



A Review of Wells Fargo's Subprime Lending

CRL Issue Paper

April 2004

Wells Fargo & Company, a diversified financial services company, provides retail and business banking, insurance, investments, mortgages and consumer finance across the US. Its distribution system encompasses both traditional and non-traditional channels. Wall Street analysts praise Wells Fargo's revenue and sales growth, diversification, distribution/marketing prowess, and standout risk management.

Despite Wells Fargo's success, there appear to be serious trouble spots in its subprime mortgage lending, particularly the predatory practices of Wells Fargo Financial (WFF) that victimize low-wealth consumers. While these practices have been criticized by community groups since the mid-1990s, they apparently have been tolerated by Wells Fargo management because of the unit's profitability.

Background

A major money center bank, Wells Fargo operates approximately 3,000 bank branches, more than 750 home mortgage "stores," and about 1,200 consumer finance offices in the US, Canada, Latin America, and the Pacific Islands. Moody's has rated Wells Fargo's bank subsidiary AAA—the only bank with this rating—as a result of its consistent profits and conservative credit culture. In 2003, Wells Fargo's net income rose 14% to \$6.3 billion, on revenue of \$28.4 billion.

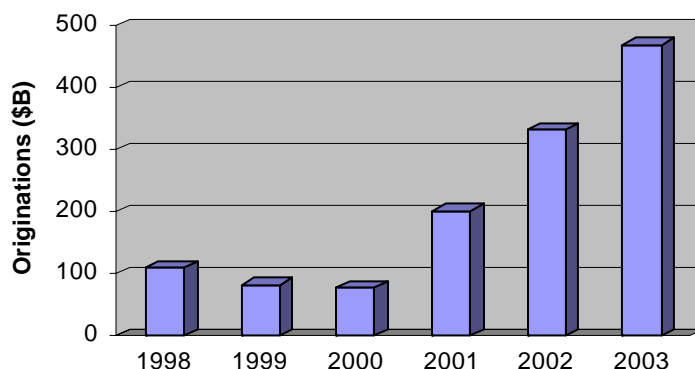
The company was formed through a \$3.4B "merger of equals" between Norwest and Wells Fargo banks in 1998. Norwest was the surviving entity, but the new company adopted the Wells Fargo name. The merger combined one of the nation's most efficient banks with a strong revenue generator.

Under CEO Richard Kovacevich, Wells Fargo bank branches have become retail "stores" that push as much product as possible. Selling several products helps pay the high fixed cost of maintaining a branch, and also creates customer "loyalty" by making it hard for someone to leave the bank that has their checking account, home loan, insurance policy, credit card accounts, etc.

Wells Fargo Mortgage Lending

One of the biggest drivers in Wells Fargo Bank's steady income growth is its mortgage business, which contributes approximately one-third of the company's earnings year after year. Des Moines-based Wells Fargo Home Mortgage (WFHM) is one of the nation's largest mortgage originators and servicers. At the end of 2003, WFHM originations hit \$470B and mortgage servicing reached a record \$664B.

Wells Fargo Mortgage Originations, 1998-2003



Source: 2003 Mortgage Market Statistical Annual, Inside Mortgage Finance

	Originations (\$B)	Market Share	Industry Rank
1998	\$109.5*	7.7%	1
1999	\$ 82.0*	6.4%	2
2000	\$ 76.5	7.3%	1
2001	\$202.0	8.8%	1
2002	\$333.0	13.3%	1
2003	\$470.0	12.5%	1

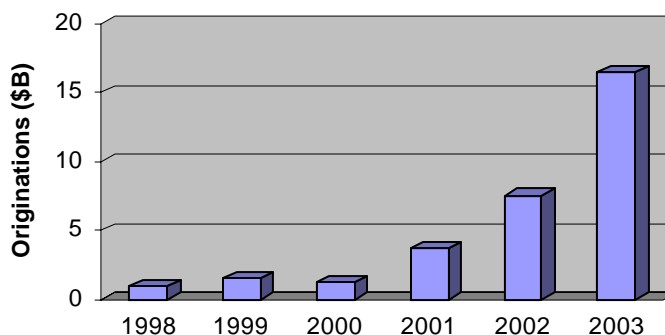
* Norwest Mortgage

According to Peter Wissinger, named president and chief operating officer of WFHM in 2000, the company's focus has been (and remains) increased efficiency, higher ancillary revenue, and new channels & partnerships. The first two items are especially important given Wells' higher reliance on retail originations compared with other major lenders.

