OFFICE OF INSPECTOR GENERAL
Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

To: Edward J. DeMarco, Acting Director

From: Steve A. Linick, Inspector General

Subject: Management Alert: Delay Implementing Advisory Bulletin No. 2012-02

Date: August 5, 2013

Attached is a staff memorandum that details OIG's concerns about the delay authorized by FHFA for Fannie Mae and Freddie Mac to comply with Advisory Bulletin No. 2012-02, which relates to the classification of certain assets, including single-family residential mortgage loans. The advisory bulletin was issued in April 2012, yet FHFA has since given the GSEs until January 1, 2015—almost three years after the issue was first identified—to fully implement it.

Because the advisory bulletin involves matters central to sound risk management and accounting practices at Fannie Mae and Freddie Mac, my staff recommends that FHFA: (1) require Fannie Mae and Freddie Mac to promptly report to FHFA and OIG the estimated impact on their financial statements as if the advisory bulletin took effect immediately, and thereafter provide such reports on a quarterly basis; and (2) provide OIG written justification for agreeing to the delay to the advisory bulletin's implementation.

I would appreciate if you or your designee could address these recommendations in writing by Monday, August 12, 2013.

OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

To: Steve A. Linick, Inspector General

From: David Z. Seide, Director of the Office of Special Projects
Robert C. Hinkley, Attorney Advisor, Office of Special Projects

Subject: Management Alert: Delay in Implementing Advisory Bulletin No. 2012-02

Date: August 2, 2013

Background

Classification of loans according to risk characteristics is a critical factor considered by financial regulators to evaluate a financial institution's safety and soundness. Given that a majority of their assets are concentrated in loans, Fannie Mae and Freddie Mac (the enterprises) consider accounting for loan loss reserves to be an accounting policy critical to the understanding of their financial statements.[1] FHFA recognized the importance of risk management in this area when it issued Advisory Bulletin No. 2012-02 on April 9, 2012.[2]

The advisory bulletin directed the enterprises and the Federal Home Loan Banks (FHLBanks) to classify any outstanding loan balance in excess of the fair value of the property, less cost to sell, as "Loss" when the loan is no more than 180 days delinquent. The issue was identified by FHFA examination staff during the course of a credit examination of Freddie Mac completed in January 2012.

The advisory bulletin's background section provided the following rationale:

> 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. <u>The classification of assets is a critical element in evaluating the risk profile and the adequacy of capital, loan loss reserves, and earnings</u>. (Emphasis added.)

[1] Fannie Mae 2012 SEC Form 10-K, at 69, available at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/10k_2012.pdf. Freddie Mac 2012 SEC Form 10-K, at 191, available at http://www.freddiemac.com/investors/er/pdf/10k_022813.pdf.

[2] FHFA, *Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention*, 2012-AB-02 (April 9, 2012). Accessed August 5, 2013, at http://www.fhfa.gov/webfiles/23875/AB2012-02_Framework_for_Classifying_Loans.pdf.

Moreover, the background section specifically notes that the advisory bulletin is intended to apply the same classification rules to Fannie Mae and Freddie Mac that other federal banking regulators apply to the financial institutions under their supervision.

> 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.[3]

As relevant here, the bulletin directed the enterprises to classify any single-family residence loan delinquent for 180 or more days as a "Loss."[4] In additional written guidance, FHFA provided to the enterprises the following as the basis for a 180-day delinquency benchmark:

> The Advisory Bulletin aligns FHFA's supervisory expectations with those outlined in the U.S. bank regulatory agencies' policies that are consistent with international standards outlined by the Basel Committee on Bank Supervision. <u>The 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</u>.[5] (Emphasis added.)

[3] The Uniform Retail Credit Classification and Account Management Policy was issued by the Federal Financial Institutions Examination Council, a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Consumer Financial Protection Bureau.

[4] The bulletin states that directive as follows: "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."

[5] 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).

