



FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

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FRAMEWORK FOR ADVERSELY CLASSIFYING LOANS, OTHER REAL ESTATE OWNED, AND OTHER ASSETS AND LISTING ASSETS FOR SPECIAL MENTION

Introduction

This Advisory Bulletin establishes guidelines for adverse classification and identification of Special Mention assets and off-balance sheet credit exposures at Fannie Mae and Freddie Mac (Enterprises) and the Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities), excluding investment securities. These guidelines describe sound practices for managing credit risk at the regulated entities.

Background

The purpose of this guidance is to establish a standard and uniform methodology for classifying assets of the Enterprises and the FHLBanks based on the credit quality of the assets. The classification of assets is a critical element in evaluating the risk profile and the adequacy of capital, loan loss reserves, and earnings. The classification of assets also provides a mechanism to affirm the regulated entity's internal risk identification processes and provides a common set of classification definitions to serve as the basis for asset quality metrics. In addition, this guidance describes procedures for listing assets for Special Mention, which we believe 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 banking regulators in June, 2000, which established specific procedures for the adverse classification of residential mortgage loans and other retail loans.

Guidance

Adverse Classification of Assets

Classification Definitions and Treatment

The following definitions will apply when examiners evaluate and adversely classify assets at the regulated entities.

Substandard - Exposures classified **Substandard** are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Exposure so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the exposure. These weaknesses are characterized by the distinct possibility that the regulated entity will sustain some loss if the deficiencies are not corrected.

Doubtful - Exposures classified **Doubtful** have all the weaknesses inherent in those exposures classified **Substandard** with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss - Exposures classified **Loss** are considered uncollectible and of such little value that the exposures continuance as a balance sheet asset is not warranted. This classification does not mean that the exposure has absolutely no recovery or salvage value; rather, it is not practical or desirable to defer writing off this asset, even though partial recovery may occur in the future.

Regulated entities should charge-off the portion of the asset adversely classified as Loss. A charge-off must result in the balance of the asset being reduced by the amount of the Loss. There may be instances in which the regulated entity receives full or partial payment, either through liquidation of the collateral or other means, for an asset previously classified Loss. In such a case, the regulated entity may report a recovery of the charged-off asset either through the loan loss reserve or as a reduction of Other Real Estate Owned (REO) expenses in the income statement depending upon the specific circumstances.

Loans

Single Family Residential Mortgage Loans

Single family residential mortgage loans 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 impracticable to individually review specific loans to determine credit quality. The loans may be classified on an individual basis 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.
- A current assessment of value should be made before a single family residential loan is more than 180 days past due. Any outstanding loan balance in excess of the fair value of

the property, less cost to sell, should be classified Loss when the loan is no more than 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, loans should be 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 charge off should be classified Substandard until the borrower demonstrates the ability and willingness to repay for a period of at least six months.
- Fraudulent loans, not covered by any existing representations and warranties in the loan purchase agreement, should be charged off within 90 days of discovery of the fraud, or within the delinquency time frames specified in this adverse classification policy, whichever is shorter.

The charge-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 cost to sell, sufficient to recover the recorded investment in the loan. 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, like 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 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.

Acquired Member Assets (AMA)

Some FHLBanks purchase mortgages from their members through the Mortgage Partnership Program (MPF) or the Mortgage Purchase Program (MPP). Both of these AMA programs are designed to share credit risk between the FHLBank and the member.

AMA are adversely classified according to the guidelines previously described for single family mortgage loans. Due to the loss sharing structure of the loans, however, a difference from the

guidelines is in the calculation of the amount of Loss. As offset to the amount of collateral shortfall in the determination of the amount of Loss, examiners will consider the availability of the First Loss Account, in the case of loans acquired through the MPF, or the Lender Risk Account, in the case of loans acquired through the MPP, supplemental mortgage insurance, credit enhancements, and/or guaranty provided through a federal program like the Federal Housing Administration or the Veterans Administration.

Multi-Family Residential Mortgage Loans

Multi-family residential mortgage loans consist of first mortgages secured by multi-family (5 units or more) residential real estate. Multi-family real estate loans that are current and are adequately protected by the current sound worth and debt service capacity of the borrower, the cash flow from the underlying collateral or guarantor with demonstrated ability and willingness to perform on the loan, should not be adversely classified. The guidance that follows applies to the adverse classification of multi-family 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 multi-family real estate loan should not automatically be adversely classified or charged-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.

Multi-family 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 multi-family 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 amount secured by the fair value of the collateral, less cost to sell, and that is considered to be uncollectible, should be classified Loss and charged off. The portion of the loan balance that is adequately secured by the value of the collateral, less cost to sell, 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 only when the potential for loss may be mitigated by the outcome of certain near-term (generally, within 90 days) pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. The Doubtful classification is seldom used and reserved for those situations described here.

When analyzing a formally restructured multi-family 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 orderly repayment of the loan in accordance with reasonable modified terms.

Advances

Advances made by the FHLBanks to their members generally pose minimal credit risk. Advances are collateralized and supported by membership stock. In addition, Section 10 of the Federal Home Loan Bank Act (FHLBank Act) establishes a priority lien for FHLBank advances over other creditors. 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 housing authorities or insurance companies. In such cases, examiners will evaluate the facts and circumstances to determine whether it is appropriate to adversely classify the advance.

Other Real Estate Owned

Other Real Estate Owned 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 carrying value of the REO in excess of fair value, less cost to sell, should be classified Loss, net of any applicable valuation allowance. Examiners will evaluate all relevant factors in making a judgment with regard to adverse classification of the remaining book value of the REO.

Other Assets and Off Balance Sheet Credit Exposures

Although not specifically enumerated, the regulated entities may have other assets, such as accrued interest, or off-balance sheet credit exposures, such as standby letters of credit, that warrant adverse classification. Examiners will review the facts and circumstances in conjunction with the adverse classification definitions to determine the appropriate treatment for such assets or off balance sheet credit exposures.

Listing Assets for 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:

Special Mention - A ***Special Mention*** exposure 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*** exposure is not adversely classified and does 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 category is not to be used as a means of avoiding the decision to either adversely classify an asset or pass it without criticism. Instead, it should be used to provide guidance to management on corrective measures that might be taken to strengthen an asset to avoid a potential deterioration in the asset's quality and serves as an indicator of the quality of the loan portfolio.

Single-family mortgages held by Fannie Mae, Freddie Mac, or the FHLBanks that have been modified under one of the federally recognized loan modification programs (e.g., Home Affordable Refinance Program or Home Affordable Modification Program) or a proprietary loan modification program, 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 for a period of six months. If the loan becomes delinquent after modification, adverse classification would occur according to the previously described criteria for single-family mortgage loans.

Conclusions Based Upon Level and Trend of Adversely Classified Assets

The level of adversely classified assets or assets listed for Special Mention is an indicator of the regulated entity's asset quality, overall risk profile, and may be an indicator of risk management practices regarding underwriting and loan administration. 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. 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 the FHFA as part of its supervision program.

EFFECTIVE DATE

This Advisory Bulletin is effective upon issuance.

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. Contact Kari Walter, Senior Associate Director, Office of Examination Policy and Programs at (202) 649-3405 or Kathy Beach, Senior Bank Examiner, Office of Examination Policy and Programs at (202) 649-3521 with questions pertaining to this Advisory Bulletin.