Wells Fargo's "Two Channels" of Subprime Lending

Wells Fargo's subprime mortgage lending totaled \$16.5B in 2003. While this is modest volume compared to Wells Fargo's prime mortgage originations, the company now ranks # 8 among B&C lenders and generally has been doubling its subprime volume each year since 2000.

**Wells Fargo Subprime Mortgage Originations,
1997-2003**



Source: 2003 Mortgage Market Statistical Annual, Inside Mortgage Finance

	Subprime Mortgage Originations (\$MM)	Market Share	Industry Rank
1997	\$ 230	0.2%	N/A
1998	\$ 884	0.6%	29
1999	\$ 1,480	0.9%	22
2000	\$ 1,184	0.9%	21
2001	\$ 3,679	2.1%	12
2002	\$ 7,547	3.5%	10
2003	\$16,485	5.0%	8

Wells Fargo originates subprime loans through Wells Fargo Home Mortgage and Wells Fargo Financial. The two organizations got into subprime lending in different ways, and have completely separate (and often very different) sales forces, organizational cultures, and operating practices.

Channel #1: Wells Fargo Home Mortgage -- Subprime lending as product expansion

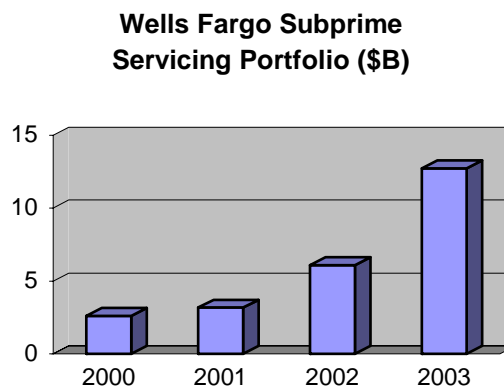
Wells Fargo—still Norwest at the time—was attracted by the profit potential in subprime lending: “[The Money Store] made 85% of our earnings on one-tenth the volume,” stated a Norwest executive in 1998.¹ In addition, Norwest realized it had advantages over subprime finance companies because it could hold or sell loans and, as a depository, didn’t have to rely on warehouse lending or the commercial debt market for capital.

Further, Norwest management realized that subprime lending as practiced by finance companies had serious flaws. It saw that lenders were originating loans at almost any cost, securitizing them and recording a significant gain on sale, but ultimately creating no real equity. (This point was missed by First Union, who acquired the Money Store for \$2.1B in 1998 only to write off \$1.7B its investment two years later.)

As a result, Norwest chose to create its subprime mortgage business internally. It purchased Directors Mortgage Loan Corp of California in 1995 to use as a subprime lending and servicing platform. Renamed Directors Acceptance, the unit opened its corporate headquarters in Carlsbad CA and began making loans in early 1997.

Directors original goal was to reach loan volume of \$500MM in three years. Management believed it could achieve this by tapping Norwest customers who had been turned down for conventional loans—reportedly 30,000 denied applications in 1995 alone.

Using its large sales organization and branch network, WFHM has rapidly grown its subprime originations and industry position. Wells also set up a separate servicing site for subprime loans in Charlotte, NC, and created a specialized default management team. In 2000, Fitch gave Wells a RPS2 rating (the best) for its subprime servicing, citing the performance of collections and loss mitigation staff dedicated exclusively to subprime loans, and the performance of Wells' portfolio. By year-end 2003, Wells Fargo had a subprime portfolio of \$12.7B.



