FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

AB 2018-05: OVERSIGHT OF MULTIFAMILY SELLER/SERVICER RELATIONSHIPS

Purpose

This advisory bulletin communicates to Fannie Mae and Freddie Mac (the Enterprises) the Federal Housing Finance Agency's (FHFA) supervisory expectations to maintain the safety and soundness of their operations by effectively managing multifamily Seller/Servicer relationships.

FHFA expects each Enterprise to assess financial, operational, legal, compliance, and reputational risks associated with its multifamily Seller/Servicer counterparties and take appropriate action to mitigate those risks or reduce Enterprise exposures. Counterparty risk management, as part of a board-approved risk management framework, should include an Enterprise's multifamily Seller/Servicer business operations.

This advisory bulletin is applicable to the counterparty risk management of third-party relationships managed by an Enterprise's multifamily business unit. FHFA expects the Enterprises to institute proper controls and perform monitoring to identify and manage risks associated with any multifamily counterparty.

Background

Each Enterprise uses a limited network of Seller/Servicers that originate and service multifamily loans. These loans can be retained in an Enterprise's portfolio or used as the underlying collateral for securitizations usually sold to investors. Multifamily loans are generally larger than residential loans and have more complicated servicing requirements. Multifamily servicing requirements include performing periodic property inspections and collecting rent roll reports that are used to evaluate the value and stability of the underlying multifamily property. Multifamily loan servicing also presents risk factors such as determining net operating cash flow derived from a subject property, as well as calculating economic metrics (*e.g.*, occupancy and vacancy rates, average monthly rents, and regional unemployment rates). Multifamily underwriting criteria include maximum loan-to-value and minimum debt service coverage ratios as the basis for approval.

The term Seller/Servicer, as used in this advisory bulletin, includes approved bank or nonbank entities with a contractual relationship with an Enterprise that originate and service multifamily loans. With Enterprise approval, a designated multifamily servicer can use a subservicer (a servicer that performs servicing on behalf of the servicer) to perform the servicing administration of a loan for a fee. Multifamily Seller/Servicers routinely engage in all aspects of a loan's lifecycle. Nonbank multifamily Seller/Servicers include publicly traded or privately owned commercial real estate companies.

Guidance

Oversight of multifamily Seller/Servicer relationships should be part of a risk management framework that includes periodic evaluation of counterparty financial performance; operational risk factors; and legal, compliance, and reputational risks. That information is used in the approval and ongoing monitoring of multifamily Seller/Servicers to ensure compliance with Enterprise guidelines. An effective risk management framework helps management achieve an Enterprise's performance and profitability targets and prevent financial loss. It also should promote appropriate reporting and compliance with laws and regulations and help to avoid damage to the Enterprise's reputation and associated consequences.

Risk Management Framework

A risk management framework is an important element of corporate governance. Further, an effective risk management framework includes policies that support risk-related decision making. As outlined in Standard 8 of the Prudential Management and Operations Standards (PMOS), prudent risk management processes address the general responsibilities of the board of directors and senior management. The board is responsible for establishing and overseeing a robust risk management governance structure whereas management is responsible for the development, implementation, and maintenance of the risk management framework.

A risk management framework considers each multifamily Seller/Servicer's lifecycle to include selection of Seller/Servicers; (due diligence including eligibility validation); ongoing monitoring (performance, compliance reviews, and training schedules); and corrective action (remediation, suspension, or termination).

Policies and procedures should be tailored to the oversight of multifamily Seller/Servicers to enable an Enterprise to consistently identify, measure, monitor, and control aggregate and emerging risks. Established policies should outline the role and responsibilities of the first line business units and the second line, enterprise risk management (ERM), which oversees risk management and assesses risk independent of the first line units. The responsibilities for risk ownership, management, control, oversight, and assurance should be clearly understood by both the first line business unit and the ERM group. Policies and procedures should also address the frequency of reporting, escalation, and tracking of policy exceptions or waivers by the Enterprise's senior management team to the board of directors or committee thereof, depending on the issue and risk exposure to the Enterprise.

In addition, policies should address the remediation of deficiencies or weaknesses identified in performance standards or in particular risk areas, as appropriate. The policies should also set standards for taking timely corrective action against a multifamily Seller/Servicer depending on the level and seriousness of the findings.

Selection of Multifamily Seller/Servicers

Due diligence, including research and analysis of a multifamily Seller/Servicer's financial condition, operational capabilities, and reputation, is expected before approving a multifamily Seller/Servicer. The Enterprise should evaluate the factors referenced below in the due diligence process, in addition to compliance with eligibility requirements, to assess the strength of the Seller/Servicer.

