Treasury Department
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Communications Division, 3rd Floor
Office of the Comptroller of Currency
250 E Street, SW
Washington DC 20219
Docket No.: 00-06

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington DC 20551
Docket No.: R-1055

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Mr. Robert E. Feldman
Executive Secretary
Attn: Comments/OES
Federal Deposit Insurance Corp.
550 - 17th Street NW
Washington DC 20429

Manager, Dissemination Branch
Records Management and Information Policy
Office of Thrift Supervision
1700 G Street NW
Washington DC 20552
Attn: Docket No.: 2000-15

RE: Docket No.: OCC-00-06; FRB-R-1055; OTS-2000-15
Risk Based Capital Standards; Recourse and Direct Credit Substitutes

Ladies and Gentlemen:

Wells Fargo & Company ("Wells Fargo") is pleased to comment on the Joint Notice of Proposed Rule Making on the capital treatment of transactions involving recourse and direct credit substitutes.

Wells Fargo is a financial holding company which has subsidiary banks in 21 Midwestern and Western states. Our lead bank has a mortgage company subsidiary that is one of the largest originators and servicers of residential mortgage loans in the country. Our consumer finance company operates nationwide and provides servicing for other finance companies. Other subsidiaries are engaged in the securities brokerage, investment banking, venture capital and insurance businesses. Wells Fargo's banking subsidiaries engage in all aspects of the trust business, including personal trust, investment management, employee benefits, master trust

and corporate trust, as well as a full range of deposit taking, lending and other banking activities. Many of these trust activities are of the nature of servicing activities.

In general, Wells Fargo supports the proposed agencies' rules. In particular, Wells Fargo endorses the continued action of the agencies to reduce the risk-weighting of highly rated private label mortgage and asset-back securities to 20%. The agencies' use of external credit ratings to determine risk-weighting of holding securities is consistent with investors' and other market participants' methods of determining such risks. Wells Fargo supports the agencies' insight in utilizing a multi-level rating-based approach to assessing the capital requirements necessary for holding private-label securities. This approach to risk-weighting will enable financial institutions to diversify their investments thereby reducing risk to the banking system. We strongly encourage adoption of final rules incorporating this principle.

Wells Fargo has some concerns in the residential mortgage context, however, that the treatment of certain representations and warranties as credit enhancements, along with the benchmark for unreimbursed servicing advances, creates inappropriate burdens on supervised issuers/lenders versus non-supervised issuers/lenders. In addition, Wells Fargo accepts the agencies' invitation to comment on the issue of providing a premium refund provision when selling residential loan pools.

Representations and Warranties

The agencies' proposed definition of credit enhancing representations and warranties is too broad. This definition fails to take into account the operational necessity of certain standard representations and warranties which, on their face, appear to function as credit enhancements, but are intended to cover normal operational risks. The term credit enhancing representations and warranties is defined as follows:

> Representations and warranties extended by a bank when it transfers assets (including loan servicing assets) or assumed by the bank when it purchases loan servicing assets that obligate the bank to absorb current losses on transferred assets or serviced loans. These representations and warranties typically arise when the bank agrees to protect purchasers or some other party from losses due to the default or nonperformance of the obligor on the transferred assets or serviced loans, or insufficiency in the value of collateral supporting the transferred assets or serviced loans.

A wide variety of representations and warranties are required by investors in both conforming and non-conforming loan sales. These representations and warranties are established by the market to protect the investor from various risks related to the asset being purchased. The two primary risks covered by the warranties are:

1. The operational risk of the loan originator; and

2. The need of the investor to insure the assets being purchased are the assets the investor intended to purchase.

The warranties used to cover these risks have become standard in the industry. However, the examples provided in the commentary classify certain standard warranties covering operational risk as recourse obligations of supervised lenders. The following comments address Wells Fargo's rationale for not classifying standard warranties as credit enhancing:

Investment Quality Warranties

An example in the commentary states a warranty that "no circumstances exist involving the loan collateral or the borrower's credit standing that could cause the loan to become delinquent" will receive recourse treatment. This standard warranty has become known in the loan sale transaction as an investment quality warranty. The intended purpose of this warranty is not to function as a credit enhancement, but to provide investors with additional comfort that no material event has occurred to the collateral or the borrower's financial status between the loan origination and the date of the sale. Any credit enhancement aspect of the warranty is minimal as it is providing the assurances only on the date of the sale, not into the future, as required by the agencies' definition.