Source: Inside B&C Lending

Channel #2: Wells Fargo Financial – Unfettered consumer lending

Wells Fargo's consumer finance company, originally Dial Finance, was acquired by Norwest in 1982. At that time, Dial Finance had 460 stores in 38 states, and assets of \$1.1 B.

From 1984-87, Dial/Norwest Financial was consistently the top performing business segment at Norwest Bank; in 1986 the unit generated 60% of the entire company's profits. In 1987, Duff & Phelps rated Norwest Financial the nation's premier consumer finance company, and one analyst later asserted that the unit's consistent profitability "was probably what spared Norwest from being taken over."²

In 1994, American Banker called Norwest Financial "the powerful profit engine [that] helped propel Kovacevich into the catbird seat on Wall Street."³ At that time, Norwest stock was trading at 225% of book value, the highest multiple among nation's largest regional banks.

The same American Banker article described the Norwest Financial culture and profitability:

To step inside Norwest Financial is to enter a flexible, fast-paced world where federal regulation takes a backseat to competition and discipline...In most cases, the unit can open offices in any state without going through an elaborate approval process. There is no federal regulation and state lending laws are not onerous.

*On average, first-year start-up costs for a new office are about \$200K, versus \$1mm for a de novo commercial bank branch. Most new units break even by the third year, versus five years for a new bank branch. As for why bank regulators keep their hands off: liability funding comes entirely from non-deposit sources and is composed of commercial paper and long term debt. Equity capitalization exceeds 20% of assets...And there are rewards to go with the risks: First Manhattan Co estimates Norwest Financial enjoyed an average 21% yield on receivables in 1993, versus an average 6.3% cost of funds.*⁴

Most of Norwest Financial's growth during the late 1980s and 1990s came via acquisitions of other consumer and auto financing companies. It also added a credit card business through two banking subsidiaries, insurance business lines, and a collection service. In addition, Norwest expanded beyond the US through acquisitions of Trans Canada Credit in 1992 and Island Finance (the largest consumer finance company in Puerto Rico) in 1995.

For further growth, Norwest Financial pursued vigorous cross selling campaigns with other Norwest divisions by, for example, providing lists of customers who were renters to Norwest Mortgage and targeting that unit's homeowners for financing purchases of furniture, appliances, etc. It took over Norwest bank's credit insurance operation and began cross-selling this to its customers and mortgage customers. The unit also relied on selling "new" loans to its existing customer base: in 1999, Norwest Financial reported that 60-65% of its volume came from borrowers who were already in debt to them.⁵

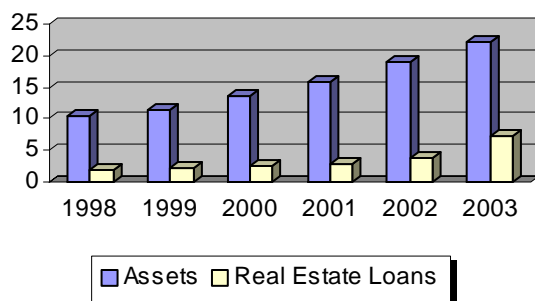
While the consumer finance unit grew and its name changed over time (ultimately to Wells Fargo Financial in 2000), its senior management has remained intact for years. David Woods, Norwest Financial's chairman and CEO until 2000, joined Dial Finance in 1970. Tom Shippee, current COO of Wells Fargo Financial, has been with the subsidiary for almost 30 years. Norwest/Wells Fargo top management sets profit goals for the unit and allowed it to operate with relatively little oversight of day-to-day operations. "From our perspective," said one executive "[this] is the only way to go. You cannot take a business that's been successful, managed away from a bank culture, and convert it and have it continue to be successful."⁶

