Federal Housing Finance Agency

**ADVISORY BULLETIN**

**AB 2023-04: Supplemental Guidance to Advisory Bulletin 2021-03: Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention**

## Purpose

The Federal Housing Finance Agency (FHFA) is issuing this Advisory Bulletin as supplemental guidance to FHFA Advisory Bulletin 2021-03: *Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention* (Advisory Bulletin 2021-03), published on August 25, 2021.[1] This Advisory Bulletin is intended to clarify FHFA's existing guidance and is applicable to Fannie Mae and Freddie Mac (collectively, the Enterprises).

## Background

Since the publication of Advisory Bulletin 2021-03, FHFA has observed the Enterprises' implementation of the guidance and has determined the need for additional clarification. This Advisory Bulletin elaborates on certain elements of Advisory Bulletin 2021-03 and provides clarifications related to asset classifications, Loss-classified balance calculations, and other accounting topics.

## Guidance

This guidance is organized by illustrative questions that a reader may have when considering the guidelines set forth in Advisory Bulletin 2021-03.

### 1. What does the term "balance" (as in an asset's balance or a loan's balance) mean in terms of accounting measurement basis?

[1] *FHFA Advisory Bulletin 2021-03: Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention*, August 2021.

Unless specified otherwise, (*e.g.*, a requirement to classify and report assets by their unpaid principal balance), the term “balance” is defined as follows:

- For financial assets such as loans, advances, or financing receivables, “balance” means the asset’s amortized cost basis regardless of whether the asset is classified as held-for-investment (HFI) or held-for-sale (HFS) or accounted for under the fair value option (FVO). Amortized cost basis is the sum of unpaid principal balance, unamortized cost basis adjustments, and accrued interest receivable (AIR). For Enterprises that elect the option provided by U.S. Generally Accepted Accounting Principles (GAAP)[2] to report and disclose AIR separately from amortized cost, amortized cost basis will include only unpaid principal balance and unamortized cost basis adjustments. Contra-accounts such as allowance for credit losses or valuation allowance are excluded from the calculation of the amortized cost basis.

- For non-financial assets such as Real Estate Owned (REO), “balance” means the asset’s initial carrying amount for REO classified as HFS (the cost basis). Contra-accounts such as valuation allowance are excluded from the calculation of the HFS REO’s cost basis.

- Off-balance-sheet credit exposures refer to those that are neither unconditionally cancellable nor accounted for as derivatives or insurance contracts. For these exposures, “balance” means the Enterprise’s maximum exposure to loss without consideration of potential recoveries such as those from collateral, credit enhancements or recourse to another party. Specifically:

    - For standby letters of credit, “balance” means the remaining notional amount of the standby letter of credit.

    - For loan purchase commitments, “balance” means the remaining notional amount of the legally binding commitments to purchase mortgage loans.

    - For financial guarantees, “balance” means the maximum potential future payments that a guarantor could be required to make.

## 2. How and when is the fair value of a single-family residential mortgage loan’s collateral determined?

Collateral fair value should be determined in accordance with U.S. GAAP[3] using a property valuation technique that meets industry and professional standards (*e.g.*, the Interagency

[2] *See* Financial Accounting Standards Board (FASB)’s Accounting Standards Codification (ASC) 326, *Financial Instruments – Credit Losses*.
[3] *See* FASB ASC 820, *Fair Value Measurement*.

Appraisal and Evaluation Guidelines), such as an appraisal or a valuation produced by automated valuation models. The valuation technique chosen should produce a reasonably reliable estimate of fair value.

Collateral fair value should be determined at a point in time that provides a reasonable basis for the classification decision. Advisory Bulletin 2021-03 provides that an assessment of current fair value should be made before a loan with a loan-to-value ratio greater than 60 percent is more than 180 days delinquent. A loan that has a loan-to-value ratio below 60 percent and is therefore exempt from adverse classification should be based on a collateral valuation that is no more than 90 days old. Subsequent valuations should be performed and documented at least quarterly until the loan is no longer classified.

### 3. For financial assets not classified as HFS or not accounted for under the FVO, should the expected proceeds from non-freestanding credit enhancements always be included in the calculation of the Loss-classified balance to be written off?

