September 9, 2019

Alternative Reference Rates Committee ("ARRC")

Via email submission to: arrc@ny.frb.org

Re: Consultation Response – ARRC Consultation Regarding More Robust LIBOR fallback Contract Language for New Closed-End, Residential Adjustable Rate Mortgages

Wells Fargo & Company ("Wells Fargo") submits this response to the ARRC Consultation regarding more robust LIBOR fallback contract language for new closed-end, residential adjustable rate mortgages. Wells Fargo recognizes the critical work of the ARRC to identify best practices for effective contractual fallback language. We hope these efforts will reduce market disruption in the event that LIBOR is discontinued. In addition, Wells Fargo appreciates the tremendous work of the ARRC Consumer Products Working Group in developing this consultation, taking into consideration a wide range of views from members regarding the complex issues related to the LIBOR transition.

Responses to Questions:

A. Triggers

Question 1: *Should fallback language for ARMs include either of the pre-cessation triggers (triggers 4(G)(ii) and 4(G)(iii))? If so, which ones?*

Trigger 4(G)(ii) should be included to allow banks to respond to regulatory guidance. In the case that the LIBOR Administrator's regulator opines that the Benchmark is no longer reliable or representative and triggers are not included elsewhere, nationally-chartered banks will need an opportunity to transition. We note that the Replacement Index and Margin will be operative immediately after this trigger and this may cause challenges in converting so quickly. These challenges could include giving notices or other communications and implementing necessary adjustments to systems and reporting and payment processes.

We have a concern about the practical effect of trigger 4(G)(iii). This trigger can be activated from any number of possible sources and by any number of possible events. Since there is no central source for this trigger, some market participants, especially smaller or regional servicers and investors may have challenges monitoring these occurrences. In addition, as we read the trigger, a prohibition in one state would not affect obligations in any other state. Therefore, a note holder or servicer could be required to treat two similarly situated obligations arising out of different states differently. This trigger is unlike all other triggers endorsed by the ARRC. We are concerned about unintended consequences and are not convinced about the need for this trigger.

Question 2: *Please indicate whether any concerns you have about these pre-cessation triggers relate to differences between these triggers and those for standard derivatives or relate specifically to the pre-cessation triggers themselves.*

Wells Fargo is concerned about the potential basis risk with derivatives if ISDA does not include any similar precessation triggers. Although the parties to most ARMS do not themselves include a derivative, other parties in the mortgage ARM marketplace may use derivatives to hedge their various exposures or interests. We support ISDA triggers that align with ARRC triggers.

Question 3: *If pre-cessation triggers are not included, what options would be available to market participants to manage the potential risks involved in continuing to reference a Benchmark whose regulator has publicly determined that it is not representative of the underlying market?*

If precessation triggers are not included, we see no practical or viable options for market participants to manage the "unrepresentative rate" risk.

Question 4: *The ARM language proposed uses simplified language in an effort to be more comprehensible for the consumer market. Is the simplified language appropriate or are there concerns with the language not matching ISDA or other cash product language precisely?*

The "simplified" language of the proposed language is consistent with the relatively "simplified" language of the ARM itself. The standard LIBOR ARM is both quantitatively and qualitatively different from the contracts used for most of the other cash products for which ARRC has made recommendations. The level of complexity of the typical LIBOR ARM is quite different from the level of complexity of the typical syndicated or other business loans or floating rate notes. As such, the simplified language is much more appropriate than would be language similar to the ISDA or other cash products fallbacks. Language of that intricacy would be confusing for consumers and difficult to explain. In addition, more complex provisions within a consumer products, such as residential mortgages, could increase, rather than decrease, litigation risk for all parties.

B. <u>Replacement Index and Margin</u>

<u>Step 1: ARRC Replacement Index</u>

Question 5: *Is the replacement index determined by the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Federal Reserve Board or the Federal Reserve Bank of New York the best choice as the first step of the waterfall? Why or why not?*

Wells Fargo supports the use of a replacement index recommended or determined by a governmental entity as the first step in the waterfall, especially if the index includes a recommended spread adjustment (See answer to Question 6). The use of such an all-inindex has the following benefits: (i) because it is produced by a relevant governmental entity, it would be less likely to manipulation and would not be subject to the problems that might arise with a privately-produced index, (ii) it would be publicly available and would be widely accessible, (iii) it would satisfy market requirements for reliability and predictability, and (iv) it would constitute a single source for index replacement that includes a credit-spread adjustment. If Note Holders determined the replacement index, different Note Holders might select different indices, which could result in different outcomes across the same consumer product type.

Question 6: *As noted in the narrative, the ARRC has committed to recommending spread adjustments for cash products that reflect the general difference between various tenors of LIBOR and SOFR. In addition, the ARRC has committed to seeing all-in, "spread- adjusted" rates published for use in cash products (e.g., a SOFR-based spread-adjusted replacement index for 1-year LIBOR). Should the ARRC recommend a spread adjustment for LIBOR ARMs and other consumer products, and should the corresponding spread- adjusted rate be the replacement index for the LIBOR ARMs?*

If the ARRC does in fact publish a replacement index, the ARRC should definitely recommend a spread adjustments for LIBOR ARMS and other consumer products, and should also publish replacement indices with the related spread adjustments included. Such an "all-in" rate would be easier for servicers to handle because it would eliminate the need for the additional calculation. In addition, it would be easier for the parties to understand and to explain to consumers. Finally, the inclusion of a rate *and* adjustment will reduce the likelihood of a market disruption upon LIBOR cessation.