The consumer finance company has its own system to support origination, funding, servicing, collections and reporting of subprime loans. According to public statements, Wells Fargo Financial does not use credit scoring but relies heavily on collateral-based underwriting on real-estate secured loans.⁷ "The loan is only going to be as good as the appraisal value is low; [and] as long as the LTV is low, you keep the borrower paying because the amount of debt at stake is not worth losing a house over," according to one exec.⁸

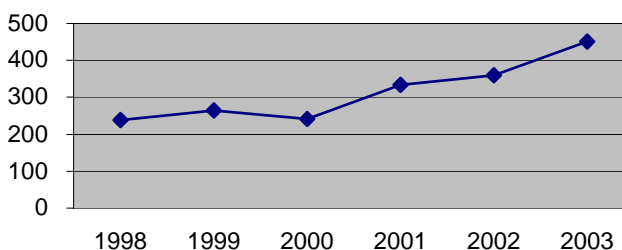
In the late 1990s, Wells Fargo Financial continued to be profitable, but its growth was disappointing to Wells Fargo top management. Daniel Porter, previously a GE Capital executive, was hired to succeed David Woods in 1999, and implemented changes designed to reclaim the unit's double-digit profit growth. "I wanted to compete with the likes of Citifinancial...but they had a broader set of products and greater focus on real estate," he said.⁹ These changes included (1) adding technology, (2) achieving greater scale and geographic distribution through acquisitions, (3) expanding real estate loan offerings to range from prime to "near-prime" to subprime, and (4) moving the credit card operation to Nevada and South

Carolina so it could charge higher rates and fees. The result was higher concentrations of real-estate secured loans, and higher profits.

Wells Fargo Financial Assets (\$B)



Wells Fargo Financial Net Income (\$MM)



Wells Fargo Financial (\$MM)				
	Assets	Revenue	Real-estate Secured Loans	Net Income
1998	\$10,516	\$2,000	\$1,889	\$239
1999	\$11,283	\$2,184	\$2,137	\$265
2000	\$13,576	\$2,234	\$2,507	\$241
2001	\$15,909	\$2,623	\$2,984	\$334
2002	\$18,988	\$2,220	\$3,732 est	\$360
2003	\$22,281	\$2,689	\$7,200 est	\$451

Source: Wells Fargo earnings statements, Wells Fargo Financial 10-K/405, and 10-Q SEC filings. Real-estate secured loan estimates based on statements included in Wells Fargo earning releases

CRL Concerns with Wells Fargo Subprime Lending Practices

Getting a clear and complete picture of Wells Fargo's subprime lending is difficult, because the company originates loans through two units with sometimes very different operating practices. In addition, many standard methods of analyzing a lender's mortgage activity cannot be used with Wells Fargo because (1) a significant portion of Wells Fargo Financial's loans are not reported in its HMDA data, and (2) Wells Fargo Financial does not securitize its loans, so securities prospectuses describing loan terms are not available.

Nonetheless, we have seen Wells Fargo Financial embrace a host of practices that victimize low-wealth consumers, including excessive fees and high interest rates, deceptive marketing and customer steering, loan "flipping," overpriced insurance, and sham "open-end" loans and credit cards.

Many of these are long-standing practices, and community groups such as ACORN have complained about them for years. Others are newer, and appear to have been adopted at least in

part to circumvent state anti-predatory lending laws. The major abuses identified by ACORN, the Center for Responsible Lending, and other organizations are described below:

- **Excessive Fees:** As recently as 2002, WFF had been regularly financing fees of 10% into refinanced first mortgages. To add insult to injury, they often labeled their fees “discount points,” although borrowers also were charged very high interest rates. In response to growing public attention, WFF lowered its standard amount of fees to 7% of the loan amount in May 2003, and subsequently said they were limiting fees to 5%.¹⁰

In a January 2004 meeting with CRL staff, WFF executives indicated that they now routinely charge customers, regardless of credit score, 4% in prepaid finance charges.

