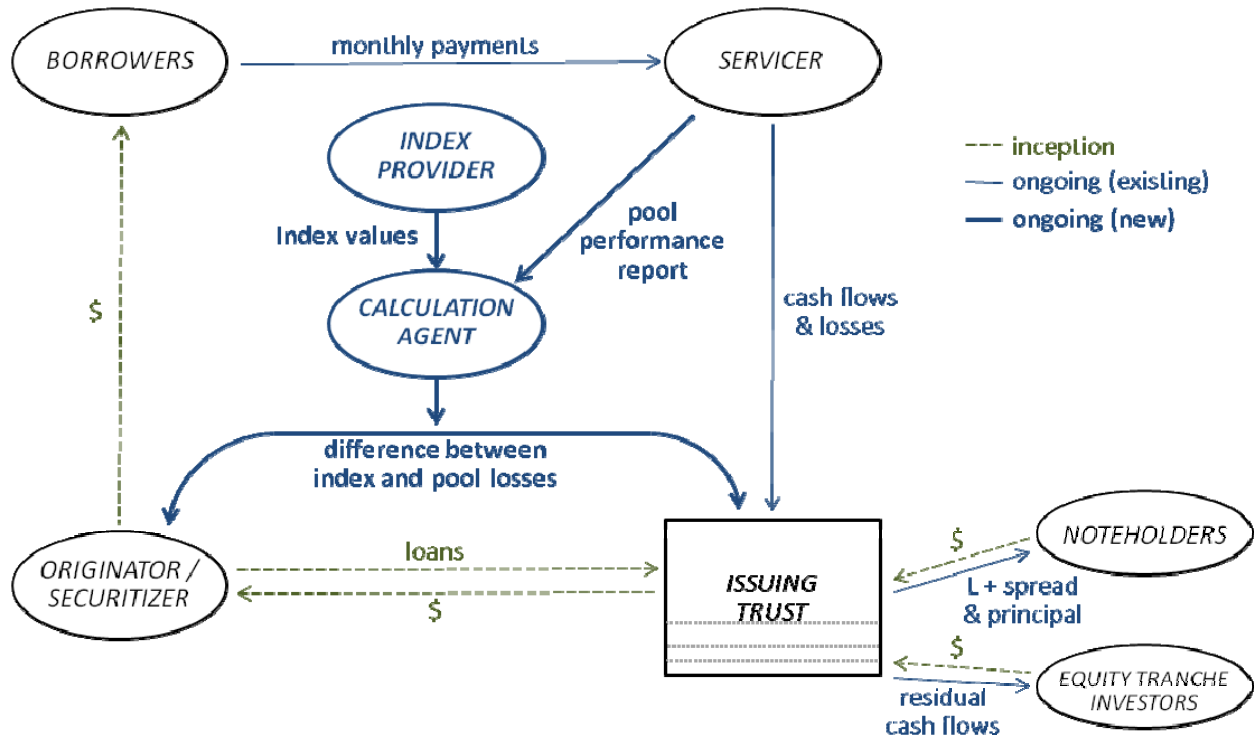
Securitization structures in which the securitizer and/or originator retains the underwriting risk could be achieved with modest change to existing market practice. As illustrated in the diagram below, the securitizer and/or originator could enter into a swap or other such contract with the issuer to pay or receive the difference between the index and pool losses, as determined by a calculation agent based on index values and a pool performance report from the servicer. Given that the issuer is already receiving principal losses on the underlying loan pool, payment or receipt of the difference between the index and pool losses would result in net principal losses reflecting only the index. Investors would thus face only the systematic economic risk. The retention of 100% of the underwriting risk in such a structure should be construed to satisfy

or worse. More information and historical index values are available at

[www.consumercreditindices.standardandpoors.com](http://www.consumercreditindices.standardandpoors.com).

