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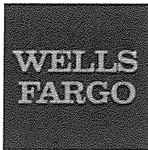

Wells Fargo & Company
420 Montgomery Street, 12th Floor
MAC #A0101-121
San Francisco, CA 94104

July 29, 2011

The Honorable Martin Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th St, NW
Washington, DC 20429

The Honorable Daniel Tarullo
Board Member
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable John Walsh
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Re: Capital Treatment of Mortgage Servicing Assets and Related Liabilities

Dear Acting Chairman Gruenberg, Board Member Tarullo and Acting Comptroller Walsh:

Wells Fargo & Company ("Wells Fargo") is a $1.2 trillion diversified financial services company providing banking, insurance, trust and investments, mortgage banking, investment banking, retail banking, brokerage and consumer finance. At March 31, 2011, we were the nation's #1 originator[1] and #2 servicer[2] of mortgage loans.

[1] Inside Mortgage Finance, April 29, 2011.
[2] Inside Mortgage Finance, May 5, 2011.

We are taking this opportunity to express our concern with an important aspect of the adjustments to the capital components in the Basel Committee's 'Framework for More Resilient Banks and Banking Systems' issued in December 2010 (the "Basel III Framework"). Specifically, the Basel III Framework dramatically changes the treatment of mortgage servicing rights ("MSRs") from current regulatory capital guidelines promulgated by the U.S. federal banking agencies ("Banking Agencies"). Where the Banking Agencies currently permit MSRs along with certain other assets to be included in (that is, not deducted from) capital components in an amount up to 100% of Tier 1 capital (subject to certain other adjustments), with any excess being deducted 50/50 from Tier 1 and Tier 2 capital, Basel III limits MSRs to 10% (15% when aggregated with certain other items) of Basel III's definition of Common Equity Tier 1, which is only a component of Tier 1 and in any event is more narrowly defined than the existing common equity component and includes other provisions penalizing MSRs (all as discussed further below). We understand that the Banking Agencies will use the Basel III Framework to revise existing U.S. regulatory capital rules, including rules addressing the regulatory capital treatment of MSRs. As set forth in this letter, we believe additional enhancements can and should be made by the Banking Agencies when adopting the Basel III Framework in the U.S. We believe these enhancements will more appropriately recognize the value of servicing related assets for regulatory capital purposes and provide a more competitive landscape for banking institutions that originate and securitize mortgages, creating MSRs in the process, or choose to invest in MSRs.

When considering our proposals, we ask that the Banking Agencies also recognize that MSRs are at relatively low levels due to the current stage of the business cycle. The Basel III Framework was issued and is being implemented at a time in the business cycle when mortgage servicing values are low resulting from a prolonged period of historically low interest rates. As interest rates increase and refinancing activity subsides, loan duration will increase as will the duration and value of MSRs. As this occurs, MSR capital rules provided under the Basel III Framework would become increasingly punitive, creating additional capital demands. Capital rules that may have resulted in intended consequences when calibrated to a single point in the business cycle could result in unintended consequences and become progressively punitive at other points in the cycle.

Moreover, we believe that the Banking Agencies should be very concerned about the impact of these rules on U.S. mortgage lending activity, and consequently on the U.S. residential and commercial real estate sectors – critical drivers of U.S. economic recovery. The Basel III Framework attempts to address banking sector capital weaknesses through an abundance of regulatory capital changes. However, concurrently implementing a significant amount of capital changes could lead to less credit availability and higher costs of borrowing. These byproducts could have negative long lasting impacts on consumers and immediate unintended effects on the economic recovery.

Summary of Recommendations

Wells Fargo urges the Banking Agencies to adopt the following approach with respect to the capital treatment of MSRs and related liabilities in connection with implementing the Basel III Framework for U.S. banking institutions:

(1) Excess servicing fees, a component of MSRs, should be excluded from the calculation of items subject to the 10% and 15% limits when calculating regulatory capital and instead be handled similarly to the capital treatment of trading assets. That would include treating excess servicing fees as a traditional securitization, using the ratings based approach. Our recommendation is based on the underlying economics and tax treatment of excess servicing fees, and recognizes that this component of MSRs is highly liquid and separately traded similar to trading assets;

(2) The deferred tax liabilities associated with MSRs should continue to be netted against MSRs for capital purposes, as now permitted by the Banking Agencies. The continuation of current rules would require no disruptive changes during the implementation of the new standards;

(3) The current risk weighting applied to MSRs should be carried forward and incorporated in the forthcoming revised capital rules, requiring no changes in connection with the implementation of the new standards that might otherwise disrupt mortgage markets.