Further, from Wells' description WFF underwriting procedures to the Federal Reserve, it is clear that WFF continues to make HOEPA loans, potentially including loans in excess of an 8 percent points-and-fee threshold (excluding prepayment penalties and yield spread premiums).¹¹ One possible explanation is that WFF's uses a limited definition of “points” that fails to adequately capture all of the points and fees a borrower pays on a loan.

- **Unfair and Inconsistent Pricing:** Wells Fargo subprime borrowers will not get the best loan possible, if their first contact is with WFF. As mentioned earlier, WFF executives have admitted that its customers get higher-priced loans compared to similar subprime customers at Wells Fargo Home Mortgage.

And while WFHM now screens all borrowers through an “A-Filter” to identify the best interest rate they qualify for, WFF “does not classify credit as prime or subprime as a factor in setting APRs”,¹² suggesting that there is room for wide variation in the terms offered clients. ACORN has identified several troubling examples of WFF borrowers with good credit receiving loans with excessive fees and high interest rates.

- **Prepayment Penalties:** As with WFHM loans, a large portion of WFF subprime loans contain prepayment penalties. ACORN found too that WFF borrowers frequently were unaware that their loans contained a prepayment penalty, because the loan officers never pointed it out or deliberately misled them.

Wells Fargo does not publicly disclose the size of those fees, but we note that the vast majority of Wells Fargo Home Mortgage loans carry prepayment penalties of six months interest on 80 percent of the amount prepaid.¹³ This equates to fees of approximately 3.5% of the loan amount or higher—an average of \$5,300 on each loan. In most cases, this will be equity stripped directly from consumers' homes.

- **Mandatory Arbitration:** Historically, Wells Fargo loans carried a mandatory, pre-dispute arbitration clause that waived a borrower's right to access the courts and diverts cases to a costly private legal system that favors the lender. Borrowers were left with no choice but to waive these rights, because arbitration clauses are presented on a take-it-or-leave-it basis. WFHM recently ceased this practice, when Freddie Mac announced it

would no longer purchase loans with mandatory arbitration clauses. However, we have seen no evidence that WFF, which holds all its loans in portfolio, has followed suit.

Mandatory arbitration almost always has several features that would make it difficult, if not impossible, for a WFF borrower to prevail in a dispute with the company, including high costs, limited discovery, inconvenient venue, prohibition of class actions, no public record, and limited judicial review. The National Consumer Law Center advocates believe these clauses are the single biggest threat to consumer rights in recent years.¹⁴ Mandatory arbitration is expensive for consumers, denies them their rights under law, and, in the vast majority of cases, benefits only lenders. Public Citizen, a Washington consumer advocacy group, estimates that filing a claim on a loan of \$75,000 can cost a borrower more than \$2,000, plus thousands more in fees paid to the arbitrators who decide the case.¹⁵

- **Single-Premium Credit & Life Insurance:** Wells Fargo Financial regularly financed credit insurance policies into their home loans until October 2002, when the Federal Reserve changed regulations to discourage these policies. ACORN has found that WFF continues to sell single-premium life insurance to its borrowers, with the same financial impact on consumers that the Federal Reserve sought to outlaw. ACORN also found that these policies often were sold deceptively with high-pressure tactics.¹⁶

It is interesting to note that insurance has been a trouble spot for WFF in the past. In 1998, Norwest Financial paid \$870,000 to 3,000 Texas consumers to settle claims they had been misled into buying credit and collateral insurance on loans in what was called insurance “jamming.”¹⁷

- **Refinancing without Benefit (flipping):** Wells' loan officers frequently convince borrowers to refinance in transactions that provide little benefit to borrowers but generates profits for WFF from financed fees, increased interest revenues, and other terms that tack on extra costs. On the other hand, one community group has learned that WFF employees who leave the company are told that if at their next employer they refinance any Wells Fargo loans, they will be sued for \$2000 for each loan.¹⁸

