FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2021-03: Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention

Purpose

This Advisory Bulletin (Advisory Bulletin, or guidance) establishes guidelines for adverse and non-adverse classification of assets (assets refer to on-balance sheet or off-balance sheet credit exposures) at Fannie Mae and Freddie Mac (Enterprises) and the Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities). These guidelines describe sound practices for managing credit risk at the regulated entities. This guidance does not apply to investment securities.[1] This Advisory Bulletin rescinds and replaces *Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets For Special Mention* (AB 2012-02), and rescinds *Clarification of Implementation for Advisory Bulletin 2012-02, Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention* (AB 2013-02).

FHFA examiners will evaluate how the regulated entities apply this guidance to their classification practices.

Background

The purpose of this Advisory Bulletin is to establish a standard and uniform methodology for classifying regulated entity assets based on their credit quality, as well as to affirm the basis for writing off loans classified as Loss. Asset classification is a critical element in evaluating the risk profile of the regulated entities. Asset classification also provides a mechanism to validate the regulated entity's internal risk identification processes and establishes a common set of classification definitions to serve as the basis for asset quality metrics. In addition, this Advisory Bulletin describes procedures for listing assets for Special Mention, which can be an effective method to identify and rectify weaknesses in credit management practices before deterioration occurs. This guidance considers and is generally consistent with the *Uniform Retail Credit Classification and Account Management Policy* issued by the Federal Financial Institutions Examination Council (FFIEC) in June 2000, which established specific procedures for the adverse classification of residential mortgage loans and other retail loans.

[1] Investment securities refer to securities subject to the guidance of the Financial Accounting Standards Board (FASB)'s Accounting Standards Codification (ASC), Topic 320, Investments – Debt Securities, and Subtopic 325-40, Investments – Other - Beneficial Interests in Securitized Financial Assets.

This Advisory Bulletin is intended to be consistent with applicable statutes, regulations, and Generally Accepted Accounting Principles (GAAP). It does not relieve or diminish the responsibility of a regulated entity's board of directors or management to follow applicable laws, rules, and regulations and to conform to applicable accounting standards, *i.e.,* GAAP. Any conflicts should be resolved to comply with applicable laws and regulations, and to conform to applicable accounting standards.

Guidance

I. Definitions

The following definitions apply when considering the adverse classification of assets at the regulated entities.

An asset classified ***Substandard*** is protected inadequately by the current net worth and paying capacity of the obligor, or by the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

An asset classified ***Doubtful*** has all the weaknesses inherent in one classified ***Substandard*** with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

An asset, or portion thereof, classified ***Loss*** is considered uncollectible, and of such little value that its continuance on the books is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value; rather, it is not practical or desirable to defer writing off an essentially worthless asset (or portion thereof), even though partial recovery may occur in the future.

II. Adverse Classification of Assets

A. Single-Family Residential Mortgage Loans

Single-family residential mortgage loans, including FHLBank Acquired Member Assets (AMA),[2] consist of first mortgages secured by one-to-four family residential real estate. Given their size, general homogeneity, and the volume of residential mortgage loans at the Enterprises and the FHLBanks, it may be impractical to individually review specific loans to determine credit quality. Such loans should be classified using the following guidelines:

- Single-family residential real estate loans that are delinquent 90 days or more with loan-to-value ratios greater than 60 percent, should be classified Substandard.

[2] The AMA regulation (12 CFR part 1268) authorizes FHLBanks to acquire certain assets (principally, conforming residential mortgage loans) from their members and housing associates and prescribes the parameters within which each FHLBank may do so.

- A current assessment of value should be made before a single-family residential mortgage loan with a loan-to-value ratio greater than 60 percent is more than 180 days past due. Any outstanding loan balance in excess of the sum of (i) current fair value of the collateral, less costs to sell, and (ii) any expected proceeds from non-freestanding[3] credit enhancements should be classified Loss not later than when the loan is 180 days delinquent. Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status.
- When a borrower is in bankruptcy, a portion of the loan should be classified as Loss and written down to the fair value of the collateral, less costs to sell, within 60 days of receipt of the notification of filing from the bankruptcy court or within the delinquency time frames specified in this policy, whichever is shorter, unless it can be clearly demonstrated and documented that repayment is likely to occur. Any loan balance remaining after write-off should be classified Substandard until the borrower demonstrates the ability and willingness to repay for a period of at least six consecutive months.
- Fraudulent loans, if not covered by any existing representations and warranties in the loan purchase agreement, should be classified as Loss and written off within 90 days of discovery of the fraud, or within the delinquency time frames specified in this adverse classification policy, whichever is shorter.