Question 7: *As noted in the narrative, in addition to recommending SOFR, the ARRC may recommend forward-looking term SOFR rates if it is satisfied that a robust, IOSCO- compliant term rate that meets its criteria can be produced. If the ARRC recommends forward-looking term rates (e.g., 1-month, 3-month, 6-month, etc.) and a corresponding spread adjustment, should a spread-adjusted term rate be the replacement index for LIBOR ARMs, or would a spread-adjusted average (simple or compounded) of SOFR be more appropriate? Please provide support for your answer*

All indications are that a forward looking term rate (FLTR) would be easier for market participants to administer and to explain to consumers. The majority of industry LIBOR ARMs have a one-year tenor. However other LIBOR ARMs and other consumer products use shorter FLTRs (i.e., 1, 3, or 6 months). If SOFR FLTRs develop, Wells Fargo believes the resulting rates would be a good fit and would support their use in LIBOR ARMs and other consumer products. As noted above in our answer to Question 6, we strongly urge the ARRC to include a spread adjustment as part of any published rate.

If a SOFR FLTR does not develop, Wells Fargo would support the use of a simple spread adjusted average inclusive of a spread adjustment for LIBOR transition.

We note, however, that the economic results of any such solutions have not yet been determined. In addition, unlike some other cash products, the effects on third party investors, in addition to the effects on the initial parties, will be important to the ultimate decision.

<u>*Step 2: Note Holder Determined Replacement Index and Margin*</u>

Question 8: *Should the Note Holder have the responsibility as the 2nd and last step of the waterfall? Why or why not?*

Wells Fargo believes that the Note Holder is the appropriate party to determine the benchmark under the second and final step of the waterfall. It would be inappropriate to require the Borrower to make any such determination. Furthermore, other than the Borrower, no other party has the contractual right to effect such a determination.

Question 9: *Should the Note Holder have the ability to make adjustments (positive or negative) to the loan's margin to more closely approximate LIBOR at the time of replacement? Why or why not? If you do not believe the Note Holder should make adjustments to the loan's margin, and potential replacement indices diverge from the value of the current Index, what provision or step should be taken to preserve that consistency?*

Wells Fargo believes that it is important for the Note Holder to have the ability to make these types of adjustments, because this is the only way to maintain the balance between the interests of the various parties and to maintain the original agreement made among the parties. We do not believe that allowing the Note Holder to make such adjustments will create any incentives to benefit itself at the expense of the borrower.

Question 10: *If the Note Holder is a trust (for example, as may occur in agency or private label MBS), is there some entity other than the Note Holder that should be responsible for identifying the Replacement Index if Step 1 of the waterfall fails? Please provide sufficient rationale for your answer.*

For the reason described in our answer to Question 8 above, Wells Fargo believes that the Note Holder is the appropriate party to identify a replacement index, regardless of who or what type of entity the Note Holder might be. Allowing this determination to be dependent on the type of entity (i) would be difficult to address in a standard mortgage note, (ii) would create confusion in the marketplace, and (iii) may be challenging to implement.

Whether the Note Holder could delegate such a responsibility to a third party in a separate agreement, for example to the servicer by way of a servicing agreement, is a different question. These types of arrangements, outside of the Note Holder – Borrower agreement, we understand to be beyond the scope of this consultation. Nonetheless, because they are part of the fabric of the mortgage ARM marketplace, and involve important duties and responsibilities, we suggest that these types of relationships should be considered and discussed in another forum.

C. Other Questions

Question 11: *Will this language have unintended consequences not considered by the ARRC working group, such as title insurance restrictions, state law endorsement or filing restrictions, etc.? If so, please explain and provide information about why this language would present challenges. If there are concerns with this proposed language, please be sure to specify if concerns relate to this proposed language, or index replacement language in general.*

Because unintended consequences are almost, by definition, unforeseeable, it is too early to tell whether any exist and what they are. We are comforted by the fact that unlike other asset classes, index replacement is a relatively common occurrence in the consumer residential mortgage market. In some ways, many of the possible consequences may already have been faced and addressed.

D. General Feedback

Question 12: *Is there any provision in the proposal that would significantly impede ARM originations? If so, please provide a specific and detailed explanation.*

Wells Fargo understands that the ARRC Accounting and Tax Subgroup have sought guidance and relief from the Internal Revenue Service and the Treasury Department regarding the tax treatment of the use of fallback provisions under the material modification provisions of Section 1001 of the Internal Revenue Code and related regulations and various other tax and accounting issues. Since fallback provisions of LIBOR ARMs will be subject to the same provisions, Wells Fargo is very interested in the results of the ARRC's request. LIBOR ARM issuers will need to consider the possible tax and accounting issues when issuing ARMS and may need to adjust final fallback language and related implementation after any guidance or relief is received. Similar issues relating to hedge accounting and embedded derivatives will need clarification to avoid uncertainty and market disruption.

Question 13: *Please provide any additional feedback on any aspect of the proposal.*

None at this time.

Wells Fargo wishes to thank the ARRC Consumer Products Working Group for the opportunity to provide this feedback on the LIBOR ARM Fallback Consultation. We are happy to discuss our responses further or provide any additional information that may be helpful.

Thank you,

Wells Fargo Bank, National Association