

**REDACTED**

Federal Housing Finance Agency  
Office of Inspector General



**More than Eight Years After  
Issuing its Advisory Bulletin, FHFA  
Has Not Held the Enterprises to its  
Expectations on Charging off  
Delinquent Loans or Communicated  
New Expectations**

This report contains redactions of information that is privileged or confidential.

Evaluation Report • EVL-2020-003 • September 10, 2020



EVL-2020-003

September 10,  
2020

## Executive Summary

The Federal Housing Finance Agency (FHFA or Agency) was established by the Housing and Economic Recovery Act of 2008 (HERA) to serve as the supervisor and regulator of Fannie Mae and Freddie Mac (together, the Enterprises) and the Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities). Its statutory mission includes ensuring the safety and soundness of its regulated entities so that they serve as reliable sources of liquidity and funding for housing finance and community investment. For the Enterprises, FHFA fulfills its mission through its Division of Enterprise Regulation (DER), which conducts targeted examinations and ongoing monitoring of the Enterprises during each year according to a risk-based supervisory plan. To communicate its supervisory expectations on specific matters to its regulated entities and to its examiners, FHFA issues advisory bulletins.

FHFA, and other federal financial regulators, consider classification of loans according to risk characteristics to be critical in assessments of a financial institution's safety and soundness. In April 2012, FHFA issued Advisory Bulletin (AB) 2012-02, *Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention*. That advisory bulletin establishes a system for loan classification that aligns with the practices used by other federal financial regulators and provides consistency between the Enterprises. It directs the regulated entities to classify any outstanding loan balance in excess of the fair value of the property, less cost to sell, as "Loss" when the single-family loan becomes no more than 180 days delinquent and to charge off the portions of those loans classified as loss so they are no longer considered an asset on the balance sheet (180-day charge-off threshold). In this evaluation, we assess FHFA's efforts to oversee Enterprise implementation of the 180-day charge-off threshold.

While AB 2012-02 was effective upon issuance, FHFA advised the Enterprises to submit implementation plans for the advisory bulletin. After reviewing the Enterprise plans, the Agency rejected both plans in December 2012 on the grounds that they did not meet the criteria established in the advisory bulletin. FHFA explained that the purpose of AB 2012-02 was to ensure that the Enterprises "take effective and expedient action to address delinquent and impaired loans and to appropriately recognize them in a timely fashion." FHFA repeatedly delayed the effective date of AB 2012-02 until January 2015, almost three years after issuance, at the request of the Enterprises.

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Notwithstanding the instruction in the advisory bulletin for a 180-day charge-off threshold, and a stated purpose to establish standard and uniform methodologies between the Enterprises, neither Enterprise's revised implementation plan adopted the 180-day charge-off threshold nor were they consistent. One Enterprise proposed a charge-off threshold [REDACTED] than the 180-day threshold and the other proposed a threshold [REDACTED], even though their single-family loans were underwritten to substantially similar standards. While FHFA generally acknowledged that the revised plans were an improvement, the Enterprises did not meet the charge-off expectation in the advisory bulletin.

In 2015 and 2016, DER initiated targeted examinations of the Enterprises to assess their implementation of AB 2012-02. Our review of the workpapers found that examiners [REDACTED] that the 180-day charge-off threshold was not being followed. We also found inconsistencies in the examination record and inadequacies in the documentation explaining how the charge-off issue was resolved. Although examiners [REDACTED] with the 180-day charge-off threshold, DER ultimately [REDACTED].

While FHFA has received intermittent recommendations to issue additional guidance or revise AB 2012-02, it has taken no action on those recommendations. More than eight years after its issuance, FHFA has not held the Enterprises to the 180-day threshold in the advisory bulletin for charging off delinquent single-family loans and has not articulated a new expectation in the form of a revised advisory bulletin or other Agency guidance. The expected increase in credit losses due to the COVID-19 pandemic, as well as accounting changes from the Enterprises' adoption of the Current Expected Credit Loss framework (CECL), underscores the need for FHFA to articulate clear expectations to ensure the Enterprises recognize losses in a timely fashion and to oversee Enterprise implementation of those expectations.