A warranty of this nature is intended to insure the investor that, as of the transfer date, the status of the loan being purchased has not materially changed since its origination. Without an investment quality warranty, the investor would have to perform a credit and collateral review of each individual loan. This would be necessary to ensure the individual loan file information has not materially changed from the date of the origination to the date the loan is transferred. A review of this nature would need to include underwriting of the borrower, along with verification of the collateral's value. Given the scale of most transfers of mortgage assets, to require investors to perform this extreme due diligence undermines investors' expectations, and thereby adversely affects investors' interest in buying from supervised lenders. This review requirement would be too burdensome and places supervised lenders at a disadvantage when selling mortgage assets.

The risk of providing investment quality warranties is minimal to the supervised lenders. Any material change to the status of the collateral or the borrower's credit standing would be detected by the lender's normal operations. The lender has the risk of a borrower's deteriorating financial status or declining collateral value if it continues to own the loan. By selling the loan, any future risk from a borrower's deteriorating financial status or declining property collateral value is eliminated. In addition, if a loan defaults or if the property is damaged, the maintenance of hazard insurance and mortgage insurance makes the risk of a lender suffering a catastrophic loss under this warranty remote.

Wells Fargo recommends that the agency recognize the limited risk posed by an investment quality warranty and treat such a warranty as one covering normal operational risk.

Environmental Warranty

The commentary states a warranty that "asset collateral is free of environmental hazards . . . for certain types of properties which have been subject to environmental assessments" is an acceptable operations risk. This would imply that for an environmental warranty to not to be considered recourse, some type of environmental assessment would have to be performed on the property. If this is the prevailing interpretation, then an unreasonable burden has been

placed upon supervised residential lenders. This burden is unreasonable because environmental assessments are neither economically feasible nor otherwise needed for individual residential properties. Requiring an environmental assessment on residential properties will place supervised lenders at a competitive disadvantage with non-supervised lenders regarding residential whole loan sales.

Due to the lack of potential liability caused by a warranty of this type, it does not make sense for a supervised lender to incur the expense of an environmental assessment for a single family property. To do an environmental assessment for each property simply to avoid capital requirements would be unduly burdensome and a waste of the supervised lender's resources. Therefore, Wells Fargo believes only reasonable operational risks would be present if each individual first lien mortgage loan met the following conforming conventional secondary market conditions:

- The lender obtains an environmental lien protection endorsement (ALTA Endorsement 8.1) for each loan originated or comparable coverage in states where standard ALTA forms of coverage are unavailable; or

- The lender obtains an appraisal report or other property valuation report with no notation of any hazardous condition observed during the inspection of the subject property through the normal research involved in performing the appraisal or the preparation of the valuation report.

Wells Fargo believes the above standards would be sufficient to cover the operational risk caused by an environmental warranty without performing an environmental assessment to avoid recourse treatment. This will keep supervised lenders competitive with non-supervised lenders.

<u>Warranty To Repurchase Loans Becoming More Than 30 Days Past Due Within A Designated Period After Sale</u>

On occasion, sales of residential mortgages include a warranty that the seller will repurchase a loan which becomes more than 30 days delinquent within a certain period after the sale. Generally, this period does not exceed four months. Pursuant to the commentary, this warranty will require recourse treatment.

The intent of this limited warranty is not to provide a credit enhancement for a short period of time (up to four months), but to insure against the transfer of a loan with various deficiencies. This is due to the industry's assumption that an early payment default on a new loan is an indicator that unsatisfactory conditions were present at the time of origination. These conditions are usually improper underwriting or fraud during the origination process. This warranty simply allows the investor to have the seller repurchase the loan without having to prove either of these conditions exist.

It is true such conditions are covered in other warranties given as part of the loan sale. However, a breached warranty must still be proven by the investor. From the investor's perspective, proving improper underwriting or fraud on a loan is too time consuming and costly. It has become commonplace in the industry to assume that a loan which defaults within a few months of origination has been improperly underwritten or contains some aspect of fraudulent

origination. This warranty allows for immediate repurchase without the cost and time of proving the breach. This warranty simply streamlines the repurchase process for loans which are in breach of other operational risk warranties.

