FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2024-03: FHLBank Member Credit Risk Management

Purpose

This Advisory Bulletin (AB) provides guidance to the Federal Home Loan Banks (FHLBanks) on ensuring a sound member credit risk management framework. It is intended to memorialize the Federal Housing Finance Agency's (FHFA) longstanding expectations that an FHLBank's underwriting and credit decisions should reflect a member's financial condition and not rely solely on the collateral securing the member's credit obligations. Effective underwriting enables an FHLBank to stand ready to lend to its members under terms and conditions that are appropriate for the members' financial condition and needs, providing stability during periods of financial distress, especially for smaller members that have limited or no access to the capital markets.

Although each FHLBank has its own member credit framework, during recent examinations, FHFA supervision staff observed weaknesses in the FHLBanks' credit risk management, along with misconceptions about the role an FHLBank should play in lending to members in a distressed financial condition. FHFA subsequently provided direction to the FHLBanks through the examination process, reemphasizing its expectations regarding a sound credit risk management framework. This AB reiterates these expectations and provides additional guidance for establishing and maintaining a sound credit risk management framework. Each FHLBank should maintain a member credit risk management framework consistent with the guidance set forth in this AB, as well as other existing guidance on similar or related topics.

The first part of the Guidance section provides an overview of FHFA's expectations for the components of the FHLBank's member credit framework, including credit risk governance, member credit assessment, and monitoring of credit conditions. The second part of the Guidance section outlines key elements in the oversight of troubled members[1], including escalation policies and procedures, coordination with members' prudential regulators, and default/failure/insolvency management policies and procedures.

[1] For purposes of applying the guidance, a "troubled member" or "member in troubled condition" is a member that exhibits poor or unsatisfactory financial performance or condition and is susceptible to further deterioration, and/or exhibits severe weaknesses and/or unsafe and unsound practices or conditions that threaten the viability of the entity.

Background

Each FHLBank is responsible for measuring, monitoring, and managing member credit risk. Applicable statute, regulation, and guidance establish the FHLBanks' authority to make advances and renewals only if they can be safely made.[2] Each FHLBank has explicit statutory authority to grant or deny any application for an advance, in its discretion and on such conditions as the FHLBank may prescribe.[3] The Advances regulation establishes expectations regarding the exercise of this discretion, providing that an FHLBank may limit or deny a member's application for an advance if, in its judgment, the member evidences "financial or managerial deficiencies, as determined by the Bank, that bear upon the member's creditworthiness" or other deficiencies calling into question whether the FHLBank can safely make an advance or renewal to the member.[4]

As stated in AB 2013-09 *Collateralization of Advances and Other Credit Products to Insurance Company Members*,

> The first line of defense to ensure repayment of an advance or other credit product is the financial health of the member, irrespective of whether the member is a depository institution or an insurance company. The second line of defense is the quality of the collateral and the extent to which the FHLBank has a first-priority security interest in the collateral.

While AB 2013-09 applies specifically to insurance company members, the AB highlights that the first line of defense[5] for assurance of repayment of an advance and other credit obligations is the member's financial health. Additionally, AB 2013-10 *Collateralization of Advances and other Credit Products; Perfection and Control of Collateral* sets expectations for the FHLBanks to establish collateral procedures and criteria to determine when to take physical possession of whole loan collateral, one example of which is the deterioration of the financial condition of a member.