We made two recommendations to address the shortcomings our evaluation identified. In a written management response, FHFA agreed with both recommendations; however, the Agency did not commit to a time frame by which it would revise the advisory bulletin after it determines the appropriate charge-off threshold or criteria. As a consequence, FHFA's time frame for completing its actions is open-ended. The Agency acknowledged in its management response that classification of loans according to risk characteristics is a critical factor in assessing the safety and soundness of the Enterprises, but its leisurely approach to revising the advisory bulletin is incongruent with that supervisory posture.

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This report was prepared by Adrienne Freeman, Investigative Counsel, and Philip Noyovitz, Investigative Evaluator. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, [www.fhfaoig.gov](http://www.fhfaoig.gov), and [www.oversight.gov](http://www.oversight.gov).

/s/

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## ABBREVIATIONS .....

AB	Advisory Bulletin
CECL	Current Expected Credit Loss
DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
FHLBanks	Federal Home Loan Banks
GAAP	Generally Accepted Accounting Principles
HERA	Housing and Economic Recovery Act of 2008
OCA	Office of the Chief Accountant
OIG	Federal Housing Finance Agency Office of Inspector General
SEC	Securities and Exchange Commission

## **BACKGROUND** .....

FHFA was established by HERA (P.L. 110-289) to serve as the supervisor and regulator of the Enterprises and the FHLBanks. Its statutory mission includes ensuring the safety and soundness of its regulated entities so that they serve as a reliable source of liquidity and funding for housing finance and community investment.

FHFA executes its duty to supervise the regulated entities through statutorily required annual examinations. DER is responsible for developing and implementing FHFA’s supervision program for the Enterprises. According to FHFA’s Examination Manual, DER examines risk management practices and the regulated entity’s financial condition and safety and soundness relative to applicable laws, regulations, supervisory guidance, and prudent business practice. DER performs those examinations through ongoing monitoring activities and targeted examinations in accordance with a risk-based supervisory plan. Since 2008, FHFA has also served as conservator of the Enterprises.

To communicate its supervisory expectations on specific matters to its regulated entities and to its examiners, FHFA issues advisory bulletins. As supervisor of the Enterprises, DER conducts examinations to, among other things, assess whether the Enterprises’ practices comport with the supervisory expectations set forth in FHFA’s advisory bulletins.

### **Under Generally Accepted Accounting Principles, Financial Institutions Are Expected to Timely Recognize Losses**

As registrants with the Securities and Exchange Commission (SEC), the Enterprises are required to prepare and file with the SEC financial statements in accordance with generally accepted accounting principles (GAAP). Under GAAP, management is expected to make its best estimate of expected credit losses and recognize those losses through a charge to income, and by charging off loans if they are deemed uncollectible.

Prior to 2012, the Enterprises, in general, charged off loans at the end of the foreclosure process or when a foreclosure alternative was executed. Under that approach, years could pass before an Enterprise recognized its losses.

### **FHFA Recognized the Importance of Asset Classification and Loss Recognition Through Charge-Offs to Manage Credit Risks, and Issued Supervisory Expectations in 2012**

Federal financial regulators consider classification of loans according to risk characteristics to be a critical factor in assessing a financial institution’s safety and soundness. Because the majority of Enterprise assets are concentrated in mortgages, the Enterprises consider

accounting for loan loss reserves to be an accounting policy critical to the understanding of their financial statements.

Following the identification of significant credit risk management issues at one of the Enterprises during the 2011 examination cycle, FHFA determined that a supervisory policy on asset classifications with standards for when loans need to be charged off was “necessary.”

On April 9, 2012, FHFA issued Advisory Bulletin (AB) 2012-02, *Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention*. According to the advisory bulletin, its purpose is:

[T]o 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.<sup>1</sup>

FHFA explained in AB 2012-02 that it intended to apply the same classification rules to the Enterprises that other federal financial regulators apply to the financial institutions under their supervision for the adverse classification of residential mortgages.<sup>2</sup> The Agency recognized the need to establish consistency between the Enterprises and align with the system for loan classification followed by federal financial regulators. AB 2012-02 defines three different categories for adversely classifying Enterprise loans and other assets, including “Loss.” According to FHFA:

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.