<sup>2</sup> To the extent that industry-wide underwriting quality may deteriorate, a true “market-basket” index may contain an element of underwriting risk. For example, overall mortgage default rates during the recent financial crisis were clearly exacerbated by an increase in originations of riskier categories such as subprime, high LTV, Alt-A, etc. particularly from 2005 to 2007. Such “systematic underwriting risk” could be mitigated easily by defining the index or sub-indices using criteria such as vintage, credit score bands and/or other criteria to control the composition of the index such that it is known and static throughout the life of any transaction. As explained later in this section, the incentives provided by index-based structures in which the securitizer and/or originator retain their underwriting risk via the difference between the index and pool performance should tend to promote better industry-wide underwriting quality.

the credit risk retention requirement, without specifically requiring retention of a minimum interest in the securitization notes themselves<sup>3</sup>.



Ideally, the index could be tailored to closely match the composition of the underlying asset pool to accommodate any unusual concentrations by geography, product type, or credit quality distribution arising from market position or origination strategy. This might be accomplished by specifying a weighted basket of standard indices, each reflecting a different credit score band, product type and/or geographic region<sup>4</sup>. Specification of a weighted basket index effectively discloses a clear depiction of the constituent risks to investors, allowing them to differentiate pricing according to their assessment of the relative risks and correlations of the constituents, in turn providing useful market pricing signals back to the origination process. If the index is more closely matched to the composition of the underlying asset pool, the difference between the specified index and pool losses will more closely reflect underwriting risk.

<sup>3</sup> In addition to achieving the credit risk retention requirement's objective of reducing misalignment of incentives, this underwriting risk retention structure can be logically reconciled with the credit risk retention requirements on the basis that it is economically equivalent to a 100% credit risk retention bundled with an index-based hedge, both of which would be permissible in separate transactions under the proposed rules.

<sup>4</sup> Such structures have been employed quite successfully in the "catastrophe bond" market, where the loss-triggering mechanism for many securities has been based on a security-specific event loss index calculated according to a matrix of market share factors specified by state and line of business, multiplied by a corresponding matrix of published industry loss estimates for each catastrophe event.



Regardless of how closely matched the index is to the underlying asset pool, investors are exposed only to the systematic economic risk of the index. An index mismatched to the underlying asset pool causes a portion of the systematic economic risk in the underlying pool (the difference between the specified index and a hypothetical “best” index) to be retained by the securitizer and/or originator, which impacts investors only to the extent of issuer’s counterparty exposure to the securitizer and/or originator for the potential difference.

For a number of reasons, it may be advantageous for the index to reflect a measure of default rather than loss, adjusted by some factor to reflect the expected relationship between default and loss<sup>5</sup>. For example, the S&P/Experian Consumer Credit Default Indices reflect new instances of accounts having a given level of delinquency (90 days past due for mortgages) or worse status. Not only does a default-based index result in a more timely settlement (e.g. losses on mortgages might not be realized until completion of foreclosure), it removes subjectivity over the servicer’s loss recognition, mitigation and workout procedures. The recognition of default as the key event, distinct from Loss Given Default (which may be approximately zero on some portion of defaults which cure), is also recognized in the Basel II’s PD-LGD regulatory capital framework.