Implementation of these recommendations, in our view, would not diminish the quality or robustness of the Banking Agencies' capital standards. Excess servicing fees are a financial entitlement – that is, a payment stream created by contract with a real and ascertainable value. Further, no changes would be required to U.S. generally accepted accounting principles ("U.S. GAAP") in order to align our proposed capital treatment of MSRs with their characterization as intangibles under U.S. GAAP, nor would these recommendations affect how MSRs and related liabilities are currently reflected in balance sheets included in applicable regulatory filings. Moreover, for purposes of reporting capital computations, our recommendations would help provide a more level playing field for U.S. institutions in relation to non-U.S. institutions that do not have a comparable amount of MSRs due to the more prevalent use of on balance sheet covered bonds as a funding mechanism. They would also encourage continued support of the servicing business by financial institutions – a critical component of the mortgage lending industry.

The Proposed Treatment of MSRs is Punitive to U.S. Banks

The Basel III Framework requires that MSRs be capped at 10% of a bank's common equity (after application of regulatory adjustments) when calculating regulatory capital. In addition, when computing Common Equity Tier 1, banks must deduct the amount by which the aggregate of (1) MSRs, (2) significant investments in the common shares of unconsolidated financial institutions and (3) deferred tax assets, exceeds 15% of Common Equity Tier 1. Under the Basel III Framework, the sum

of these three items not deductible from Common Equity Tier 1 is to be further risk weighted at 250%. If applied to MSRs in their entirety, this approach would result in a significant increase, when compared with existing requirements, in the amount of regulatory capital required to be maintained against MSRs and illustrates the Basel Committee's skeptical view of the value that MSRs have as assets to financial institutions. For the reasons discussed further below, we believe that this skepticism is misplaced, and reflects a highly Euro-centric approach that will negatively impact U.S. banks and consequently U.S. mortgage lending activity.

The Proposed Treatment of MSRs Reflects a Euro-centric Approach

The approaches to financing mortgage origination in Europe and the U.S. are fundamentally different. In Europe, a large proportion of mortgages are retained on balance sheet by the originating banks and funded with covered bonds[3] (essentially nothing other than bonds secured by a revolving pool of mortgages), benefitting from legislation in many jurisdictions to make the financing arrangements attractive. In that model, the servicing component of the cash flow is never separated from the underlying mortgage loans and no MSR is created. In the United States, mortgage originations are largely financed through securitizations (most often through programs involving guarantees from Ginnie Mae, Fannie Mae or Freddie Mac (the "Mortgage Agencies")). The servicing component of the cash flows – that is, MSRs, both normal and excess – are separated from the other entitlements to principal and interest. MSRs are an outgrowth of the financing method and, at least in any volume, are unique to the U.S. The Basel III Framework's treatment of MSRs would have a disproportionate and punitive effect on U.S. institutions when compared to non-U.S. institutions. In short, these rules will have little or no business impact in Europe, but will have profound impacts in the U.S.

We appreciate that the U.S. delegation to the Basel Committee recognized that MSRs have value and defended the position that the full deduction of MSRs initially proposed by the Basel Committee was unnecessary; this had a positive influence on the final Basel III Framework when compared with the December 2009 proposals (which required that 100% of MSRs be deducted from Common Equity Tier 1). However, we believe that Banking Agencies should further remedy the fact that the Basel III Framework penalizes institutions that securitize loans as a funding source for loan production by unnecessarily discounting the value of MSRs. Our proposals will align capital rules to better reflect the value of MSRs and in turn provide a more level playing field for U.S. institutions in relation to non-U.S. institutions and consistency in capital treatment among alternative mortgage funding approaches.

[3] Based on a September 2010 report from the European Covered Bond Council, the total volume of outstanding covered bonds in 2009 was approximately 2.4 trillion Euros. With a few exceptions, U.S. financial institutions have generally not participated in the covered bond market; the last U.S. covered bond issuance was in 2007. In the U.S., the covered bond market is less developed relative to the European Union and currently does not provide a feasible source of significant funding.

Capital Rules Should Recognize That Excess Servicing Fees are Separable and Liquid

Mortgage servicing rights represent rights to service mortgage loans for others. Banks recognize MSR assets when they purchase servicing rights from third parties, or retain servicing rights in connection with the sale or securitization of loans they originate. Generally, MSRs are a component of the total spread between the average interest rate of loans included within a mortgage-backed security (MBS) and the MBS pass-through coupon coupled with escrow account earnings, ancillary income and late fees retained by the servicer.

