ADVISORY BULLETIN 2005-AB-05

May 18, 2005

Federal Housing Finance Board
Office of Supervision

To:	Federal Home Loan Bank Chairs, Presidents, Chief Financial Officers, Controllers, Risk Management Officers, Directors of Internal Audit, and Managing Director of the Office of Finance
From:	Stephen M. Cross Director Office of Supervision
Subject:	Risk Management Oversight

Background:

As a matter of sound practice, the board of directors and senior management of each Federal Home Loan Bank (Bank) should ensure that the Bank's risk management process is effective and that the risk management oversight responsibilities of the board of directors, senior management, and other Bank personnel are clearly defined. Moreover, the board of directors and senior management should ensure that the Bank's risk management is undertaken on an enterprise-wide basis and the Bank's organizational structure is consistent with sound risk management practices. To support the board of directors and senior management in carrying out their oversight responsibilities, each Bank should have in place a risk management function or unit with the capability of monitoring, measuring, and evaluating the Bank's risk exposures. In assessing a Bank's corporate governance and the quality of its risk management oversight, examiners will review a Bank's compliance with the Finance Board's regulations regarding risk assessment and risk management and the extent to which the Bank's risk management oversight activities comport with sound practice and with the guidance set forth below.

Guidance:

The board of directors ultimately is responsible for a Bank's risk management. To meet their fiduciary responsibilities, board members must understand the Bank's risk exposures. While Finance Board regulations require board members to review Bank's risk assessment annually, board members also should require regular reporting of the Bank's risk positions on an enterprise-wide basis.

Responsibilities of Senior Management.

Senior management is responsible for complying with risk measurement parameters established by the Bank's board of directors, understanding risk positions, and implementing a risk management structure. Thus, management must establish a risk management monitoring and reporting function on an enterprise-wide basis that is independent of business line or risk assumption processes. While the risk management function will monitor risk positions, business line officers and managers are responsible for ownership of the risk positions taken and explanation thereof and for the results, ramifications, and opportunities of these risk positions.

Responsibilities of Enterprise Risk Management Function.

Advisory Bulletin 2004-AB-05, *Interest Rate Risk Measurement,* highlights the importance of maintaining an independent and enterprise-wide risk management function. The process of identifying, measuring, monitoring, and reporting risk should be managed separately from business units and individuals conducting risk-taking activities. As a matter of sound practice, a Bank should have a risk management function or unit(s) with clearly defined responsibilities that reports directly to executive management and has regular reporting responsibility to the board of directors or a committee thereof.[1] The risk management function should not report to business units that undertake risk positioning. The risk management function should have the authority to ensure:

- The establishment of a framework for identifying, measuring, monitoring and reporting on financial (market and credit risks) and operational risks, *e.g*., legal and reputation risks.
- The development and maintenance of sound models for risk measurement.
- The review and approval of pricing models and valuation systems used by front and back-office personnel.
- The performance of model validation and effectiveness procedures.
- The development of risk limit policies and the monitoring of positions for adherence to these policies.
- The design of stress scenarios to measure the affects of unusual market conditions.
- The monitoring of the variance between the actual volatility of portfolio value (profit and loss) and that predicted.
- The reporting of risk exposures to senior management and the board of directors or a committee thereof on a regular basis.
- The coordination of risk management with all business units of the Bank as a means of ensuring that all risks, including legal and reputation risks, are factored into the decision-making process.
- The preparation of risk assessments.
- The risk management function should be examined by the internal audit function to ensure that risk management objectives are being achieved.

[1] The independent risk management function can be accomplished through either a centralized or decentralized structure. Regardless of the structure a Bank elects, senior management must ensure that adequate controls are in place to ensure the integrity of the aggregate risk information reported.

Responsibilities of Heads of Business Units.

The heads of business units play a key role in the development and management of the Bank's risk. While the risk management function is responsible for analyzing, monitoring, and reporting upon risks on an enterprise wide basis, the heads of business units are the first-line risk managers of the Bank. In that role, business unit heads have primary responsibility for managing and controlling risks of the business unit within the parameters set by the Bank's board of directors. In order to satisfactorily discharge those responsibilities, the business unit head should be performing periodic risk assessments.

Principal Finance Board Contacts:

Anthony Cornyn, Senior Advisor to the Director, Office of Supervision 202-408-2522, cornyna@fhfb.gov.

An Advisory Bulletin is an Office of Supervision (OS) staff document that provides guidance to the Banks and the Office of Finance regarding particular supervisory issues. Although an Advisory Bulletin does not have the force of a regulation or an order, it does reflect the OS position on the particular issue and will be followed by examination staff. If non-compliance with an Advisory Bulletin is cited as the basis for a supervisory determination, the determination is subject to review by the Board of Directors pursuant to the procedures of 12 C.F.R. § 907.9. Advisory Bulletins are effective upon issuance.