According to its recently announced “Responsible Lending” practices, WFF now requires that refinances provide a “tangible benefit” to consumers. However, it defines this to include a loan that reduces a customer's current monthly debt payments by any amount. Based on this definition, WFF could charge over \$17,000 in fees to a consumer to refinance \$10,000 in 29% interest credit card debt, and still provide a “benefit.”¹⁹

- **Hidden Variable Interest Rates:** WFF borrowers often were led to believe they were receiving fixed interest rates when their loans actually contained a variable rate, which could only go up. ACORN found that Wells Fargo Financial loans frequently contained variable interest rates that might start at 11% and have a ceiling of 17%. Structuring the loan with a variable interest rate also enabled Wells Fargo Financial avoid any restrictions in state law on the length or amount of prepayment penalties, under an interpretation of federal law by the federal Office of Thrift Supervision later reversed.

- **Spurious Open-End Loans:** WFF sells consumers revolving lines of credit secured by their homes, in many cases systematically tacking on home-secured credit cards with high interest rates as junior mortgages which were never requested by the borrowers. WFF appears to be transforming what are closed-end loans in every other respect into open-end loans by adding an additional page into the loan documents setting out a credit limit. This enables WFF to evade reporting requirements and insulates the company from liability under state and federal consumer protection laws.

But more important, these open-end credit cards or lines of credit harm consumers in a several ways: (1) the higher interest rates on the credit lines rack up large interest payments; (2) the home-secured debts inflate borrowers' loan-to-value ratios, making it more difficult for them to refinance out of their loans; and (3) borrowers often do not realize that the credit cards/lines are secured by their homes and thus are unaware of the real risk and costs of their Wells Fargo loans.²⁰

We believe that WFF used these open-end loans in order to evade a number of state and federal anti-predatory lending laws, many of which to date have tended not to include open-end loans in the scope of covered loans.

- **Live Checks:** To bring customers in, Wells often mails out unsolicited live checks to homeowners for a few thousand dollars. In reality, these are loans with interest rates of 25% or 30%, and are aimed at vulnerable homeowners who either do not understand what they are getting into and/or are confronting difficult personal situations. In sending out the live check, WFF's apparent goal is to get the homeowner to refinance their entire mortgage with them.

Wells Fargo defends its use of live checks and relies upon disclosures to make the claim that borrowers understand that these are loan products.²¹ However, the California Department of Corporations filed suit against Wells in January 2003 for \$38.8 million in civil penalties for charging borrowers rates above those listed on the loan contracts, after Wells failed to correct the overcharges after an earlier notification.²² We also wonder if consumers actually have read the disclosure "fine print", which indicates that borrowers who make a late payment will be in default on their loan, and may be required to pay the entire outstanding balance immediately.

- **HMDA Under-Reporting:** The Center for Responsible Lending's analysis of Wells Fargo home loans has revealed substantial discrepancies between courthouse records and data reported under the Home Mortgage Disclosure Act (HMDA), suggesting a pattern of under-reporting loans originated by Wells Fargo Financial. This has prevented regulators from fairly evaluating Wells Fargo's lending patterns by dramatically under-reporting lending activities by its subprime subsidiary.

In 2002, courthouse records from 17 states revealed that WFF made 20,847 loans in these states. For that year, however, WFF only reported to the federal government that it made 4,770 loans in the same states. In other words, Wells Fargo underreported the number of

loans made by its subprime unit in these states by more than 400%. In state after state, across every region of the country, WFF HMDA filings fail to match the number of subprime loans indicated by courthouse records.

While Wells Fargo has offered no convincing explanation for these discrepancies, we estimate that at least some are the result of WFF open-end loans discussed previously, since these are exempted from HMDA reporting requirements. We note that WFF reported significantly more HMDA loans in Georgia, a state with restrictions on open-end subprime loans.

