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Wells Fargo Plunges Into Mortgage Muck

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After avoiding major trouble most of the year, Wells Fargo & Co. has finally bogged down in the mortgage muck that's muddying one major bank after another.

Wells Fargo, the fifth-largest U.S. bank, waded into the mess by saying it will recognize $1.4 billion in losses in the fourth quarter on home equity loans that aren't being repaid as the real estate slump deepens in California, the Midwest and other major markets.

Until Wells Fargo's disclosure late Tuesday, the San Francisco-based bank had been largely unscathed by the turmoil that has battered a long list of other major lenders.

"Clearly, this is a disappointment because (Wells) had been seen as better managers of credit than many other big banks," said RBC Capital Markets analyst Joseph Morford. "But now they have a big blemish on them, too."

After gaining 34 cents to finish at $29.83 in Tuesday's regular session, Wells Fargo shares plunged $1.40, or 4.7 percent, in the extended trading that followed a Securities and Exchange Commission filing outlining the bank's home equity loan losses.

"Maybe people are going to be freaked out about Wells Fargo's losses, but they shouldn't be," said Punk, Ziegel & Co. analyst Richard Bove. "Wells Fargo isn't superhuman and they made some bad loans just like everyone else."

Wells Fargo still remains in far better shape than many of its peers because it sold most of the $2 trillion in home loans that it originated since 2001 and invested relatively little money in the mortgage-backed securities that are lumping other big banks with multibillion-dollar losses.

The first whiff of Wells Fargo's home equity woes surfaced last month when the bank reported it lost $153 million on the portfolio in the third quarter, up from $27 million at the same last year.

Wells Fargo's chief executive, John Stumpf, spooked investors even further two weeks ago when he described the current real estate slump as the worst since the Great Depression and reiterated earlier projections that the bank's home equity losses would continue to rise next year.

Given that so many other banks had disclosed plans to write off huge losses in the fourth quarter, Wells Fargo might have decided it was an opportune time to clean its financial house too, Morford said.

After being promoted to chief executive officer four months ago, Stumpf also may have wanted to make sure that he isn't blamed for any ill-advised loans taken on by his predecessor, Richard Kovacevich, Bove said.

Besides taking a hit on its home equity portfolio, Wells Fargo also is retroactively registering $265 million in expenses tied to its share of the costs for a $2.25 billion settlement that credit and debit card network Visa Inc. reached with American Express Co. earlier this month. Wells Fargo owns a 5 percent stake in Visa.

The legal expenses will trim Wells Fargo's previously reported earnings for the second quarter of 2006 by 2 cents per share and lop off 4 cents per share from its earnings for its most recent quarter ended in September.

Wells Fargo said most of its anticipated loan losses are concentrated in a $11.9 billion bundle of high-risk home equity loans that the bank intends to liquidate. The nettlesome loans represent about 14 percent of the bank's total home equity portfolio of $83.4 billion.

The bank said most of the delinquent loans originated from mortgage brokers or other lenders on the wholesale market and are concentrated in areas experiencing the sharpest declines in home values.

Although Wells Fargo didn't pinpoint the troubled markets in Tuesday's SEC filing, management has previously said the bank is experiencing its biggest headaches in California's Central Valley and "auto-belt" states in the Midwest.

"Given today's uniquely challenging environment, we believe that sharpening our focus on our better-performing and relationship-based home equity loans is in the best long-term interest of our company," Stumpf said in a statement.

The cautious approach is a stark change from a few years ago, when Wells Fargo and other banks sought to cash in on rapidly rising real estate prices by offering unusually low interest rates during the first few years of a mortgage while also lowering the bar to qualify for a loan.

Although Wells Fargo has maintained that it imposed higher standards than most other lenders, the bank has still been stung as eroding real estate prices left borrowers owing more money than their property was worth.

In other cases, borrowers are facing substantially higher monthly payments as the teaser rates on their mortgages expire and they can't refinance into more affordable loans. Facing a financial squeeze, some of these borrowers are trying to stay current on their primary mortgage and skipping payments on their home equity lines of credit.

As part of the mad scramble to buy real estate before the downturn, some mortgage brokers simultaneously lined up home equity loans for borrowers along with the primary loan used to buy the property.

This maneuver, known as a "piggyback," enabled cash-strapped borrowers to immediately tap into their home equity lines of credit to cover the down payment for the purchase, leaving the lenders with no little or no protection against a default as real estate prices plummeted.

It's unclear how many of Wells Fargo's home equity losses stemmed from piggyback loans.

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