The importance of considering a member's financial condition as a primary consideration is reflected in FHFA's regulation on FHLBank Membership, which provides that an applicant shall be eligible for membership only if "its financial condition is such that advances may be safely made to it."[6] With respect to that requirement, the Membership regulation states that the "availability of sufficient eligible collateral to secure advances to the applicant is presumed and shall not be considered in

[2] *See, e.g.*, 12 CFR 1266.4(a)(2).
[3] *See* 12 U.S.C. 1429.
[4] *See* 12 CFR 1266.4(a)(1).
[5] First Line of defense in the context of AB 2013-09 refers to the main source of assurance of repayment of an advance, whereas the second line of defense in AB 2013-09 is described as the quality of the collateral and the extent to which the FHLBank has a first-priority security interest in the collateral. The lines of defense described in AB 2013-09 should not be confused with the three lines of defense in risk management generally, i.e., the split of responsibilities and functions across areas of the FHLBanks to ensure effective risk management. The Credit Risk Governance Section of this AB refers to the first and second lines of defense in risk management as the front line (or business line) and enterprise risk management functions, respectively.
[6] *See* 12 CFR 1263.6(a)(4), (d).

determining whether an applicant is in the [required] financial condition."[7] The preamble to the final rule adopting this provision explained that the "financial condition" standards for depositories were being adopted "in order to minimize the possibility of the FHLBanks becoming a liquidity source for weak or failing institutions."[8] Although this concept is not expressly restated in the regulatory section governing the "financial condition" determination for insurance companies and non-depository CDFIs, it is conceptually applicable to the assessment of all types of applicants.

Guidance

To ensure the FHLBanks fulfill their mission in a safe and sound manner, each FHLBank should have in place a member lending risk appetite, a risk management framework, and practices designed to ensure credit is extended only to creditworthy members. To safely lend, each FHLBank should reasonably ensure that a member taking an advance is likely to repay the advance. The lending framework of each FHLBank should center on member creditworthiness and not focus primarily on pledged collateral. The credit risk management framework should follow a holistic approach that incorporates quantitative and qualitative components and ensures lending terms and conditions are commensurate with a member's financial condition, its financial capacity and willingness to repay credit obligations. The FHLBanks should inform members of their lending criteria and possible constraints and work with members, their primary regulators, and the Federal Reserve Banks to minimize disruptions to member liquidity access when the risk of lending to a member exceeds the FHLBank's risk tolerance. FHFA expects the FHLBanks to incorporate the following guidance to manage the credit, reputation, and systemic risks associated with advances activities, taking into consideration statutes, regulations, and other FHFA supervisory guidance.

Components of the Member Credit Framework

Credit Risk Governance

The board of directors (board) or a designated board level committee should approve policies to ensure that FHLBank staff appropriately assess and manage member creditworthiness and establish member's financial condition as the primary determining factor for extending credit and avoiding losses. Further, the board should ensure that management develops procedures to ensure effective implementation of the board-approved policies. These policies and procedures should emphasize that the primary source of a member's creditworthiness is the member's capacity and willingness to repay its credit obligations from business operations and that a member's creditworthiness assessment should not exclusively rely on the collateral pledged to support credit management decisions.

The policies and procedures governing member credit risk should define the roles and responsibilities of each line of defense and each line should be independently accountable for different aspects of the member credit risk management process. As provided in AB 2005-05 *Risk Management Oversight*,

[7] *See* 12 CFR 1263.11(c).
[8] 61 FR 42530, 42537 (Aug. 16, 1996). *See also* 60 FR 54958, 54964 (Oct. 27, 1995) (proposed rule explaining the provision as "seek[ing] to avoid having the Banks become lenders of last resort").

each FHLBank should establish a risk monitoring and reporting function on an enterprise-wide basis that is independent of business line or risk assumption processes. While the enterprise risk management function will monitor risk positions, business line officers and managers are responsible for the ownership of the risk positions taken and hold the responsibility for the "results, ramifications, and opportunities of these risk positions."

Additionally, the policies and procedures for a comprehensive member credit risk management framework should include adequate credit underwriting standards, internal controls, and processes to assign ratings to members based on their capacity and willingness to repay advances. The framework should account for differences in charter type, member size, legal framework governing the relationship with the member, and other unique factors applicable to some members because of their business model or specific industry concentration. The member credit policies should include prudential limits that align with the FHLBank's credit and collateral risk management practices and ensure sufficient support when borrowings approach the FHLBank's risk tolerance. The credit underwriting should be consistent with each FHLBank's credit rating definitions, and the procedures should require timely reassessment of member creditworthiness when necessary.