**Wells Fargo Financial
2002 Home Loans for Selected States**

State	#WFF loans per courthouse records	#WFF loans reported under HMDA
Alabama	904	22
California	5,464	20
Colorado	1,636	1
Florida	2,956	1,599
Georgia	861	1,220
Illinois	1,311	0
Nebraska	358	620
New Jersey	666	1
New York	644	0
North Carolina	961	0
Ohio	1,300	876
Oregon	61	9
Rhode Island	61	9
South Carolina	378	0
Tennessee	1,454	0
Texas	1,194	0
Washington	697	402
TOTAL	20,847	4,770

Conclusion

Lulled by favorable analyst reports, Wells Fargo investors may not realize they are subsidizing a predatory lender. In addition, limited regulatory oversight and loopholes in regulations have enabled Wells Fargo Financial to hide predatory practices from federal regulators. Sadly, the people who see these problems most clearly are the unit's customers, who too often face the loss of their home or financial ruin as a result.

About the Center for Responsible Lending

The Center for Responsible Lending is dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is a national nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families.

For additional information, please visit our website at www.responsiblelending.org.

Issue Paper: Wells Fargo's Subprime Lending

Notes

¹ "Norwest Mortgage Exec Sees Opportunity in Subprime", National Mortgage News, 16 Nov 1998.

² "Norwest's Pitchman" Institutional Investor, Dec. 1, 1996

³ "Norwest Racking Up Major Profits from Consumer Business" American Banker, 28 March 1994

⁴ Ibid.

⁵ Wells Fargo Financial SEC 10-K filing, 12/31/98

⁶ "Subprime Credits Beckon to Banks", US Banker, 10 Oct 1995

⁷ Ibid.

⁸ Ibid.

⁹ "Parting Thoughts from Wells Consumer Finance Exec", American Banker, 28 July 2003.

¹⁰ "Wells Fargo Facing Tough Criticism," Los Angeles Times, March 2, 2003.

¹¹ Wells Fargo Aug. 11 Federal Reserve Response p. 33.

¹² Wells Fargo Aug. 11 Federal Reserve Response p. 33

¹³ SEC 424b(5) filings available at www.sec.gov:

STRUCTURED ASSET INVESTMENT LOAN TRUST 2003-BC9 (August 23, 2003); ASSET BK FDG CORP ABFC MTG LN 03 WF1 (March 25, 2003); ASSET BACKED FUNDING CORP CERT SE 02 WF1 (March 28, 2002); ASSET BK FDG CORP ABFC MTG LN 02 WF2 (October 28, 2002).

¹⁴ National Consumer Law Center <<http://www.consumerlaw.org/initiatives/model/arbitration.shtml>>

¹⁵ Public Citizen <<http://www.citizen.org/congress/civjus/arbitration/articles.cfm?ID=7360>>

¹⁶ **Stop the Stage Coach!** Association of Community Organizations for Reform Now (ACORN). May 2003
<http://www.acorn.org/index.php?id=64>

¹⁷ "Norwest subsidiary settles with 3,000 Texas consumers// \$869,435 payment comes after claims the company misled customers about buying loan insurance." Austin American-Statesman. 30 September 1998.

¹⁸ Inner City Press "Wells Fargo Watch" <www.innercitypress.org>

¹⁹ Assumes WFF replaces 29% rate credit card debt with 10% mortgage loan. The related reduction in monthly payment would be \$154. If \$150 were added back to the mortgage (still providing a "benefit" of \$4 per month to the consumer), this would increase the loan principal by \$17,092.

²⁰ Wells Fargo credit card agreement includes the following text: "If there shall be any default in payment of any sums due under the Credit Card Account Agreement,...[we can] terminate the Credit Card Account Agreement and require you to pay the entire outstanding balance in one payment...and sell the land herein conveyed at public auction for cash."

²¹ Wells Fargo Financial, "Wells Fargo Overall Response to ACORN's May 5, 2003 Report" at 11.

²² "State Sues to Void 'Instant Loans' by Wells Fargo Unit," Los Angeles Times, by E. Scott Reckard, January 10, 2003.