Assets classified as “Loss” are considered uncollectible and are charged off so as to no longer be considered an asset on the balance sheet. In FHFA’s view, prompt recognition of probable incurred losses was consistent with GAAP.

While AB 2012-02 stated that it was “effective upon issuance,” FHFA directed the Enterprises to submit implementation plans, including establishment of an asset classification

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<sup>1</sup> FHFA, Advisory Bulletin 2012-02, [\*Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention\*](#), at 1 (Apr. 9, 2012).

<sup>2</sup> See Uniform Retail Credit Classification and Account Management Policy issued by federal financial regulators in June 2000, which established specific procedures for the adverse classification of residential mortgage loans and other retail loans.

and reporting system and amendment of existing practices, to comply with the advisory bulletin. In response, the Enterprises submitted implementation plans.

Eight months after the issuance of AB 2012-02, FHFA notified the Enterprises that the plans submitted “did not meet the criteria established” and directed them to develop and resubmit implementation plans within 30 days. FHFA explained that the purpose of the advisory bulletin was to ensure that the Enterprises:

[T]ake effective and expedient action to address delinquent and impaired loans and to appropriately recognize losses in a timely fashion. The guidance also is intended to reduce reliance on models and associated management assumptions, and create better discipline and transparency around the recognition of problem assets and the management of impaired loans. Moreover, the standard and uniform methodology outlined in the [advisory bulletin], when applied appropriately, results in a consistent process and produces asset quality metrics that are comparable among the GSE’s (sic).

FHFA considered compliance with its advisory bulletins one of the highest priorities. The Agency directed the Enterprises “to fully implement the Advisory Bulletin for purposes of their financial reporting for the period beginning on January 1, 2014.”

In a set of Questions and Answers attached to each of these letters, the Deputy Director, DER, explained:

FHFA expects that the regulated entities will deal timely with loan delinquencies. When a loan is 180 days delinquent, our review of the data indicates that under most circumstances, the likelihood of full repayment is remote.<sup>3</sup>

In the Agency’s view, AB 2012-02 embodies a basic principle in GAAP that losses should be recognized on loans that are deemed uncollectible and that there should be no delay in loss recognition of probable incurred losses.

### **FHFA Delayed Implementation of the Charge-Off Threshold until January 2015**

FHFA repeatedly delayed the effective date of AB 2012-02 until January 2015, almost three years after issuance, at the request of the Enterprises.

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<sup>3</sup> FHFA, “Questions and Answers Regarding FHFA Bulletin 2012-02,” attachment to letters from the deputy director of FHFA Division of Enterprise Regulation to Fannie Mae’s and Freddie Mac’s CEOs (Dec. 5, 2012).

We issued a Management Alert in August 2013 raising concerns about the untimely implementation of AB 2012-02.<sup>4</sup> We reported that FHFA recognized that appropriate classification of assets according to risk characteristics was a key safety and soundness practice that could have an impact on loan loss reserves and that the loan loss reserve was a critical/significant accounting estimate for both Fannie Mae and Freddie Mac. We explained that the then-Deputy Director, DER, acknowledged that full implementation of AB 2012-02 by the Enterprises “could potentially require them to charge-off billions of additional dollars related to loans classified as ‘Loss.’”<sup>5</sup> In response, FHFA explained that “changes in a significant policy, such as AB 2012-02, require considerable changes to systems and operations that could take time to complete in a safe, sound and well controlled manner.”<sup>6</sup>

In mid-2014, the Enterprises submitted revised implementation plans. The Enterprises did not adopt the 180-day charge-off threshold,<sup>7</sup> and their proposed thresholds were not consistent, even though the Enterprises’ single-family loans were underwritten to substantially similar standards. One Enterprise proposed a [REDACTED] than the 180-day threshold in AB 2012-02, and the other proposed a [REDACTED].<sup>8</sup>

DER responded to these proposed revised plans. While it found that the proposed [REDACTED] charge-off period was [REDACTED], that proposed threshold did “ [REDACTED] [REDACTED].” The Agency informed the other Enterprise that it considered the proposed plan as an [REDACTED].