Each FHLBank should support the prudential lending limits it establishes with robust credit risk, financial risk, and operations analytics and complement the limits with supplemental controls as may be necessary. The FHLBank should demonstrate the feasibility, soundness, and completeness of its suite of prudential lending limits through robust scenario analyses that assess implications of business concentrations on the FHLBank's balance sheet, funding activities, liquidity profile, retained earnings and total capital levels, collateral management (including margin calls, possession, and liquidation), and other relevant factors. Scenario analyses should include the potential for widespread member advance demand (in contrast to assuming that increased advance demand is limited to one large counterparty). Supplemental controls may include tenor restrictions and/or collateral restrictions for indebtedness exceeding a percentage or dollar threshold. The board should periodically review and approve the prudential lending limits.

Each FHLBank should ensure that its member agreement(s) give the FHLBank the ability to request and obtain financial data and other non-public information[9] between financial reporting periods to ensure its internal member credit ratings reflect members' current financial condition. Each FHLBank should request that members provide sufficient information to explain material adverse financial changes that a member may not have previously disclosed at the time of an advance request (including but not limited to disclosures in the member's most recent financial statements). Each FHLBank should establish requirements for its members to inform the FHLBank about adverse changes in a timely manner.

[9] Examples include changes in cash positions and updates on deposit flows to inform the FHLBank about what tenor of advances are appropriate at the time of an advance request.

Member Credit Assessment

The process for assessing member credit risk should include risk identification, measurement of specific risks, methodologies to generate credit scores complemented by risk-based credit reviews, ongoing member and industry monitoring, tracking of risk concentrations, and, as appropriate, scenario analyses and stress testing to ensure the member credit process remains reasonable over time. The credit risk framework should be commensurate with the risk, size, and business complexity of the FHLBank's members.

Member Credit Rating Methodology

The methodology used to generate credit ratings should effectively and accurately segment members according to their financial condition and credit risk and lead to ratings that help quantify the risk and provide timely identification of institutions with weak financial condition. The rating process should be based on a sound assessment of member creditworthiness, including a thorough evaluation of a member's ongoing financial viability. A comprehensive methodology to assess creditworthiness should incorporate quantitative and qualitative information that leads to a rating representing the risk of lending.

Considerations for Quantitative Factors in the Methodology

Quantitative data points include financial performance data covering areas of risk previously identified for each member type. The FHLBank should tailor the measures according to the risk profile of each type of member. For example, for depositories, the quantitative data points should address all Uniform Financial Institutions Rating System (UFIRS) components, such as, member capital position, asset quality, income performance (earning), liquidity position, asset/funding concentrations, interest rate risk exposure, financial trends, and risk associated with the parent company or the member's dependency on the parent company's strength. Additionally, for insurance company members, quantitative factors should include reinsurers' financial data, reserves, underwriting profitability (e.g., combined ratios), liquidity, and any other financial measures that address credit risk for specific insurance business lines. The FHLBanks should also account for the members' business models and financial structures in their quantitative assessment of credit.

As quantitative processes of a credit framework are limited by the existing data and algorithms, an FHLBank should supplement those processes with written credit analyses highlighting elements of the assessment that the models are unable to assess.[10] Model/methodology output should be updated as frequently as data becomes available, and the depth and frequency of the written credit reviews should be commensurate with the risk. Although relying on audited data is preferrable, when needed (e.g., rapid economic change or deterioration or uncertainty of the financial condition of a member), an FHLBank should update credit ratings using data obtained directly from the members or any other

[10] Refer *to* AB 2013-07 *Model Risk Management Guidance* and AB 2022-03 *Supplemental Guidance to Advisory Bulletin 2013-07 – Model Risk Management Guidance* for guidance on models supporting the credit risk framework, and ensuring models continue to perform as intended as market conditions change.

sources that might become available while waiting for audited financials (or data from call reports). As the scoring methodologies and/or models are limited by the historical data used in their construction, they may not always incorporate emerging risks. If the FHLBank believes a member's circumstances might have changed and cannot secure additional information, the FHLBank should consider whether continuing to extend credit is appropriate.