In the example below, we summarize the components of the servicing fee and highlight the elements of a total MSR, including normal and excess servicing fees:

Figure 1: Components of Servicing Fee and Total MSR

COMPONENTS OF SERVICING FEE

Average Interest Rate of Loans Within a MBS	5.55%	(Received from Borrowers)
MBS Pass-through Coupon Rate	5.00%	(Paid to MBS investors)
Total Spread - Servicing Fee	0.55%	
Guarantee Fee	15 bps	(Paid to Agency)
Normal Servicing Fee	25 bps	(Paid to Servicer)
Excess Servicing Fee	15 bps	(Paid to Servicer or Securitized)

COMPONENTS OF MSR

+	Normal Servicing Fee	**MSR Components Inseparable from Servicing Agreement**
+	Escrow Account Earnings	
+	Ancillary Income	
+	Late Fees	
-	Cost to Service	
+	Excess Servicing Fee	**Separable from Servicing Agreement**
=	**Total MSR**	

Normal servicing fees are indivisible from servicing agreements. These fees create a source of compensation to the servicer, provide an incentive for responsible servicing and provide protection to Mortgage Agencies by ensuring ongoing servicing of the investment portfolio. In contrast, excess servicing fees represent incremental interest spread that can be separated from the servicing agreement. This incremental interest spread could initially be securitized as part of the MBS coupon, sold to the Mortgage Agencies as a future guarantor fee, or retained as an income stream that could be held or eventually securitized as excess interest only and sold. The ultimate characterization depends on which execution creates the most value. Separation and securitization of excess servicing fees requires approval by the Mortgage Agencies and would require a contractual amendment to existing servicing agreements.

Historically, alternative regulatory capital treatment approaches for excess servicing fees have been considered by the Banking Agencies and were commented on in conjunction with the issuance of a Final Rule on August 10, 1998[4]. At that time, the Banking Agencies were open to different options, including reporting excess servicing fees separately for regulatory capital purposes. In 1998, the Banking Agencies decided to increase the Tier 1 capital limitation for MSRs from 50% to 100% of Tier 1 capital, noting that the decision to increase the capital limitation mitigated the capital effects of reporting excess servicing fees as MSRs. While this was true at the time, the capital standards released by Basel III provide a punitive treatment towards excess servicing fees. Factors that supported separating excess servicing fees for regulatory capital purposes in 1998 still exist today.

We are concerned that the Basel III Framework does not adequately reflect the fundamental differences that exist between normal and excess servicing fees or the feasibility of a defined revenue stream associated with a properly adjusted risk-weighted asset. While we recognize the Basel Committee's objectives of improving the quantity and quality of regulatory capital, we believe that for regulatory capital purposes, excess servicing fees should be separated from normal servicing fees and treated similarly to trading assets for the following reasons:

- Excess servicing fees can easily be separated from the servicing asset. Realization of the excess fee is not dependent on an ongoing performance of servicing.
- Excess servicing fees are similar to other investment securities; they can be securitized and sold in a secondary market creating liquidity.

Excess Servicing Fees Are Separate Assets

Servicers have an opportunity to separate the ownership of excess servicing fees from their other servicing assets and monetize the expected cash flows. Following the sale of a loan, no additional service must be performed by the servicer to monetize and realize the value of the excess servicing fees.

In contrast, normal servicing fees cannot be monetized without foregoing the servicing relationship and related ancillary benefits. The servicer has two options for realizing the normal fee cash flow: (1) sell the total MSR or (2) provide ongoing servicing and receive the cash flow as borrowers of the underlying loans make interest payments.

Further, separating the excess servicing fee aligns with the tax treatment for servicing assets. Unlike U.S. GAAP, U.S. tax law provides that mortgage servicing fees up to a safe harbor amount are not required to be capitalized for tax purposes. The safe harbor, as prescribed under U.S. tax law, is intended to measure a reasonable amount of compensation for servicing, which is generally equal to the contractual normal servicing fee. For tax purposes, normal servicing fees are reported as taxable income as future services are provided. At the time that the MSR asset is created under U.S. GAAP, the tax

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[4] Risk-Based Capital Guidelines; Capital Adequacy Guidelines, and Capital Maintenance: Servicing Assets; Final Rule.

basis in the asset is zero and the book basis is equal to fair market value. The difference between the tax basis and the book basis in the MSR asset results in the creation of a deferred tax liability. Excess servicing fees, generally an amount in excess of the safe harbor, are for tax purposes treated as an asset separate from the MSR. U.S. tax law treats the contractual right to service fees in excess of the reasonable compensation safe harbor as an asset to be capitalized at the time of loan sale because no future servicing is needed to 'earn' the excess asset.