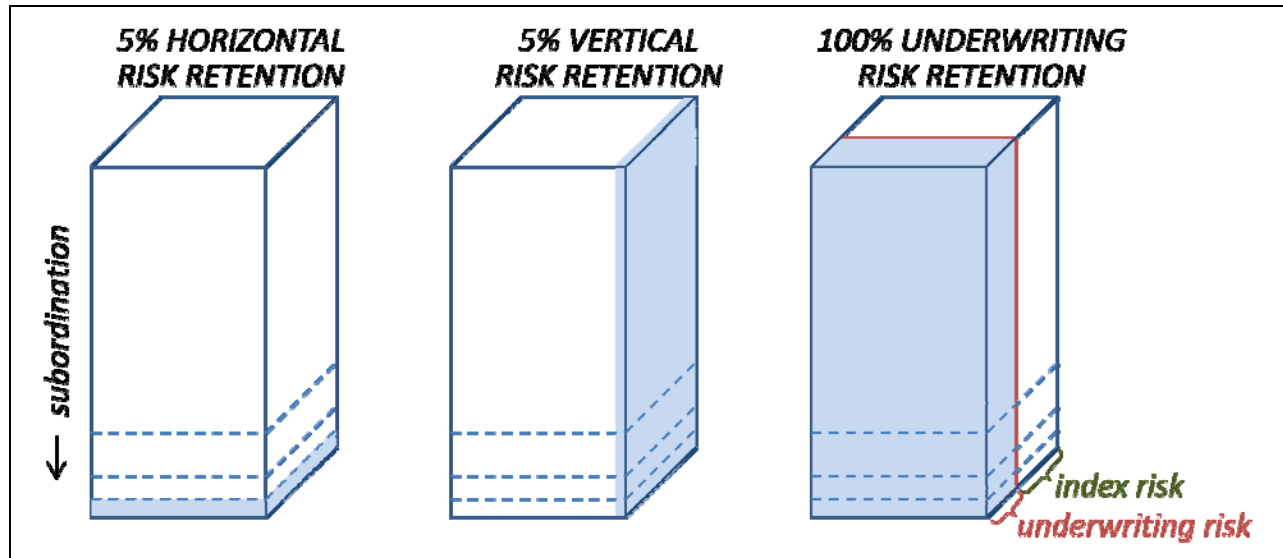
Also not that if the default loss rate adjustment factor is applied to the index only (rather than to the difference between the index and the equivalent metric of default with respect to the underlying loan pool), the structure effectively embeds a fixed recovery price on defaulted loans in the underlying pool, further eliminating potential conflicts of interest between the servicer and investors.

The issuer’s counterparty exposure to the securitizer and/or originator could be mitigated with a collateral account (or similar structure) funded with a portion of the initial proceeds of the securitization. Such a mechanism might also fulfill the statutory 5% risk retention requirement should 100% retention of underwriting risk (and 0% of the systematic economic risk represented by the index) be too difficult to construe as meeting the statutory requirement.

With respect to the proposed credit risk retention structures, one might think of underwriting risk retention as a third dimension to the horizontal/vertical framework, as illustrated in the diagram below. The proposed horizontal and vertical (as well as “L-shaped”) slices each include pro-rata shares of both the underwriting risk and systematic economic risk. Instead, 100% of a “front” slice of underwriting risk could be retained extending fully in both horizontal and vertical dimensions (i.e. without any subordinated or pro-rata interests), while transferring 100% of a “back” slice of systematic risk into a traditional tranching securitization structure.

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<sup>5</sup> Such a factor might even be dynamic, for example, based upon a relevant Home Price Index (HPI) for mortgages. However, casual statistical analysis of realized losses in securitization mortgage pools suggests that recovery rates (as opposed to default rates) have not been that sensitive to HPI, with average losses increasing by approximately 5%-10% of principal for a life-of-loan 20% decrease in state-level HPI. Note that a default rate index is agnostic as to the cause of default, and implicitly includes any influence of decreases in HPI on default rates.



Underwriting risk retention aligns the incentives of the securitizer and/or originator with those of investors better than the proposed horizontal, vertical and L-shaped risk retention structures. With underwriting risk retention, each securitizer and/or originator has the incentive to outperform the index, rather than the “race to the bottom” incentive of structures which embed a put option on pool performance. To the extent that misaligned incentives of pre-crisis securitizations caused underwriting risk to become a macro-scale systemic risk, or at least exacerbated the impact of the downturn, the incentive to outperform the index in an underwriting risk retention structure should have the opposite effect: a virtuous circle in which average quality improves as each participant attempts to outperform the average represented by the index.

Because underwriting risk retention would leave investors with net risk to the index only, it eliminates the reliance on representations and warranties which have proven contentious and difficult to enforce. Investor could instead focus on the macroeconomic risks of the index in relation to the structure, rather than attempting to perform loan-level due diligence on the underlying collateral of the securitization.

Further, underwriting risk retention causes servicer performance to impact only the securitizer and/or originator, rather than the investor. This eliminates the serious conflicts of interest between servicers and some classes of investors that have emerged in the recent crisis, and enhances the servicer’s flexibility for loss mitigation (especially if the servicer is affiliated with the securitizer and/or originator).