Considerations for Qualitative Factors in the Methodology

Qualitative factors that may influence the credit assessment include character of management, corporate structure complexity, risk associated with nontraditional ownership structures (e.g. private equity firms), business models with concentration in high-risk products or investments, unique business models, underwriting strategies, industry and market conditions and trends, changes in borrowing behavior, management deficiencies, existence of enforcement actions, and any other aspects that an FHLBank deems necessary to incorporate.

An FHLBank's written member credit reviews should incorporate qualitative factors to complement member credit methodologies that rely on a quantitative approach. Written credit reviews should include well supported conclusions of the analyst's assessment of the quantitative and qualitative data.

In general, if the FHLBank does not have expertise with the financial structure of specific members, it should gain sufficient knowledge to properly evaluate credit risk of these members.[11]

Ongoing Appropriateness of the Methodology

The FHLBanks should proactively and periodically evaluate the adequacy of their frameworks and their qualitative and quantitative components as economic conditions evolve. For example, the FHLBanks should prudently inquire about qualitative conditions from the members' primary regulators as they are closer to the specific conditions of their regulated financial entities. A robust credit risk management framework should also include forward looking assessments of emerging risks to ensure that the FHLBanks' methodologies and monitoring processes remain adequate as market conditions change.

Considerations for Credit Ratings and Credit Rating Process

The credit ratings generated by an FHLBank's methodology should be well defined, appropriately align with its member credit capacity limits, include credit tenor limitation as the creditworthiness of

[11] The assessment of some mission-oriented institutions might depend on their size and the lending sector or primary financing sector. For instance, Rocio Sanchez-Moyano and Sara Simms found variations in key financial ratios (e.g., deployment, self-sufficiency, loan loss reserve, and net charge-off ratios) across Community Development Financial Institutions (CDFI) depending on the lending industry (e.g., lending to small business or real estate lending such as housing development, commercial real estate, and community facilities) that were not necessarily related with their inherent risk. Rocio Sanchez-Moyano and Sara Simms, *"Understanding CDFI Financial Data: A Primer for New Investors,"* Federal Reserve Bank of San Francisco, (December 2023).

the member deteriorates, and have adequate discriminative power. The credit ratings process should also timely identify any need for the FHLBank to adopt more restrictive credit and collateral requirements. Additionally, the credit rating process should be transparent. Prudent credit risk management practices include adjusting credit ratings as financial conditions change. The framework should incorporate controls to address situations when a member's condition deteriorates rapidly and when a potential downgrade to less than satisfactory credit rating is imminent. In these cases, the FHLBank should ensure it is able to evaluate any requests for extensions of credit and to promptly take risk-mitigating credit and collateral actions as necessary. Additionally, the FHLBank should support and document any overrides that deviate from previously approved methodologies.

Monitoring Credit Conditions

Ongoing monitoring is vital to track member performance and industry conditions so that the FHLBank can adjust ratings as needed, make informed credit decisions, and mitigate risk. Each FHLBank should establish a process to monitor member health and industry conditions regularly, including:

- Monitoring market indicators such as news, member equity price volatility, credit default swaps, and any other frequently updated indicators of risk that could potentially threaten the financial stability of a member.
- Monitoring changes in the market environment and specific industries significantly affecting the member's business.
- Monitoring significant changes in the member's borrowing behavior.
- Monitoring asset growth of the member and its parent company.
- Obtaining reports of examination from the member's primary regulator, as well as any attendant enforcement actions, and incorporating this information in the rating review process, when applicable.
- Monitoring members' risk concentrations.
- Monitoring changes to a member's funding structure, for example, the member's reliance on more unstable sources, such as concentrations in brokered deposits, deposits obtained through solicitation on listing services, and uninsured deposits.
- Identifying emerging risks that the existing credit rating and review process might not account for; examples include monitoring industry changes and identifying member engagement with new, higher-risk products.
- Understanding alternative borrowing sources which may be available to members, assessing members' (especially large depository members) preparedness to borrow from the Federal Reserve Banks' discount windows, and factoring alternative liquidity sources in member-creditworthiness determinations.[12]

[12] The National Credit Union Administration Central Liquidity Facility is another back-up funding source available to Federal- and state-chartered credit unions.