For those lenders providing early payment default warranties for new production, the risk is minimal because loan defaults tend to peak in years 3-5. For sales of seasoned mortgage assets, which are less common than sales of new whole loans, higher risk in the years 3-5 can be reflected in the price. After the fifth year, risk would again diminish. From a pure business perspective, classification of an early payment default warranty as a credit enhancement imposes a significant business hardship to supervised lenders in light of the limited risk posed by such a contract provision. The costs of holding additional capital are far higher than the risks associated with a warranty that would, in all likelihood, not come into play. If the agencies were to continue to classify a warranty of this type as a credit enhancement, the resulting capital treatments would be burdensome to supervised lenders, making them not as competitive as non-supervised lenders.

Premium Refund

The commentary invited lenders to comment on whether a premium refund provision in loan sale contracts should receive recourse treatment. In a loan sale transaction, a premium refund clause requires the seller to refund the premium paid by the investor on any loan which prepays within a stated period after the loan is transferred. Generally, this period of time is up to six months, and on a more limited extent, 12 months with the refund being prorated on a monthly basis.

The primary purpose of the premium refund is to reimburse the investor if a transferred loan prepays within a short period of time after the sale. An investor purchases the loan at a premium with the intention of receiving the benefits during the life of the loan. If the loan prepays quickly, the investor incurs a loss on the purchase of the loan. The reason to refund the premium is because loans which prepay in the first few months after the transfer are typically in the process of refinancing at the time of the sale to the investor. A refinance or a contemplated prepayment by the borrower is typically unknown to either the seller or investor at the time of the sale. If known, the investor would not have purchased the loan, and certainly would not have purchased it at a premium.

Since the primary purpose of premium refunds is only to provide reimbursement for the few loans which pay off quickly after the transfer, recourse treatment for the entire premium paid would be inappropriate. Calculating the recourse obligation on the whole pool would be inappropriate as the amount refunded is limited to the few loans which prepay in the time specified.

If the agency requires recourse treatment for the total premium paid on the pool, the resulting capital requirements would be burdensome to supervised lenders. This burden would not allow supervised lenders to compete on a level playing field with non-supervised lenders. The result would require supervised lenders to receive an even higher price (larger premium) for the loan pool to cover the cost of the additional capital requirements. Wells Fargo recommends the agencies determine premium refund provisions as not being recourse obligations of the seller.

Loan Servicing - Benchmark For Insignificant Unreimbursed Advances

Wells Fargo supports the agencies' approach to servicing advances. However, we question the validity of the one percent (1%) benchmark for insignificant unreimbursed servicing advances. For example, in terms of the 1% benchmark, it appears that servicers of FHA loans currently do not receive reimbursement for $2,300 to $2,500 in outlays per loan. Based on the FHA loan limit, this amount would frequently put servicers over the 1% limit because they are not reimbursed for the first 60 days of interest once a loan goes into default. In addition, reimbursement is at the HUD debenture rate rather than the rate of the note or security. The unreimbursed amount for delinquent VA loans is even higher. In both instances, however, the full faith and credit of the United States stands behind the reimbursement obligation; it is only the mechanics of the programs that result in shortfalls in individual loan situations. The concept of a flat percentage benchmark will force lenders to institute complex tracking procedures to determine the amount of capital they should hold. In addition, investors are creating and expanding loss mitigation programs which will also affect the reimbursement levels. These programs will increase the frequency of adjustments to reimbursements, both up and down, depending upon when foreclosures are completed on an investor's specified timeline. The more realistic standard to administer would be:

- No limit on servicers under standard programs of FNMA, FHLMC, VA, FHA and FHLB; and
- No limit on servicers for other secondary market investors, provided the investors' reimbursement policies are substantially equivalent to the standards of FNMA, FHLMC, VA, FHA or FHLB.

This approach would be consistent with the industry's position that servicer cash advances are part of normal mortgage servicing functions and do not constitute credit enhancements. Wells Fargo recommends the utilization of the standards set forth above in determining the recourse obligations created by servicing advances.

Once again, Wells Fargo appreciates the opportunity to comment on the joint notice.

Sincerely,

George W. Fehlhaber
Senior Vice President & Treasurer