Excess Servicing Fees Are Liquid

Excess servicing fees are similar to senior (non-credit enhancing) interest-only strips (I/O strips), that is, securities based on the interest payments received from a mortgage pool. I/O strips are liquid assets and in general are treated as trading assets by the Basel III Framework.

Currently, Mortgage Agency approval is required to securitize excess servicing fees. Once securitized, the excess servicing fees can be freely transferable and sold at market-determined prices with investors assuming the risks of ownership. Selling excess servicing fees is a method utilized to expeditiously monetize the asset without forgoing the economic benefits of the residual servicing asset.

Following is a summary of some of our past excess servicing fee sales:

Figure 2: Excess Servicing Fees Sold by Wells Fargo

Security Identifier	Date	Notional (in millions)	Strip (bps)	Book Value (in millions)
Freddie Trust 241	9/15/2006	$ 2,000	32.6	$ 9
Fannie Trust 376	9/20/2006	2,300	31.1	3
Fannie Trust 378	11/2/2006	37,600	29.1	473
Freddie Trust 247	4/18/2007	108,600	25.9	1,148
Freddie Trust 249	5/14/2007	26,900	24.4	291
Fannie Trust 384	9/19/2007	33,500	22.1	294
Freddie Trust 254	2/15/2008	14,100	18.9	93
Fannie Trust 387	5/8/2008	22,100	18.6	136
Freddie Trust 255	5/14/2008	6,800	19.1	45

As indicated in Figure 3 below, in 2011, there has been a resurgence of excess servicing fee transactions which we believe is due in part to banks anticipating and reacting to expected capital changes stemming from Basel III, coupled with high investor demand for this type of investment product.

Figure 3: Recent Excess Servicing Fee Sales

Security Identifier	Date	Notional (in millions)	Servicer
Fannie Trust 406	3/23/2011	$ 1,242	Ally Bank
Fannie Trust 407	4/25/2011	1,463	Bank of America, NA
Fannie Trust 408	5/20/2011	291	CitiMortgage, Inc

We are also aware of initiatives in the financial services industry (led in one instance by the Federal Housing Finance Agency) which provide alternative servicing compensation models, including eliminating or significantly reducing the servicing fee with the premise that ancillary income and late fees provide adequate servicing compensation. In this instance, the interest spread would be free from the agency mandated servicing fee providing servicers the ability to freely securitize the spread. These initiatives should result in additional liquidity being added to the excess servicing market. Considering historical market activity and ongoing initiatives, we maintain that there is and will continue to be liquidity for excess servicing fees.

Excess MSRs Should Be Treated Similar To Trading Assets For Capital Purposes

As the mortgage servicing markets have matured, MSRs have benefitted from increased liquidity and the valuation of excess servicing fees has improved. So while the quality of the asset is strengthening, Basel III capital standards are moving towards discounting their value. In light of the increased discounting of servicing assets, we believe it is now appropriate to have capital rules recognize the fundamental differences between excess and normal servicing fees. We believe, for regulatory capital purposes, that excess servicing should be excluded from the calculation of items subject to the 10% and 15% limits when calculating regulatory capital and instead go through a traditional securitization treatment using the ratings based approach. Doing so will provide capital reporting symmetry with financial institutions that purchase excess servicing fees – a purchaser of excess servicing fees would account for the asset similar to an I/O strip under regulatory capital guidelines.

Existing Deferred Tax Liability Netting Rules Should Continue

Existing U.S. capital rules permit banks to deduct disallowed mortgage servicing assets on a basis that is net of associated deferred tax liabilities[5]. As described above, these deferred tax liabilities represent the tax effect of the differences between book basis and tax basis in the servicing asset. For tax purposes, a servicing contract's 'reasonable compensation' is treated as income in future periods to coincide with performance of services. From a book perspective, this income is recognized at the time of loan sale coinciding with recognition of an MSR asset.