In a follow-up discussion on our 2013 Management Alert in August 2014, staff in FHFA’s Office of the Chief Accountant (OCA) reported to us that the Enterprises lacked sufficient

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<sup>4</sup> See OIG, [Management Alert: Delay Implementing Advisory Bulletin No. 2012-02](#) (Aug. 5, 2013).

<sup>5</sup> *Id.* at 4, footnote 10.

<sup>6</sup> August 9, 2013, response to FHFA OIG management alert. See OIG, [Management Alert: Delay Implementing Advisory Bulletin No. 2012-02](#) (Aug. 5, 2013).

<sup>7</sup> The Enterprises advised the SEC that charge-offs at 180 days past due would exceed their best estimate of incurred losses. In its February 5, 2014, response to the Enterprises, SEC explained that “financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles... will be presumed to be misleading or inaccurate...” and that it expected the Enterprises to comply with GAAP. Stephanie J. Ciboroski, Letter to David C. Benson at Federal National Mortgage Association (Feb. 5, 2014) (online at [www.sec.gov/Archives/edgar/data/310522/000000000014006186/filename1.pdf](http://www.sec.gov/Archives/edgar/data/310522/000000000014006186/filename1.pdf)) and Stephanie J. Ciboroski, Letter to Robert Mailloux at Federal Home Loan Mortgage Corporation (Feb. 5, 2014) (online at [www.sec.gov/Archives/edgar/data/1026214/000000000014006205/filename1.pdf](http://www.sec.gov/Archives/edgar/data/1026214/000000000014006205/filename1.pdf)).

<sup>8</sup> Freddie Mac’s plan also applied a [REDACTED] delinquency threshold in circumstances where the servicer has not been able to contact the borrower. Freddie Mac submitted an update to FHFA in December 2014 that extended the charge-off threshold to [REDACTED] than the expectations in AB 2012-02.

loan loss reserves to cover the loss that would need to be recorded if they implemented the 180-day charge-off threshold in AB 2012-02 in January 2015.

## **FACTS AND ANALYSIS .....**

### **The Enterprises Asserted that Adherence to the 180-Day Charge-Off Threshold Would Cause Them to Violate GAAP**

As publicly traded companies, the Enterprises must comply with GAAP. Both Enterprises disclosed in their financial statements that the accounting methods relating to charge-offs of delinquent loans in AB 2012-02 were different from their existing accounting methods and would require operational changes. Neither disclosed the financial statement impact of implementing those accounting changes.

Based on their experiences, neither Enterprise considered a single-family loan to be uncollectible at 180 days. They repeatedly maintained to FHFA that implementation of the 180-day charge-off expectation in AB 2012-02 would not be consistent with GAAP because the 180-day period did not represent their best estimate of credit losses.

The record shows that the Enterprises, SEC, and FHFA discussed the Enterprises' concern over several years (2012-2014). However, FHFA did not revise or rescind AB 2012-02, and both Enterprises did not implement its 180-day charge-off threshold.

### **According to the Office of the Chief Accountant, the Enterprises' Business Presents Unique Challenges to Implementation of the 180-Day Charge-Off Threshold**

The Chief Accountant reported to us that FHFA's OCA participated in internal discussions within FHFA on the merits of the Enterprises' claim that implementation of the 180-day charge-off expectation would cause them to run afoul of GAAP. He explained that FHFA issued AB 2012-02 to promote sound credit risk practices and expected that Enterprise enhancements of data collection and analysis would enable them to charge off delinquent loans closer to 180 days. According to the Chief Accountant, OCA took the position that the 180-day threshold in AB 2012-02 was not, on its face, a violation of GAAP. However, OCA recognized that the Enterprises' mission to help borrowers remain in their homes while minimizing losses was different from commercial lenders and that the Enterprises'

experiences with some loans that were delinquent more than 180 days differed from FHFA's 2012 data analytics because a segment of those loans was subject to modification.<sup>9</sup>