A simple risk retention based on 5% of principal – whether horizontal, vertical or L-shaped – crudely captures (perhaps) 5% of the underwriting risk, along with 5% of the capital-intensive systematic economic risk as well as 5% of the financing burden. This proposed alternative underwriting risk retention structure would allow the Agencies to achieve 100% retention of the risk of misaligned incentives targeted by the Dodd-Frank legislation, while allowing financing and transfer of the unbundled systematic economic risk to be obtained from capital markets. Thus each aspect of mortgages’ bundled risk and financing needs would be allocated efficiently to the most appropriate participant in the financial system.



Financial institutions should want to retain underwriting risk. Just as a hedge fund might use indices to hedge its “beta” to market performance in order to isolate its “alpha”, retaining underwriting risk allows a financial institution to isolate its relative skill, which might otherwise be swamped by the volatility of losses due to systematic economic risk.

Capital markets would also benefit from increased transparency and homogenization of risk in terms of indices, rather than treating each security as a “snowflake” with unique risks arising from the quality of the originator and servicer and selection criteria. To the extent that those benefits translate into better liquidity and tighter spreads, the economic benefit may ultimately be reflected in better loan rates for consumers.

And finally, we note that the retention of underwriting risk and transfer of systematic economic risk would be positive for prudential regulation and insurance of financial institutions, as well as the stability of the financial system overall. One of the most obvious but under-discussed aspects of the financial crisis (and those before it) is the degree to which these crises are defined by, and unmanageable because of, the correlation of asset portfolio performance amongst financial institutions. If financial institutions suffered large magnitude losses idiosyncratically rather than clustering in time during (and/or as a cause of) economic downturns, there would be no financial crises. While systematic economic risk cannot be eliminated from lending, it can be transferred to capital markets which are at least an order of magnitude larger than the combination of all bank equity capital and the FDIC’s Bank Insurance Fund.

### ***Specific recommendations in response to proposal and request for comments***

*19(a). Are there other forms of risk retention that the Agencies should permit? 19(b). If so, please provide a detailed description of the form(s), how such form(s) could be implemented, and whether such form(s) would be appropriate for all, or just certain, classes of assets.*

Experian proposes that the Agencies should permit risk retention in the form of an “underwriting risk layer” which is determined by the difference between losses on the securitized pool of assets and an appropriate index of performance for a broad market basket of similar assets, as described in the preceding sections of this letter. Rather than holding a specific tranche or pro-rata share of securitization notes, the mechanism of risk retention for this underwriting risk layer should be some form of swap, guarantee, indemnification, or similar agreement to transfer the difference between the index and pool losses back to the securitizer and/or originator.

Experian suggests that the appropriate retention level for the “underwriting risk layer” is 100% such that investors in a securitization so structured would be exposed only to index risk. The logic for including this form of credit risk retention in the menu of options is that it is economically equivalent to a 100% credit risk retention within the existing proposed options bundled with an index hedge that would be permissible within the proposed rules prohibiting hedging of the required retained interest. A securitizer and/or originator could achieve the same position in separate transactions, but might not achieve favorable accounting and/or risk-based capital treatment, and also may not find ready markets for such separate transactions.

The concept of credit risk retention without ownership of a specific interest in the securitization is already established with the proposed representative sample option for

credit risk retention. Similarly, the concept of credit risk retention by means of a guarantee or similar contractual obligation is provided in the proposed rule's accompanying commentary with respect to the Government-Sponsored Enterprises (section III.B.8 – p.52): the guarantee of timely principal and interest payments on Mortgage-Backed Securities they issue exposes them to all of the credit risk on the mortgages collateralizing these pools. In the case of underwriting risk retention, the agreement to absorb the difference between the index and pool losses exposes the securitizer and/or originator to all of the risk that the credit risk retention requirements were designed to address.

Regardless of the logic employed to deem this proposed underwriting risk retention as satisfying the statutory requirements, it is clearly consistent with the spirit of the credit risk retention requirement. Underwriting risk retention provides 100% “skin in the game”, and may achieve the goals of the credit risk retention requirements more effectively than any of the 5% retention options provided.