Each FHLBank's monitoring program should periodically reevaluate the process to determine whether the risk identification, governance, assessment, and monitoring methodologies remain valid as conditions change. When appropriate, the FHLBank should incorporate the results from monitoring activities in the member's credit ratings and associated terms of credit.

Oversight of Troubled Members

As stated in *PMOS Standard 9 – Management of Credit and Counterparty Risk*, an FHLBank "should have policies, procedures, and systems for evaluating credit risk that will enable it to make informed credit decisions."[13] In keeping with PMOS Standard 9, a sound member credit risk management framework incorporates relevant and timely information in the evaluation of member financial condition, is responsive to changes in market conditions, is subject to independent oversight, and includes contingency plans and processes for managing relationships with members in troubled condition. Accordingly, FHFA expects an FHLBank's member credit risk management framework to account for the specific risks associated with members in troubled condition. The credit risk management framework should reasonably prevent undue credit risk exposure from a troubled member and should require a review of members with poor financial health prior to fulfilling a member funding request. The FHLBanks member credit risk management framework should ensure management recognizes and continually assesses all material risks as required by *PMOS Standard 1 – Internal Controls and Information Systems*. Any decisions to renew outstanding advances or grant additional credit to troubled members, to the extent permitted by regulation, should be supported by a thorough risk analysis demonstrating the reasonable prospect of the member to return to a satisfactory financial condition.[14]

Escalation Policies and Procedures

An appropriately designed credit risk management framework should include guidelines to address specific risks with troubled members.[15] The guidelines should include escalation policies and procedures that provide sufficient time for management to take necessary risk mitigation measures prior to a member's failure or default. The framework should include escalation policies that outline criteria and guidelines for taking credit and collateral actions commensurate with changes in risk ratings, while preserving flexibility for management to determine the appropriate risk management approach depending on specific facts and circumstances. For example, as a member's creditworthiness deteriorates, an FHLBank should consider increasing credit monitoring, decreasing or eliminating borrowing capacity, shortening advance tenors, restructuring outstanding credit, or reducing credit exposure. An FHLBank also may need to take actions beyond the minimum statutory and regulatory collateralization requirements and associated guidance to ensure collateral sufficiency

[13] *See* Appendix to 12 CFR part 1236—*Prudential Management and Operations Standards*, Standard 9(6).
[14] The risk analysis can include considerations from coordination with member prudential regulators, Federal Reserve discount window, and deposit insurers, as highlighted in the following sections.
[15] Each FHLBank should determine if it is appropriate to include the guidelines for managing credit risk for troubled members in isolation or if it should be included in the overall credit risk management framework.

in the event of failure or default.[16] Escalating collateral actions could include limiting collateral pledge types, instituting mandatory collateral listing or delivery requirements, increasing haircuts, verifying the existence and quality of the collateral, and obtaining more frequent or specific collateral valuations, consistent with the overall objective of avoiding credit losses on member exposures.