### Targeted Examinations Conducted by DER in 2015 and 2016 Found that the Enterprises [REDACTED] the 180-day Charge-Off Threshold but [REDACTED]

As discussed earlier, FHFA considered compliance with its advisory bulletins one of the highest priorities, and DER conducts examinations to, among other things, assess whether the Enterprises' practices comport with the supervisory expectations set forth in FHFA's advisory bulletins. DER initiated targeted examinations of the Enterprises in 2015 and in 2016 to assess Enterprise compliance with AB 2012-02, including the 180-day charge-off expectation. Our review of workpapers for both targeted examinations identified inconsistencies in the examination record and inadequacies in the documentation regarding how the charge-off issue was resolved.

Workpapers for the 2015 examination show that examiners [REDACTED] that one Enterprise [REDACTED] the 180-day charge-off guidance of AB 2012-02 but do not explain why no [REDACTED]. Similarly, the workpapers contain no discussion of the reasons that this targeted examination was converted by DER to an ongoing monitoring activity ten months after field work was completed or why no conclusion letter was issued.<sup>10</sup>

Workpapers in the 2016 examination show that examiners identified that the Enterprise [REDACTED] the 180-day charge-off threshold and [REDACTED] on the [REDACTED] of that threshold. The Examiner-in-Charge recalled to us that examiners [REDACTED] for the Enterprise to comply with the 180-day guidance. Examination workpapers show that the examination team met with the Enterprise to discuss its charge-off practices and alerted Enterprise executives that the Enterprise's [REDACTED] the 180-day charge-off threshold was a "[REDACTED]." However, none of this work

<sup>9</sup> According to one Enterprise, analysis of its data showed that more than [REDACTED] of loans that were delinquent after 180 days converted to performing loans (generally after a modification) after one year. The other Enterprise maintained that data analytics showed that [REDACTED] of its loans that were delinquent at 180 days converted to performing loans in 2014. In the view of the Chief Accountant, this data would not support a bright line charge-off threshold of 180 days. However, he did not express a view about the appropriate length of time for such a threshold.

<sup>10</sup> In a prior OIG audit report, OIG expressed similar concerns that workpapers lacked clarity due to inconsistencies in the workpapers that did not correspond to examination findings and conclusions. In that audit, OIG recommended that DER reinforce with its examiners the need to prepare workpapers with sufficient detail and clarity to provide a third party with a clear understanding of the examination work performed. See [FHFA Completed its Planned Procedures for a 2016 Representation and Warranty Framework Targeted Examination at Freddie Mac, but the Supporting Workpapers Did Not Sufficiently Document the Examination Work](#), at 14 (Mar. 13, 2018) (AUD-2018-006).

is mentioned in the analysis memorandum, dated December 12, 2016, eight weeks prior to the end of examination field work on February 6, 2017, nor does the analysis memorandum formally recommend an [REDACTED].<sup>11</sup>

The then-Deputy Director, DER, explained to us that the [REDACTED] to the Enterprises because the Agency could not expect them to adhere to AB 2012-02's 180-day charge-off threshold and remain GAAP compliant, notwithstanding the stated expectation in the advisory bulletin. In lieu of AB 2012-02's charge-off threshold, the then-Deputy Director determined that the Enterprises' commitment to update their charge-off policies based on their data analysis along with justification of their methodology was an acceptable alternative.<sup>12</sup> However, that explanation is not in the contemporaneous examination workpapers.

Since these targeted examinations, the charge-off thresholds adopted by the Enterprises have continued to exceed the 180-day expectation set forth in the advisory bulletin.<sup>13</sup> The current Examiner-in-Charge for one Enterprise advised us that, as long as the annual analysis by each Enterprise supports charging off loans in more than 180 days, DER has taken no actions.