It may be appropriate to require the underwriting risk retention agreement between the securitizer and the issuer to be collateralized by a funded account at risk for credit losses in excess of the designated loss index. A minimum collateralization of 5% of outstanding principal potentially could be construed to satisfy the statutory credit risk retention requirement if the underwriting risk retention agreement itself does not.

This structure would be appropriate for any asset class for which a suitable index is available.

*98(a). Would the proposal inadvertently capture any kinds of hedging that should be permissible? 98(b). If so, please provide specific recommendations on how we can appropriately tailor the requirements.*

The discussion of permitted index hedging should be broadened to explicitly include indices based on a broad pool of loans similar to the underlying assets of the securitization so as not to inadvertently limit index hedging to the class of indices based on baskets of Credit Default Swaps on ABS that are discussed at length in the proposed rules. Maximum overlap limits as proposed for the ABS-linked indices could be extended to include broad loan pool indices, though for practical purposes they should not be constraining.

The proposed restrictions on transferring or pledging without recourse the interests that are required to be retained may also be unnecessarily more restrictive than the statutory language which specifies that the hedging and transferring prohibition applies to the “credit risk that the securitizer is required to retain” (emphasis added), rather than the specific interests or securities that the securitizer is required to retain. Such restrictions may impede the effective structuring of beneficial, and otherwise permissible, hedges, including those aimed at isolating and retaining a loan pool's specific underwriting risk. Experian suggests that those restrictions be modified to specifically exempt and permit any case where the securitizer and/or originator transfers or pledges a retained interest under an agreement whereby they remain exposed to the credit risk arising from those interests, and/or specifically to the difference between the performance of the securitized asset pool and that of an industry-wide index (i.e. a structure by which the securitizer and/or originator retains

the pool-specific underwriting risk but transfers the general systematic economic risk to the issuer or another third party).

*105. Should credit protection and hedging by the issuing entity of any portion of the credit risk on the securitized assets be permitted or, because such credit protection and hedges could limit the incentive of investors to conduct due diligence on the securitized assets, should all credit protection and hedging by the issuing entity (other than interest rate and currency risk) be prohibited?*

Quite the opposite: investor due diligence of pools of consumer loans is inherently imperfect due to lack of access to full details of consumer credit, as well as appraisals in the case of mortgages. Were such details available, it is unclear that investor due diligence could be effectively performed at the individual underlying asset level in a cost effective manner. And even in the best case, such due diligence could only mitigate, rather than eliminate, underwriting risk.

Rather than attempting to preserve incentives to conduct this inherently limited risk mitigation, the hedging rules should instead encourage the issuing entities to obtain full protection from underwriting risk via an arrangement with the securitizer and/or originator, or another third party. As described in the body of the letter above, an arrangement to pay or receive the difference between the performance of the pool of securitized assets and an index of performance of a market basket of assets in the same category would effectively transfer underwriting risk away from investors, leaving them exposed only to the transparent macroeconomic risk of that index.

\* \* \* \* \*

Experian appreciates the challenge the Agencies face in crafting these credit risk retention rules while balancing competing goals. On the one hand, securitization structures must be constrained to avoid the adverse incentives exposed by the financial crisis. On the other hand, re-establishing securitization markets is critical to the function of the mortgage market, particularly in light of longer-term intentions to reduce the mortgage finance system's dependence on government-backed entities in favor of the private sector and capital markets. It is in the spirit of finding the most efficient way to strike this balance that Experian offers the proposed alternative underwriting risk retention structure.



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We would be happy to answer questions or discuss our views in further detail. Please feel free to contact:

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Sincerely,

A handwritten signature in black ink, appearing to read "Steve Wagner".

Steve Wagner  
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Experian North America

cc:

Charles Chung, President – Decision Analytics, Experian North America

Tony Hadley, SVP – Government Affairs and Public Policy, Experian North America

Jason Engel, VP and Chief Regulatory Counsel, Experian North America