Yes. In accordance with U.S. GAAP,[4] the expected proceeds from non-freestanding credit enhancements should be included in the calculation of the Loss-classified balance to be written off.

This U.S. GAAP requirement would apply to all applicable instances in which a Loss-classified balance to be written off is calculated, not just to loans with loan-to-value ratio greater than 60 percent that are more than 180 days past due.

### 4. When estimating the expected proceeds from non-freestanding credit enhancements in the calculation of the Loss amount, should the expected proceeds be adjusted for a current assessment of collectability?

Yes. The estimation of expected proceeds from non-freestanding credit enhancements should consider any factors that may affect the credit enhancement provider's ability to honor valid claims. If the analysis concludes that the credit enhancement provider is unlikely to meet its contractual obligations, the Enterprises should apply an appropriate adjustment to ensure only expected proceeds from non-freestanding credit enhancements are included in the calculation of the amount classified as Loss. With respect to supplemental mortgage insurance, the Enterprises should adopt a methodology to allocate a portion of the supplemental mortgage insurance to specific loans.

[4] *See* FASB ASC 326, *Financial Instruments – Credit Losses*.

### 5. Can the calculation of an amount classified as Loss include adjustments for Credit Risk Transfer (CRT) coverage?

CRTs that are accounted for as freestanding credit enhancements should be excluded from the Loss calculation.

### 6. Can contractual terms such as representations and warranties be considered when evaluating a loan for classification?

Yes. The Enterprises may consider the extent to which contractual terms, including representations and warranties, provide protection against loss for an individual mortgage loan. The Enterprises should consider any factors that may adversely affect the enforceability of contractual terms. If the analysis concludes that the counterparty is unlikely to meet its contractual obligation, then the Enterprises should apply an appropriate adjustment to the amount classified as Loss. Notable factors to consider include the financial condition and ability or willingness of the counterparty to fulfill contractual obligations.

### 7. How should the Loss-classified balance be calculated (i) for assets classified as HFS, (ii) for assets that are classified as HFS or HFI but accounted for under the FVO, (iii) for AIR, or (iv) for off-balance-sheet credit exposures?

For a loan or financing receivable classified as HFS, including those classified as HFS but accounted for under the FVO (HFS FVO), the Loss-classified balance is calculated as any excess of the asset's amortized cost basis over its fair value. The Loss-classified balance should equal the balance of the valuation allowance account in absolute value – a contra account to the HFS loan or financing receivable.

For a loan or financing receivable classified as HFI but accounted for under the FVO (HFI FVO), if the loan is determined to be classified as Loss, the Loss-classified balance is calculated as any excess of the asset's amortized cost basis over its fair value. The Loss-classified balance should equal the balance of the valuation allowance account in absolute value – a contra account to the HFI FVO loan or financing receivable.

For an REO classified as HFS, the Loss-classified balance is calculated as any excess of the REO's initial carrying amount over its fair value less cost to sell. The Loss-classified balance should equal the balance of the valuation allowance account in absolute value – a contra account to the HFS REO.

As provided in Advisory Bulletin 2021-03, to comply with U.S. GAAP, the Loss-classified balance of assets classified as HFS (including HFS FVO) or classified as HFI but accounted for under the FVO (HFI FVO) should not be written off. Therefore, if in the next period, there is an increase in (i) the fair value of HFS (including HFS FVO) or HFI FVO loan or (ii) the fair value less cost to sell of HFS REO, the calculated Loss-classified balance would be reduced to reflect the increase in the sources of recovery.

If the Enterprises elected to write off AIR in a timely manner (*i.e.*, when transitioning a loan from accrual to nonaccrual status), the Loss-classified balance is equal to the write-off amount.

For off-balance-sheet credit exposures that are neither unconditionally cancellable nor accounted for as derivatives and insurance contracts, if an exposure is determined to be classified as Loss, the Loss-classified balance should equal the balance of the liability recognized in absolute value, in accordance with U.S. GAAP.[5] Since the exposures are off-balance-sheet, the guidance to write off the Loss-classified balance is not applicable. Therefore, in the next period, if there is an increase in the sources of recovery, the calculated Loss-classified balance would be reduced accordingly.