### **More than Eight Years After Issuing the Supervisory Expectations, FHFA Has Not Held the Enterprises to the 180-Day Charge-Off Threshold Set Forth in AB 2012-02 and Has Not Articulated a New Loss Charge-Off Threshold**

Although FHFA has accepted that the Enterprises do not charge off loans until well beyond the 180-day threshold expectation in AB 2012-02, the Agency has not revised the advisory bulletin or issued interpretive guidance to reflect its position regarding the appropriate timeframe for loan charge-offs. An FHFA working group formed to address issues involving implementation of the advisory bulletin recommended in July 2015 that the Agency consider [REDACTED] for the Enterprises and FHFA examiners on implementation of the advisory bulletin to [REDACTED].

[REDACTED]. The Chief Accountant told us that he recommended that [REDACTED].

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<sup>11</sup> Follow-up notations were added to a January 2017 meeting note in February 2017. Those notations stated that the examiners reviewed Fannie Mae's annual analysis of delinquent loans with "[REDACTED]" and "[REDACTED]" and recommended that the [REDACTED] at that time. However, the lead examiner asserted that he did not add the notations and disputed their accuracy. Subsequently, the lead examiner reported that the then-examination manager, his direct supervisor, added these notations but stated that he disagreed that examiners had not reviewed Fannie Mae's materials thoroughly prior to the January 2017 meeting.

<sup>12</sup> We take no position on whether 180 days is the appropriate benchmark for charging off Enterprise loans.

<sup>13</sup> We do not know if the Agency has accepted different approaches from the FHLBanks. A review of the FHLBanks' charge-off policies was outside the scope of this evaluation.

AB 2012-02 be [REDACTED].<sup>14</sup> However, FHFA has not issued additional guidance, and the former Deputy Director and the Examiner-in-Charge for one of the Enterprises told us there were no ongoing efforts to revise or replace the advisory bulletin. As a result, FHFA’s public expression of its supervisory expectations does not accurately reflect the Agency’s actual expectations nor the Enterprises charge-off practices.

### Losses Are Expected to Increase Due to the COVID-19 Pandemic

The COVID-19 pandemic has resulted in a sharp economic decline and unprecedented levels of unemployment. As a result, millions of homeowners have received forbearance from making their mortgage payments. The mortgage software and analytics firm Black Knight estimated that 1,425,000 Enterprise loans were in forbearance as of September 4, 2020, representing \$299 billion in unpaid principal balance.<sup>15</sup>

The Enterprises have recognized that the economic decline will likely lead to higher rates of delinquencies. In its 2020 second quarter 10-Q, Fannie Mae reported that “the economic dislocation caused by the COVID-19 outbreak could lead to significantly higher defaults on mortgage loans.” Fannie Mae also stated:

We do not expect a substantial increase in our single-family credit losses in the near term as a result of COVID-19, as we are currently offering up to 12 months of forbearance to single-family borrowers suffering financial hardship relating to the pandemic. We have suspended foreclosures and foreclosure-related activities for single-family properties through at least August 31, 2020; however, over the longer term, the COVID-19 pandemic is likely to result in higher single-family credit losses as reflected in an increased allowance for loans losses since the inception of the pandemic.

Similarly, Freddie Mac acknowledged in its 2020 second quarter 10-Q that the economic downturn could “adversely affect our business in numerous ways, including, for example, by increasing our credit losses... .” The expected increase in credit losses underscores the need for the Enterprises to recognize losses in a timely fashion, so the Enterprises’ reported finances appropriately reflect losses on delinquent loans.

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<sup>14</sup> As the Chief Accountant explained, the adoption of the Current Expected Credit Loss framework (CECL), effective January 1, 2020, may conflict with AB 2012-02’s guidance for adversely classifying individual loans. CECL, which was established by the Financial Accounting Standards Board, requires companies to establish reserves for expected losses on assets at the time that such assets are created or acquired, applying a pool level loan analysis. See also OIG, [The Current Expected Credit Loss \(CECL\) Methodology and the Enterprises and FHLBanks](#) (Sept. 24, 2019) (WPR-2019-004). AB 2012-02 does not allow pool level analysis.

<sup>15</sup> Black Knight, [Forbearances Down 1 Million from Peak](#) (Sept. 4, 2020) (online at [www.blackknightinc.com/blog-posts/forbearances-down-1-million-from-peak](http://www.blackknightinc.com/blog-posts/forbearances-down-1-million-from-peak)).