[5] 12 CFR Appendix A to Part 225, Section II.B.1.E.iii states that "Bank holding companies may elect to deduct goodwill, disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, and disallowed credit-enhancing I/Os (both purchased and retained) on a basis that is net of any associated deferred tax liability."

Since deferred taxes are a direct result of the difference in the book and tax basis in the servicing asset, any change to the book basis in the asset, whether upon an occurrence of an MSR impairing event or sale (such as a transferring of servicing rights to another servicer), will result in a change to the deferred tax liability. From a regulatory capital perspective, a bank's loss exposure to MSRs is the gross MSR net of its related deferred tax liability. Considering the direct relationship between deferred tax liabilities and MSRs, we believe that the existing regulatory capital convention should be carried forward and reflected in forthcoming capital rule revisions. Specifically, we believe that banking organizations should continue to have the option of reporting MSRs, net of related deferred tax liabilities, when applying an MSR cap and that any deferred tax liabilities applied would not be available for use in determining the regulatory capital treatment of deferred tax assets.

Existing Risk Weighting Rules Should Continue For Items Not Deducted

Using the Basel III Framework, mortgage servicing rights not deducted from Common Equity Tier 1 are risk weighted at 250%. This further reduces the value of MSRs from a capital perspective, resulting in an increase in the amount of capital needed, relative to current requirements, to maintain MSRs as investments. We submit that the fundamental characteristics, risk profile, and economics of MSRs have not significantly changed or deteriorated from a similar evaluation conducted by the Banking Agencies in 1998 so as to justify an increase in their risk weighing to 250%. Arbitrarily increasing the risk weighting of MSRs inappropriately disrupts measured business models used to effectively manage interest rate and prepayment risks.

The punitive capital requirements under the Basel III Framework specifically targeting MSRs creates a significant deterrent for U.S. financial institutions operating a servicing business – a business that contributes to a balanced model for institutions engaging in loan production. The value of servicing is countercyclical to the loan production business, and history has demonstrated that successful organizations focus on both the origination and servicing aspects of the mortgage industry to provide a consistent stream of noninterest income. To illustrate, fluctuations in servicing profitability is driven largely by changes in loan prepayments and the resulting MSR amortization. During periods of lower mortgage interest rates and increased borrower refinancing, loan prepayments increase causing MSR amortization to increase, negatively impacting servicing profitability. Increased refinance activity contributes to increased profitability of the loan production business offsetting the impact to the servicing business. We believe that regulators should support a balanced business model and therefore we encourage the regulators to implement MSR capital rules which balance capital adequacy with the need for financial institutions to maintain sound business models. Considering the factors stated above, we believe that capital rules for the amount of MSRs subject to the 10% and 15% limits but not deducted from Common Equity Tier 1 should maintain the current risk weighting applied to MSRs.

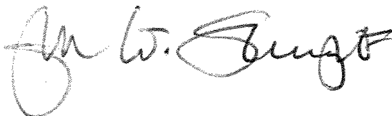
Conclusion

The Basel III Framework attempts to address banking sector capital weaknesses through an abundance of regulatory capital changes. However, concurrently implementing a significant amount of capital changes could lead to less credit availability and higher costs of borrowing. We believe refinements to the MSR capital rules proposed by the Basel III Framework can be made without compromising the Basel Committee's objective of strengthening the resilience of banks and can mitigate some risk of negatively impacting consumers and the economic recovery. Further, when considering our proposals, we ask that the Banking Agencies also recognize that MSRs are at relatively low levels due to the current stage of the business cycle. Capital rules that may have resulted in intended consequences when calibrated to a single point in the business cycle could result in unintended consequences and become progressively punitive at other points in the cycle.

For the reasons stated above, we urge that for U.S. implementation, the Banking Agencies modify the proposed Basel III Framework regarding MSRs. Our proposals do not require changes to existing U.S. GAAP and impact only regulatory capital reporting thus easing implementation efforts. We strongly believe that these proposals assist with tailoring the Basel III framework for adoption by U.S. financial institutions.

We look forward to the opportunity to further discuss the proposals expressed in this letter and would make ourselves available to meet with interested parties at their convenience.

Sincerely,



John G. Stumpf
Chairman, President and Chief Executive Officer

cc:

Norah Barger
Board of Governors of the Federal Reserve System

The Honorable Benjamin S. Bernanke
Board of Governors of the Federal Reserve System

Tim Clark
Board of Governors of the Federal Reserve System

Mike Foley
Board of Governors of the Federal Reserve System

Anna Lee Hewko
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