Regulated entities should write off the portion of the asset adversely classified as Loss except in certain limited circumstances.[4] A write-off should result in the balance of the asset being reduced by the amount of the loss. The write-off associated with any Loss classification should be taken by the end of the month in which the applicable time period elapses.

If the regulated entity can clearly document that the delinquent loan is well-secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be adversely classified. A well-secured loan is collateralized by a perfected security interest in real property with an estimated fair value, less costs to sell, sufficient to recover the loan balance. "In the process of collection" means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or restoration of the loan to a current status, generally within the next 90 days. Other exceptions to this adverse classification policy might be for loans that are supported by valid insurance claims, such as federal loan guarantee programs.

In determining a single-family mortgage loan's delinquency status, the regulated entity should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing delinquency. Alternatively, the

[3] Examples of non-freestanding credit enhancements include, but are not limited to, private mortgage insurance, the Federal Housing Administration's (FHA) insurance, the Department of Veteran Affairs' (VA) guarantee, and for the FHLBanks' Acquired Member Assets (AMA) program, the various types of permissible agreements to share credit losses in purchased loans with the selling members.

[4] 1) As required to maintain compliance with GAAP. 2) For loans classified as Held For Sale (HFS) and loans which a regulated entity has elected to account for under the Fair Value Option (FVO), no portion classified as Loss would be written off.

regulated entity may aggregate payments and give credit for any partial payment received. For example, if a regular payment is $300 and the borrower makes payments of only $150 per month for a six-month period, the loan would be $900, or three full months delinquent. A regulated entity may use either or both methods for loans in its portfolio but may not use both methods simultaneously with a single loan.

B. Multifamily Residential Mortgage Loans

Multifamily residential mortgage loans consist of first mortgages secured by multifamily (5 units or more) residential real estate. Multifamily real estate loans should not be adversely classified if they are current and are adequately protected by the underlying collateral value and debt service capacity of the property, or a guarantor with demonstrated ability and willingness to perform on the loan. The following applies to the adverse classification of multifamily residential mortgage loans.

To determine the appropriate adverse classification, examiners will evaluate the prospects that the loan will be repaid in the normal course of business considering all relevant information. This includes information on the borrower's creditworthiness and payment record, the nature and degree of protection provided by the cash flow and value of the underlying collateral, and any support provided by financially responsible guarantors. As a general principle, a performing multifamily real estate loan should not automatically be adversely classified or written off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards and have not been formally restructured due to troubled condition should not be adversely classified unless well-defined weaknesses exist that jeopardize repayment in the normal course of business. However, it would be appropriate to adversely classify a performing loan when well-defined weaknesses exist that jeopardize repayment – such as the lack of credible support from reliable sources – using the definitions of Substandard, Doubtful, and Loss set forth above.

Multifamily loans with well-defined weaknesses that subject the regulated entity to the possibility of loss, even if the loan is not seriously delinquent (90 days or more), should be classified Substandard. For a multifamily loan where there are no available and reliable sources of repayment other than the sale of the underlying real estate collateral, any portion of the loan balance that exceeds the sum of (i) current fair value of the collateral, less costs to sell, and (ii) any expected proceeds from non-freestanding credit enhancements, should be classified Loss and written off. The remaining portion of the loan balance that is adequately secured should generally be classified no worse than Substandard. The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified Doubtful, and not Loss, only when the potential for loss may be mitigated by the outcome of certain near-term (generally, within 90 days) pending events. The Doubtful classification is seldom used and is reserved for situations like those described here.

Regulated entities should write off the portion of the asset adversely classified as Loss except in certain limited circumstances.[5] A write-off should result in the balance of the asset being reduced by the amount of the loss. The write-off associated with any Loss classification should be taken by the end of the month in which the applicable time period elapses.

When analyzing a formally restructured multifamily loan, the examiner will focus on the borrower's ability to repay the loan in accordance with its modified terms. Adversely classifying a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses continue to exist that jeopardize the repayment of the loan in accordance with the modified terms.