## FINDINGS .....

1. FHFA issued AB 2012-02 in April 2012 to align with the loan classification system followed by other federal financial regulators and to establish consistency in the charge-off threshold used by the Enterprises. According to FHFA, “classification of assets is a critical element in evaluating the risk profile and the adequacy of capital, loan loss reserves, and earnings,” and a supervisory policy on classifications with standards for when loans need to be charged off was “necessary.”
2. FHFA considered compliance with its advisory bulletins one of the highest priorities and directed the Enterprises to “fully implement” AB 2012-02.
3. In the eight years since AB 2012-02 was issued, neither Enterprise has implemented the 180-day charge-off threshold in the advisory bulletin and their charge-off practices exceed this guidance.
4. FHFA has not achieved its goal of establishing standard and uniform methodologies between the Enterprises; it has not pressed the Enterprises to align their charge-off thresholds with AB 2012-02, or insisted on consistency between the Enterprises in their charge-off thresholds.
5. FHFA has never revised or rescinded AB 2012-02. As a result, this advisory bulletin does not accurately reflect the Agency’s supervisory expectations or the Enterprises’ actual charge-off practices.

## CONCLUSION .....

Federal financial regulators treat classification of loans according to risk characteristics as a critical factor in assessing a financial institution’s safety and soundness. Because the majority of Enterprise assets are concentrated in mortgages, the Enterprises consider accounting for loan loss reserves to be an accounting policy critical to the understanding of their financial statements. FHFA determined that a supervisory policy on asset classifications with standards for when loans need to be charged off was “necessary,” and issued AB 2012-02 in April 2012 to establish consistency between the Enterprises and align with the loan classification system followed by other federal financial regulators.

Eight years later, FHFA has not held the Enterprises to the expectations in AB 2012-02 and has not communicated other expectations regarding this accounting policy that are critical to the understanding of their financial statements. The expected increase in credit losses to the

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Enterprises due to the COVID-19 pandemic, as well as accounting changes from the adoption of CECL, underscore the need for FHFA to articulate clear expectations to ensure the Enterprises recognize losses in a timely fashion and to oversee Enterprise implementation of those expectations.

## **RECOMMENDATIONS.....**

We recommend that FHFA:

1. Determine the appropriate threshold or criteria for charging off delinquent single-family loans at the Enterprises and communicate that threshold or criteria through revised or new Agency guidance; and
2. Assess the Enterprises' implementation of the revised or new Agency guidance to ensure that the Enterprises' practices comport with FHFA's supervisory expectations.

## **FHFA COMMENTS AND OIG RESPONSE.....**

We provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA provided technical comments on the draft report, which we incorporated as appropriate. In its management response, which is reprinted in its entirety in the Appendix, FHFA agreed with both recommendations. In response to the first recommendation, FHFA stated that it will perform an analysis by August 31, 2021, "to determine the appropriate threshold or criteria for charging off delinquent single-family loans at the Enterprises," and based on that analysis "make revisions to [AB 2012-02], as appropriate." The Agency proposed a time frame of approximately a year to complete corrective actions to address the first part of the recommendation but did not commit to a time frame by which it would revise the advisory bulletin. As a consequence, FHFA's time frame for completing its actions is open-ended. In our view, this lengthy, open-ended time frame does not reconcile with FHFA's supervisory efforts to date. Since the charge-off threshold in AB 2012-02 went into effect on January 1, 2015, the Enterprises have submitted their data analyses of delinquent loan performance annually to FHFA for review. As a result, FHFA has the benefit of at least five years of the Enterprises' delinquent loan performance data and analysis at this time, and it is reasonable to expect that the Agency be in a position to use its analysis of those data to determine an appropriate charge-off threshold or criteria. We question whether such an analysis should require almost an additional year to complete.