FHFA made clear that a change in the risk management policies of the enterprises pertaining to single-family mortgage loans should be made. In addition, while FHFA did not conclude that current enterprise accounting policies did not conform with generally accepted accounting principles (GAAP), it stated that it regards the advisory bulletin's requirements to be consistent with GAAP and that it is fundamental under GAAP that there should be no delay in loss recognition of probable and estimable incurred losses.[6]

> ... FHFA expects the Advisory Bulletin to be implemented in a manner that is consistent with GAAP. The Advisory Bulletin 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.[7]

According to FHFA, the foregoing is also consistent with the GAAP principle codified by the Financial Standards Accounting Board in Statement of Accounting Standards No. 5 (FAS 5).[8]

To date, the advisory bulletin, which was issued 15 months ago, has not been fully implemented. While it originally stated that it was to be "effective upon issuance" (meaning on April 9, 2012), FHFA advised the enterprises that they had to submit plans for implementing the bulletin's guidance, which included the need to establish an asset classification and reporting system and the need to amend certain business practices to ensure compliance. In response, the enterprises submitted implementation plans, which FHFA determined were inadequate.

On December 5, 2012, eight months after the issuance of the advisory bulletin, FHFA sent letters to the CEOs of both enterprises informing them that the plans submitted "did not meet the criteria established" and directing them to develop and resubmit implementation plans within 30 days. FHFA further advised that it expected the enterprises "to fully implement the Advisory Bulletin for purposes of their financial reporting for the period beginning on January 1, 2014."[9]

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[6] Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 5* (March 1975). Accessed August 5, 2013, at http://www.fasb.org./pdf/fas5.pdf. Paragraph 8 provides that an estimated loss shall be accrued when: "a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. ... b. The amount of loss can be reasonably estimated."

[7] FHFA, "Questions and Answers Regarding FHFA Bulletin 2012-02."

[8] The Financial Accounting Standards Board issued a proposed update to FAS 5. See *Proposed Accounting Standards Update: Contingencies (Topic 450)* (July 20, 2010).

[9] FHFA, "Questions and Answers Regarding FHFA Bulletin 2012-02."

The enterprises have since obtained an additional one-year extension in the deadline—to fully implement the advisory bulletin by January 1, 2015. At a meeting with us held on May 2, 2013, the deputy director of the FHFA Division of Enterprise Regulation confirmed that the 2015 date is the current deadline for full implementation.[10] On May 13, 2012, FHFA issued Advisory Bulletin No. 2013-02 publicly memorializing the extension.[11]

Both Fannie Mae and Freddie Mac have recognized the potential significance of Advisory Bulletin No. 2012-02 in public disclosures made with the Securities and Exchange Commission (SEC). Fannie Mae, in its annual SEC filing for 2012 filed on April 2, 2013, states:

> The accounting methods outlined in FHFA's Advisory Bulletin are different from our current methods of accounting for single-family loans that are 180 days or more delinquent. As described in [the section of the filing dealing with] "Risk Factors," we believe that implementation of these changes in our accounting methods present significant operational challenges for us. We have agreed with FHFA that (1) effective January 1, 2014, we will implement the Advisory Bulletin's requirements related to classification, and (2) effective January 1, 2015, we will implement an updated accounting policy related to charging-off delinquent loans. We are currently assessing the impact of implementing these accounting changes on our future financial results.[12]

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[10] The deputy director also suggested that fully implementing the advisory bulletin at both enterprises could potentially require them to charge off billions of additional dollars related to loans classified as "Loss."

[11] FHFA, *Clarification of Implementation for Advisory Bulletin 2012-02, Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention,* 2013-AB-02 (May 13, 2013). Accessed August 5, 2013, at http://www.fhfa.gov/webfiles/25173/AB_2013-02_Clarification_of__Implementation_for_Asset_Classification_Framework_May_13_2013.pdf. The guidance reads as follows:

> Implementation of the asset classification framework may occur in two phases. The asset classification provisions in Advisory Bulletin 2012-02 should be implemented by January 1, 2014. The charge-off provisions have been extended and should be implemented no later than January 1, 2015.

[12] Fannie Mae, *2012 SEC Form 10-K*, p. 34 (April 2, 2013). Accessed August 5, 2013, at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/10k_2012.pdf.

Similarly, Freddie Mac's 2012 Annual SEC filing, filed on February 28, 2013, discloses:

> FHFA has informed us that we are required to implement the advisory bulletin by phasing in the adverse classification and charge-off requirements in 2014 and 2015, respectively. On January 31, 2013, we submitted a comprehensive implementation plan for the advisory bulletin to FHFA. We are currently assessing the operational and accounting impacts of this advisory bulletin and have not yet determined its impact on our consolidated financial statements.[13]

To date, neither Fannie Mae nor Freddie Mac has publicly disclosed the financial statement impact of implementing these accounting changes.