Coordination with Member Prudential Regulators, Federal Reserve Discount Window, and Deposit Insurers

Coordination among the FHLBank, members, primary regulators, the Federal Reserve Banks, and deposit insurers is paramount for ensuring that a member can obtain the funding that meets its needs when trouble arises. Specific to coordination among these parties, measures for ensuring safety and soundness when managing the risks associated with troubled members include but are not limited to:

- Communicating to members and their regulators, as applicable, the FHLBank's lending framework, the credit and collateral implications of deteriorating financial condition, and the fact that an FHLBank is not obligated to extend credit.
- Encouraging depository members (especially large depository members) to establish protocols and be prepared to borrow from the Federal Reserve discount window.
- Ensuring operational readiness[17] for timely movement or subordination of excess collateral to facilitate members borrowing through the Federal Reserve Banks for applicable member types. Specifically, the FHLBanks have tested procedures in place for subordinating liens and releasing collateral to the applicable Federal Reserve Banks, which have been informed by an understanding of each Federal Reserve Bank's processes and requirements.
- Seeking written confirmation from the appropriate prudential regulator, deposit insurer, or both, that it does not object to the FHLBank continuing to provide advances to a member when circumstances call for continued FHLBank funding to a troubled member.[18]

Default/Failure/Insolvency Management Policies and Procedures

An FHLBank's member credit risk management framework should explicitly include guidelines for navigating member default or failures and managing this increased risk. In the case of member default or failure, the resulting credit risk is higher because the primary source of repayment no longer exists, there may be impediments to immediately exercising the FHLBanks' collateral rights, and it is unlikely an FHLBank will be able to obtain additional collateral. An FHLBank's guidelines for

[16] *See, e.g.*, 12 CFR 1266.9(a)(3) (FHLBank may perfect its security interest in member collateral at any time). AB 2013-10 *Collateralization of Advances and Other Credit Products; Perfection and Control of Collateral* provides guidance on credit risk management practices and identifies criteria, such as the financial condition of a member, which may dictate that an FHLBank take steps beyond those minimal steps required by the regulation to ensure that it will have access to the collateral in the case of default.

[17] Operational readiness includes execution of agreements to subordinate liens or release collateral.

[18] Alternatively, FHLBanks can seek assurance that its activity is appropriate from the FHFA when the FHFA has discussed the condition of the member with its primary regulator and can provide such assurance. In any event, a Bank may make or renew advances to members without positive tangible capital only in accordance with the applicable requirements set forth in 12 CFR 1266.4(b) and (c).

default and failure management should consider various scenarios and address the risks from exposure to different types of members, particularly large depository members, insurance companies, and members posing unique risks. For example, default and failure plans should prepare management for a scenario where an FHLBank needs to liquidate collateral to satisfy indebtedness by, at a minimum, identifying potential vendors, developing liquidation strategies, identifying measures necessary for operational readiness, and requiring periodic table-top exercises.[19]

FHFA expects that the default/failure/insolvency policies and procedures establish roles, responsibilities, and protocols for identifying timely events of default, including when a member is placed in receivership, and for exercising the FHLBank's rights in the event of default. This includes guidelines for management to make timely determinations or, as applicable, for a FHLBank's board to make such determinations, about whether to declare an event of default, declare indebtedness due and payable immediately, and terminate membership, among other rights or obligations.

An FHLBank's credit risk management framework should require management to develop specific plans for dealing with indebtedness from defaulted and failed members and provide status updates to the applicable governance committee. The plans should establish credit and collateral management strategies, prioritizing safety and soundness and regulatory compliance. In general, workout strategies should include an orderly schedule for collecting the indebtedness while preserving collateral sufficiency.[20]

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.

[19] As provided in *AB 2013-09 Collateralization of Advances and Other Credit Products to Insurance Company Members*, FHFA expects each FHLBank to have a collateral liquidation plan with an established contingency plan to liquidate collateral for insurance company members.

[20] 12 CFR 1266.15 provides:

> If an institution's membership in a [FHLBank] is terminated, the [FHLBank] shall determine an orderly schedule for liquidating any indebtedness of such member to the [FHLBank]; this section shall not require a [FHLBank] to call any such indebtedness prior to maturity of the advance. The [FHLBank] shall deem any such liquidation a prepayment of the member's indebtedness, and the member shall be subject to any fees applicable to such prepayment.