As we found in our report, eight years have passed since FHFA issued AB 2012-02 and neither Enterprise has implemented the 180-day charge-off threshold in the advisory bulletin. Moreover, FHFA has not held the Enterprises to the charge-off thresholds in AB 2012-02, or insisted on standard and uniform methodologies between the Enterprises. This is contrary to the express purpose of the AB. The Enterprises' respective charge-off thresholds are significantly different from one another. The Agency has acknowledged in its management response that classification of loans according to risk characteristics is a critical factor in assessing the safety and soundness of the Enterprises, but its leisurely approach to revising the advisory bulletin is incongruent with that supervisory posture.

## OBJECTIVE, SCOPE, AND METHODOLOGY .....

The objective of this evaluation was to assess FHFA’s efforts to oversee Enterprise implementation of the 180-day charge-off threshold in AB 2012-02 for delinquent single-family loans. To achieve this objective, we sought to determine whether DER’s examinations of the Enterprises’ implementation of AB 2012-02 included assessments of their charge-off practices and compliance with the 180-day charge-off threshold set forth in the advisory bulletin.

We reviewed applicable guidance and standards published by FHFA in effect during the review period, including AB 2012-02 and the Examination Manual. We also requested and reviewed supervisory letters and other correspondence between DER and the Enterprises regarding their respective implementation plans. Additional materials reviewed included DER examination workpapers and planning documents focused on Enterprise compliance with the 180-day charge-off threshold.

We interviewed the former DER Deputy Director, the Chief Accountant, an Examiner-in-Charge for one of the Enterprises, and a DER examiner with knowledge of DER’s examination efforts to assess Enterprise compliance with AB 2012-02.

The fieldwork for this report was completed between March 2020 and July 2020.

This evaluation was conducted under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency’s *Quality Standards for Inspection and Evaluation* (January 2012). These standards require us to plan and perform an evaluation based upon evidence sufficient to provide a reasonable basis to support its findings and recommendations. We believe that the findings and recommendations discussed in this report meet those standards.

## APPENDIX: FHFA MANAGEMENT RESPONSE.....



# Federal Housing Finance Agency

### MEMORANDUM

TO: Angela Choy, Assistant Inspector General for Evaluations  
Office of Inspector General (OIG)

FROM: Paul J. Miller, Deputy Director *PJM*  
Division of Enterprise Regulation (DER)

SUBJECT: Draft Evaluation Report: *More than Eight Years After Issuing its Advisory Bulletin, FHFA Has Not Held the Enterprises to its Expectations on Charging off Delinquent Loans or Communicated New Expectations*

DATE: September 4, 2020

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Thank you for the opportunity to respond to the draft evaluation report referenced above (Report). As the Report accurately states, FHFA considers the classification of loans according to risk characteristics a critical factor in assessing the safety and soundness of the Enterprises, especially in the current environment due to the COVID-19 pandemic. With the potential increase in credit losses for the Enterprises, FHFA continues to monitor this situation closely. The draft Report makes two recommendations:

**Recommendation 1:** *OIG recommends that FHFA determine the appropriate threshold or criteria for charging off delinquent single-family loans at the Enterprises and communicate that threshold or criteria through revised or new Agency guidance.*

**Management Response:** FHFA agrees with this recommendation. By August 31, 2021, FHFA will perform an analysis to determine the appropriate threshold or criteria for charging off delinquent single-family loans at the Enterprises. Based on this analysis, DER will review Advisory Bulletin (AB) 2012-02, *Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention*, and make revisions to the guidance, as appropriate.

This report contains redactions of information that is privileged or confidential.

**Recommendation 2:** *OIG recommends that FHFA assess the Enterprises' implementation of the revised or new Agency guidance to ensure that the Enterprises' practices comport with FHFA's supervisory expectations.*

**Management Response:** FHFA agrees with this recommendation. Within a year of issuance of the revised AB, DER will initiate an examination activity at the Enterprises to assess their implementation of the revised guidance.

We would like to thank the OIG staff that worked with the Agency during this evaluation. If you have any questions related to our response, please do not hesitate to contact Eric Wilson.

cc: Chris Bosland  
Kate Fulton  
Scott Valentin  
Eric Wilson  
John Major

## ADDITIONAL INFORMATION AND COPIES.....

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