FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2013 – 01

CONTINGENCY PLANNING FOR HIGH-RISK OR HIGH-VOLUME COUNTERPARTIES

Introduction

This Advisory Bulletin establishes guidelines for contingency plans for high-risk or high-volume counterparties at Fannie Mae and Freddie Mac (the Enterprises), and the Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities). The guidelines describe the criteria the regulated entities should use to develop plans for managing counterparty credit risk exposures.

This guidance does not supplant existing regulations that pertain to risk management at the regulated entities.

Background

A regulated entity's prudent management of counterparty risk includes establishing and maintaining written policies and procedures to prevent excessive exposure to any counterparty in relation to the counterparty's financial condition, or excessive exposure owing to a high volume or concentration of transactions with a particular counterparty or group of related counterparties. Counterparty risk management practices should measure counterparty risk limits and exposures against policy limits (including ranges and tolerances for each factor being monitored), institute procedures for initial and ongoing monitoring of a counterparty's condition and total exposure, and establish a framework for internal reporting on counterparty risk exposures and concentrations to boards of directors and senior management. Counterparty credit risk management practices should also include contingency plans to respond when internal limits are breached.

Federal Housing Finance Agency (FHFA) Prudential Management and Operations Standards (PMOS) were effective August 7, 2012, and supplement existing FHFA regulations. They address ten separate areas relating to the management and operation of the FHLBanks and the Enterprises. Standard 8 (Overall Risk Management Processes) and Standard 9 (Management of Credit and Counterparty Risk) highlight the need for the regulated entities to establish risk management practices that measure, monitor, and control credit risk and the need to have appropriate credit risk policies, procedures, controls, and systems.

This guidance considers and is generally consistent with the *Interagency Supervisory Guidance on Counterparty Credit Risk Management* issued by the federal banking regulators in June, 2011, which established specific guidance on counterparty credit risk management, including managing concentrated exposures and counterparty terminations.

Guidance

The regulated entities should establish criteria for identifying high-risk or high-volume counterparties based on internal limits, including ranges and tolerances. The analysis to identify a high-risk or high-volume counterparty should include an assessment of whether the deterioration in the condition of the counterparty or an elimination or reduction in an exposure could result in a material loss or significant disruption to operations. The regulated entities should have written contingency plans for high-risk and high-volume counterparties, including plans for individual counterparties or groups of related counterparties. These plans should provide a variety of actions that can be followed in the event internal limits are breached, including steps to reduce counterparty exposure and procedures for an exit strategy.

FHFA expects each regulated entity's risk management practices to include:

1. A process to conduct initial and ongoing monitoring and updating of each counterparty's or group of related counterparties' condition and risk profile, and the entity's overall exposure to each counterparty, groups of related counterparties, and total entity-wide exposures; and to track emerging events that may affect counterparty condition and risk profile, in accordance with Standard 8 (Overall Risk Management Processes) of the PMOS guidelines.

2. A comprehensive set of risk limits and a mechanism for reporting violations and breaches of risk limits to senior management and the board of directors, in accordance with Standard 8 (Overall Risk Management Processes) of the PMOS guidelines.

3. Policies that limit concentrations of credit risk and establish limits on exposures to individual counterparties and groups of related counterparties, in accordance with Standard 9 (Management of Credit and Counterparty Risk) of the PMOS guidelines.

4. Step-by-step procedures and decision-making responsibilities within a written contingency plan, including delegations of authority and a description of circumstances that would require action and escalation of issues.

5. Procedures that provide for orderly reduction of counterparty exposures that exceed internal limits commensurate with the size, type, and volatility of the risk in the exposure. Such actions could include, but are not limited to: (1) Transferring any exposure that exceeds internal limits to other counterparties after conducting appropriate reviews of their financial condition; (2) Establishing new reduced limits, or prohibiting additional transactions with the counterparty; and (3) Specifying timeframes to meet targeted reduction goals for different types of exposures, including steps to reduce exposure when a counterparty's financial condition is deteriorating.

6. A schedule for periodic testing of contingency plans. The tests should recreate a regulated entity's response when internal limits are breached to test communications and procedures and assess the contingency plan's effectiveness. Testing should also identify other qualified counterparties and assess whether they could be used in the event a contingency plan is enacted. Testing should be risk-based and conducted at a frequency that is commensurate with the materiality of exposures.

7. Standards to quickly and accurately assess the quantitative impact a counterparty's failure would have on the regulated entity.

8. Requirements for periodic review and update of contractual terms that relate to counterparty terminations, and confirmation that current agreements specify the definition of events of default and other termination conditions, and the termination process that will be used.

Examiners will review policies, procedures and practices related to credit and counterparty risk management, including an entity's contingency plans for high-risk and high-volume counterparties.

<u>Related Guidance</u>

12 CFR 932.9 of the Federal Housing Finance Board's regulations sets forth limitations on unsecured extensions of credit to a single counterparty or affiliated counterparties.

Rules and Regulations of the Federal Housing Finance Agency (12 CFR Part 1236). FHFA's Prudential Management and Operations Standards.

Monitoring Unsecured Credit Exposures and Concentrations, Federal Housing Finance Board <u>Advisory Bulletin</u> 98-10, December 8, 1998.

Risk Management Oversight, Federal Housing Finance Board <u>Advisory Bulletin</u> 05-05, May 18, 2005.

Advisory Bulletins communicate guidance to FHFA supervision staff and the regulated entities on specific supervisory matters pertaining to the Federal Home Loan Banks, Fannie Mae, and Freddie Mac. This bulletin is effective immediately upon issuance. Contact Kari Walter, Senior Associate Director, Office of Supervision Policy or Kyle Roberts, Associate Director, Examination Standards Branch with comments or questions pertaining to this bulletin.