Our Concerns

We have concerns regarding the enterprises' timeframe for full and complete implementation of the Advisory Bulletin No. 2012-02. Specifically:

- FHFA examination staff identified no later than January 2012 a significant risk management issue relating to loan loss reserves, with potentially significant consequences for Fannie Mae and Freddie Mac, concerning the treatment of loans delinquent for more than 180 days.
- Appropriately classifying assets according to risk characteristics is a key safety and soundness practice that could have an impact on loan loss reserves. The loan loss reserve is a critical/significant accounting estimate for both Fannie Mae and Freddie Mac.
- FHFA recognized the issue's significance when it issued the advisory bulletin in April 2012, directing the enterprises to classify loans delinquent for more than 180 days as a "Loss." The bulletin notes that it is consistent with the system for loan classification followed by federal banking regulators.
- The bulletin states that it "embodies a basic principle in GAAP that losses should be recognized on loans that are deemed uncollectible and that <u>there should be no delay in loss recognition of probable incurred losses</u>."[14] (Emphasis added). Yet, it will not be fully implemented until January 2015, three years after the issue was first raised.
- Three years appears to be an inordinately long period to fully implement the advisory bulletin.

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[13] Freddie Mac, *2012 SEC Form 10-K,* p. 46 (February 28, 2013). Accessed August 5, 2013, at http://www.freddiemac.com/investors/er/pdf/10k_022813.pdf.

[14] FHFA, "Questions and Answers Regarding FHFA Bulletin 2012-02."

- Changing the risk management of loan loss reserves to comply with the advisory bulletin may have a material impact on the level of loan loss reserves maintained by the enterprises.
- Since the issuance of the advisory bulletin, both enterprises have issued quarterly and annual financial statements that have not followed the directive. We understand that this was done with the consent of FHFA, but we do not understand the reason for such consent being given.
- FHFA determined there was a need for an asset classification policy at the enterprises to better manage risk associated with single-family mortgage loans. Its advisory bulletin sought to implement a method widely accepted by other regulators and financial institutions in the industry. It did not find that this method would be preferable in 2015. It found it preferable immediately.
- The issuance of the advisory bulletin was a positive step. We have concerns about the delay in its implementation until 2015.

Our Recommendations

In light of the above, we recommend that FHFA: (1) require Fannie Mae and Freddie Mac to promptly report to FHFA and OIG the estimated impact on their financial statements as if the advisory bulletin took effect immediately, and thereafter provide such reports on a quarterly basis; and (2) provide OIG justification for agreeing to delay the advisory bulletin's implementation.

Federal Housing Finance Agency

MEMORANDUM

TO: Steve A. Linick, Inspector General

FROM: Jon D. Greenlee, Deputy Director, Division of Enterprise Regulation

SUBJECT: Management Alert: Delay Implementing Advisory Bulletin No. 2012-02

DATE: August 9, 2013

The purpose of this memorandum is to provide you with the Federal Housing Finance Agency's (FHFA) response to your recommendations outlined in the Inspector General's *Management Alert: Delay Implementing Advisory Bulletin No. 2012-02* (AB 2012-02), dated August 5, 2013, to Edward DeMarco, Acting Director.

FHFA appreciates the opportunity to review your Management Alert (Alert) and provide our response. As noted in the Alert, AB 2012-02 involves matters central to sound risk management at Fannie Mae and Freddie Mac (the Enterprises). FHFA-OIG expressed concerns regarding the Enterprises' timeframe for full implementation of AB 2012-02 and recommends that FHFA:

1. require Fannie Mae and Freddie Mac to promptly report to FHFA and OIG the estimated impact on their financial statements as if the advisory bulletin took effect immediately, and thereafter provide such reports on a quarterly basis; and

2. provide OIG written justification for agreeing to the delay to the advisory bulletin's implementation.

Management Response

FHFA believes that the current timeline for the Enterprises' implementation of AB 2012-02 is appropriate to accomplish the guidance's stated objective. Like all regulators of large, complex financial institutions, FHFA recognizes 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. FHFA has taken a similar approach on a number of important initiatives to ensure we meet our policy objectives without hindering the Enterprises' ability to maintain safe and sound operations. The current timeline was established based on our knowledge of the impact of AB 2012-02 on all affected Enterprise systems and operations acquired during our active supervision of the Enterprises' implementation activities through lengthy discussions, clarifications, feedback, and development of acceptable implementation plans.