Financial Risk Factors

Financial risk can result from a weak or deteriorating financial performance or condition, adverse market conditions, or extraordinary events. Effective counterparty risk management includes evaluation of a potential Seller/Servicer's financial condition to assess its ability to continue operations based on components of its capital base, sources of revenue, profit margins, liquidity sources, and cash flow. These factors should be evaluated periodically or as warranted through ongoing monitoring to determine whether a Seller/Servicer has the capacity to meet its financial obligations. The Enterprises should consider the following in assessing potential risks to an Enterprise from each multifamily Seller/Servicer's financial condition, as appropriate:

- The Seller/Servicer's ability to perform through various market conditions;
- Ability of the Seller/Servicer to meet loss sharing obligations, if applicable;
- Capability of the Seller/Servicer's management;
- Internal risk management structure of the Seller/Servicer;
- Industry reputation, product mix, geographic diversity, and estimated loan production volumes;
- The Seller/Servicer's corporate structure, ownership, and any special financial arrangements;

- Quality of the loan portfolio, when the underwriting function is delegated, or servicing performance; and

- Adequacy of the Seller/Servicer's fidelity bond and errors and omissions insurance coverage that protects the Enterprises from losses resulting from dishonest or fraudulent acts committed by the lender's employed personnel or outside parties that provide services to the lender.

Operational Risk Factors

Weak operations or controls can result in exposures to loss resulting from inadequate or failed processes, people, systems, or external events. Noncompliance with the selling and servicing agreements and guide requirements can also create operational risk exposures. Operational risk events may prevent a Seller/Servicer from fulfilling its obligations to an Enterprise pursuant to contractual terms.

The Enterprises should consider the following, as appropriate, in assessing each multifamily Seller/Servicer's operational risk:

- Ability of the servicing operations to absorb future growth in terms of staffing, facilities, and system infrastructure;

- Overall servicing performance by the servicer or subservicers, including routine property inspections and collection of rent roll reports;

- Adequacy of the Seller/Servicer's information technology management program, including information security practices;

- The Seller/Servicer's business continuity, disaster recovery, and contingency planning to minimize any potential service disruptions;

- The Seller/Servicer's risk management program, including internal controls in conjunction with periodic reviews as well as post-closing loan reviews;

- The Seller/Servicer's management team's experience level, tenure, and any possible influence by controlling shareholders; and

- The Seller/Servicer's oversight of its third-party service providers such as subservicers, information technology providers, brokers, and appraisers.

Legal, Compliance, and Reputation Risk Factors

Legal, compliance, and reputation risks can exist as a result of, among other factors, noncompliance with laws or regulations or from non-adherence to sound industry practices or Enterprise selling and servicing agreements and guides. The Enterprises should consider the following in assessing the legal, compliance, and reputation risks associated with each multifamily Seller/Servicer, as appropriate:

- Maintenance of appropriate federal and state charters or licenses required for, or relevant to, operating its business in the approved jurisdictions;
- Scope of federal and state regulatory oversight and the Seller/Servicer's compliance program for all applicable laws and regulations;
- Record of compliance from publicly available information sources including past and pending legal actions; and
- Information known or reasonably available to an Enterprise about any civil, criminal, or regulatory issues affecting the Seller/Servicer.

Ongoing Monitoring

Monitoring of multifamily Seller/Servicers is an essential component of managing the risks they pose to an Enterprise. Ongoing monitoring by an Enterprise should be guided by risk-based procedures that outline periodic reviews of critical information to assess a Seller/Servicer's performance. The Enterprise's risk-based process should be designed to ensure that the direction, depth, and frequency of reviews is commensurate with each multifamily Seller/Servicer's risk profile.

The review should be available for evaluation by staff performing oversight duties (ERM) and should take into account factors assessed during the approval process, as well as the following additional factors, as appropriate:

- The number and volume of multifamily loans sold to and serviced for an Enterprise and the mix of various product types;
- The quality of the servicing that is performed on behalf of an Enterprise;
- The terms of any risk sharing arrangements in place, periodic review of accounts maintained by third parties, and reconciliation between risk sharing obligations and account balances;

- Whether the Enterprises have the ability to collect loan data from the Seller/Servicer, such as exception and waiver statistics, including documented justifications for waivers and results of ongoing performance reviews of those loans;

- Verification of eligibility standards and other terms of business throughout the relationship;

- Results of onsite reviews to validate compliance with the servicing guide, internal controls, and other contract provisions;

- Accuracy, timeliness, and completeness of loan recordkeeping, including loan data systems and loan documentation, throughout the life of the loan; and

- Changes in a Seller/Servicer's senior management, business model, strategies, or practices.

Corrective Action

The Enterprises have a range of remedies when dealing with a Seller/Servicer that fails to meet its contractual obligations. Clear communication between an Enterprise and a Seller/Servicer is critical in resolving areas that are not in compliance with issues outlined in the respective Seller/Servicer guide requirements. Each Enterprise should have established policies that include a process for taking timely remedial action to exercise contractual rights for termination, suspension, or restriction of activities with a Seller/Servicer. Enterprise policies should include standards for taking appropriate action against a Seller/Servicer that fails to meet an Enterprise's standards of performance or that poses reputation risk because of noncompliance with applicable laws and regulations or unsound business practices.

Related Guidance

12 CFR Part 1236 Prudential Management and Operations Standards, Appendix.

Contingency Planning for High-Risk or High-Volume Counterparties, Federal Housing Finance Agency Advisory Bulletin 2013-01, April 1, 2013.

Oversight of Single-Family Seller/Servicer Relationships, Federal Housing Finance Agency Advisory Bulletin 2014-07, December 1, 2014.

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.