C. *Other Real Estate Owned*

Other Real Estate Owned (REO) should be evaluated for possible adverse classification of Substandard, Doubtful or Loss. The regulated entity should make periodic (at least annual) reappraisals of the value of the REO. In cases when a reliable appraisal is not available, or the appraisal on file is outdated, there are other acceptable methods the regulated entity can use for determining and documenting the value of the REO. For purposes of classification, any portion of the balance of the REO in excess of fair value, less costs to sell, should be classified Loss. However, the portion of the held-for-sale REO classified as Loss should not be written off. Examiners will review all relevant factors in evaluating the regulated entity's adverse classification of the remaining book value of the REO.

D. *Other Assets (including Off-Balance Sheet Credit Exposures)*

Although not specifically enumerated, the regulated entities may have other assets such as accrued interest receivables, property tax and insurance advance receivables, reverse repurchase (repo) receivables, and insurance benefit receivables that warrant adverse classification. Similarly, off-balance sheet credit exposures such as standby letters of credit and financial guarantees may also warrant adverse classification. Examiners will review all relevant factors in evaluating the regulated entity's adverse classification of the assets and off-balance sheet credit exposures.

E. *FHLBank Advances*

Advances made by the FHLBanks to their members and housing associates generally pose minimal credit risk. Advances must be fully secured by eligible collateral and, in the case of member advances, are further secured by the borrowing members' FHLBank capital stock. In addition, the Federal Home Loan Bank Act grants each FHLBank a priority lien over the liens of other similarly-situated creditors on assets securing member advances.[6] However, there may be instances in which collateral adequacy may be uncertain and/or the priority lien may not be relied upon, such as in the case of advances to

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[5] 1) As required to maintain compliance with GAAP. 2) For loans classified as Held For Sale (HFS) and loans which a regulated entity has elected to account for under the Fair Value Option (FVO), no portion classified as Loss would be written off.

[6] *See* 12 U.S.C. § 1430(e). Although this provision grants FHLBank liens priority over those of similarly-situated creditors, it does not grant FHLBank liens priority over those of creditors with liens entitled to priority under otherwise applicable law.

housing associates, or where another creditor has a superior lien under applicable law (for example, where the other creditor's lien is perfected, but the FHLBank's lien is not). In such cases, examiners will evaluate the facts and circumstances to determine whether it is appropriate to adversely classify the advance.

III. Non-Adverse Classification of Assets – Special Mention

In some instances, it may be appropriate to list an asset for Special Mention. The following definition should be used for listing an asset for Special Mention:

A ***Special Mention*** asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the assets' repayment prospects or may cause deterioration in the regulated entity's credit position at some future date. ***Special Mention*** assets are not adversely classified and do not expose a regulated entity to sufficient risk to warrant adverse classification.

Ordinarily, assets listed for Special Mention have deficiencies in the administration of those assets which corrective management action might remedy, for example, weak loan origination and/or weak servicing policies. While inadequate policies and practices could ultimately result in deterioration of the asset and adverse classification, an asset should not be adversely classified unless it also meets one or more of the adverse classification indicators. The Special Mention classification serves as an indicator of the quality of the asset portfolio and should be used to provide direction to management on corrective measures that might be taken to strengthen an asset to avoid potential deterioration in the asset's quality.

Mortgages held by the regulated entities that are in loss mitigation, or have been modified and are performing according to the terms of the modification, should be listed as Special Mention but not adversely classified. The loan no longer needs to be listed as Special Mention after performance according to the terms of the modification has occurred for a period of six consecutive months. If the loan becomes delinquent after modification, adverse classification could apply according to the previously described criteria.

The level of adversely classified assets or assets listed for Special Mention is an indicator of the regulated entity's asset quality and overall risk profile, and may indicate whether risk management practices regarding underwriting and loan administration are effective. At a minimum, management and boards of directors of the regulated entities should evaluate risk management and other asset-specific policies and procedures annually to ensure that appropriate risk controls have been implemented.[7] If the level of adversely classified assets suggests deterioration in any asset category, more frequent evaluations of the related policies and procedures are appropriate. Risk management and other policies will be reviewed by FHFA as part of its supervision program.

[7] *See* 12 CFR part 1236, Appendix (Prudential Management and Operations Standards).

Related Guidance and Regulations

FASB ASC 326-20, Financial Instruments - Credit Losses – Measured at Amortized Cost

Uniform Retail Credit Classification and Account Management Policy, FFIEC

FHFA has statutory responsibility to ensure the safe and sound operations of the regulated entities and the Office of Finance. Advisory bulletins describe FHFA supervisory expectations for safe and sound operations in particular areas and are used in FHFA examinations of the regulated entities and the Office of Finance. Questions about this advisory bulletin should be directed to: SupervisionPolicy@fhfa.gov.