## 8. How should the remaining balance of an asset be classified after the Loss-classified balance has been calculated?

For any period in which a Loss-classified balance of an asset exists, the remaining balance of the asset should be classified as Substandard. However, for AIR, since the Loss-classified balance is calculated as the entire amortized cost basis of previously recognized but uncollected interest receivable, there would be no remaining balance left to be classified.

In the subsequent periods, the classification of the remaining balance should follow the general classification guidance. However, for loans associated with a borrower who is in bankruptcy, after the Loss-classified balance is written off, any loan balance remaining should continue to be classified as Substandard until the borrower demonstrates the ability and willingness to repay for a period of at least six consecutive months.

## 9. For a borrower in bankruptcy, how should the phrase "until the borrower demonstrates the ability and willingness to repay for a period of at least six consecutive months" be interpreted?

When a borrower is in bankruptcy, the Enterprises should receive timely monthly contractual payments for six consecutive months to be eligible for re-classification. After that period, the loan balance remaining after write-off would no longer need to be classified as Substandard based on delinquency.

[5] *See* FASB ASC 326, *Financial Instruments – Credit Losses*.

## 10. How should loans from borrowers that have declared bankruptcy but remain current on their payments be classified?

Loans associated with a borrower who is in bankruptcy and remains current on their payments need not be written-off. However, if it cannot be demonstrated and documented that full repayment is likely to occur, any portion of the 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 credit enhancements should be classified as Loss and written off within 60 days of receipt of the notification of filing from the bankruptcy court or within the delinquency time frames specified in Advisory Bulletin 2021-03, whichever is shorter. Any loan balance remaining after write-off should be classified as Substandard until the borrower demonstrates the ability and willingness to repay for a period of at least six consecutive months.

## 11. When a borrower files for bankruptcy, what form of documentation would clearly demonstrate and document that repayment is likely to occur?

The Enterprises should document that the borrower is likely to repay the loan. Examples of appropriate documentation are the borrower's formal reaffirmation of the debt, and/or documented evidence that the borrower has a financial capacity and intention to repay the loans. The Enterprises may consider the borrower's payment history and loan status (*e.g.*, the loan is current at the time of the bankruptcy filing and has no prior delinquencies) when evaluating whether repayment is likely to occur.

## 12. Why are fraudulent loans not covered by representations and warranties written off within 90 days of discovery?

Loans tainted by fraud are of such questionable value that they should not be recognized as an asset on the balance sheet. The timing of any potential collection is uncertain notwithstanding a perfected security interest in the collateral or collateral fair value that would otherwise provide protection against loss. Amounts ultimately collected should be recorded as a recovery.

## 13. Is it acceptable to write off an asset before it is classified as Loss?

Advisory Bulletin 2021-03 states that the write-off associated with any Loss classification should be taken by the end of the month in which the applicable time period elapses. For example, the Enterprises should apply Advisory Bulletin 2021-03 to evaluate and classify a single-family residential mortgage loan as Loss no later than when the loan is 180 days delinquent. The Enterprises should also write off the portion of the loan classified as Loss, except in certain limited circumstances, such as when the loan is classified as HFS or accounted for under the FVO (refer to Question 7).

However, U.S. GAAP[6] also requires an entity to recognize a full or partial write-off of a financial asset in the period in which the financial asset is deemed uncollectible, which could sometimes occur before a loan is classified as Loss, such as when a non-performing single-family residential mortgage loan is transferred from HFI to HFS. Therefore, in these instances, the Enterprises may write off a single-family residential mortgage loan before it is classified as Loss.

### 14. Should a loan that has a borrower-initiated modification be listed as Special Mention for six months?

Advisory Bulletin 2021-03 does not specifically distinguish between modifications that are initiated by the borrower or another party, such as the servicer. Rather, Advisory Bulletin 2021-03 establishes performance-based indicators for classifying delinquent loans that are not otherwise well-secured and in process of collection. Thus, a borrower-initiated loan modification, which is (i) not related to a credit issue, (ii) not adversely classified, and (iii) does not evidence potential weaknesses or deficiencies in administration, may avoid a classification of Special Mention.

## Related Guidance

*Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention*, FHFA Advisory Bulletin 2021-03, August 25, 2021.

FASB ASC 326, *Financial Instruments – Credit Losses*.

FASB ASC 820, *Fair Value Measurement*.

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[6] *See* FASB ASC 326, *Financial Instruments – Credit Losses*.