As a result of extensive engagement of FHFA, the Enterprises ultimately developed realistic plans that preserve operational soundness and they have undertaken implementation actions to address relevant issues. As the Enterprises work through their implementation plans, we will continue to evaluate progress and potential challenges that may need to be addressed. FHFA has assembled a multi-disciplinary working group to address questions and issues that may arise from the implementation of AB 2012-02.

Recommendation # 1 - Require Fannie Mae and Freddie Mac to promptly report to FHFA and OIG the estimated impact on their financial statements as if the advisory bulletin took effect immediately and thereafter provide such reports on a quarterly basis.

We agree with the recommendation. FHFA will direct Fannie Mae and Freddie Mac to begin reporting this information through our confidential supervisory process, based on 3Q 2013 financial results. We also expect that Fannie Mae and Freddie Mac will disclose this information, to the extent possible, in their public financial statement filings once implementation issues are addressed and a reasonable estimate can be supported. To assist with the implementation of AB 2012-02, FHFA is developing a new Call Report schedule to monitor the Enterprises' compliance. Once implemented, the Enterprises will be required to regularly report the results of Loss classifications and charge-offs on the Call Report to FHFA.

Recommendation #2 - Provide OIG written justification for agreeing to the delay to the advisory bulletin's implementation.

FHFA recognized that a change to the risk management policies and operational practices of the Enterprises was necessary to fully implement AB 2012-02. To compel the Enterprises to immediately initiate actions to improve credit risk management practices, e.g., to accelerate mortgage loan servicing actions, FHFA made AB 2012-02 effective upon issuance.

After FHFA issued AB 2012-02 in April 2012, FHFA held a number of meetings with the Enterprises to discuss implementation of the bulletin. Given the number of significant issues that were raised, FHFA directed the Enterprises to submit an implementation plan to establish an asset classification and reporting system, and define which business practices needed to be amended to ensure compliance.

Each Enterprise submitted an implementation plan in late September/early October, followed by additional cost estimates in November. In the implementation plans, the Enterprises outlined their proposed timelines and raised a number of operational and accounting implementation issues. Freddie Mae indicated that it could only support an implementation date of January 1, 2014 or later. Similarly, Fannie Mae indicated that the classification alone could be implemented by January 1, 2014 and it could implement components of a new loan accounting systems by January 1, 2015. Further, a January 1, 2015 effective date would provide opportunities for considerable operational cost savings to the Enterprises and it would allow for implementation in a more controlled manner.

During this period, FHFA conducted its own assessment of the issues raised by the Enterprises and analyzed the Enterprises 180-day delinquent loans' performance and modification data using an FHFA dataset. FHFA found the Enterprises' assessment of the implementation complexity and financial impact to be reasonable. On December 5, 2012, FHFA issued the "*Questions and Answers Regarding FHFA Advisory Bulletin 2012-02: Application of Guidance for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special mention* (Q&A)" to provide clarification on issues of FHFA policy, implementation, and accounting in response to regulated entities' questions.

Meanwhile, FHFA directed the Enterprises to resubmit an implementation plan to ensure conformance by January 1, 2014 with the guidance and the supervisory objectives outlined in this letter. During this period, the Enterprises continued to meet with FHFA. Based on FHFA internal reviews and discussions with the Enterprises related to their significant implementation issues, such as the fact that the Enterprises have accepted processing delays from their servicers that have been compounded by the volume of delinquent mortgages, the number of delinquent loans to be serviced, and the aging of seriously delinquent loans and the manpower needed to resolve individual customer delinquency problems, FHFA determined that it was appropriate to allow the Enterprises to implement AB 2012-02 in two phases. In May of this year, FHFA amended AB 2012-02 by issuing Advisory Bulletin 2013-02 outlining the timeline for implementation: asset classification by January 1, 2014 and Loss charge-offs by January 1, 2015. The phased approach was based on careful review of relevant operational and policy factors by the FHFA's multi-disciplinary working group and was approved by senior management of the supervision program.

As we noted earlier in the memo, the Enterprises are working through their implementation plans. As they do so, we will continue to evaluate progress and potential challenges that may need to be addressed and may make further adjustments as we deem appropriate and necessary.