
Federal Housing Finance Board

Performance and Accountability Report



Fiscal Year 2005
November 15, 2005

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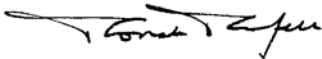
MESSAGE FROM THE CHAIRMAN

I am pleased to present the Federal Housing Finance Board's (Finance Board) Performance and Accountability Report (Report) for fiscal year 2005 (FY2005). This Report provides Finance Board financial and program performance information and summarizes the agency's success in meeting its FY2005 goals and objectives as set forth in the FY2005 Annual Performance Budget.

The Finance Board is dedicated to providing timely, reliable, and useful information to the Federal Home Loan Banks, government officials, and the public. FY2005 was a productive year at the Finance Board. In general, the agency met the goals established in the 2005 Annual Performance Budget. In addition, the Finance Board made substantial progress toward strengthening the agency and positioning itself to carry out its responsibilities more efficiently and effectively.

The FY2005 financial statements, including an unqualified opinion, are provided in this report. This clean opinion attests to the fact that the agency's financial statements are fairly presented and demonstrate discipline and accountability in the execution of its responsibilities. This report also includes a statement of reasonable assurance that the Finance Board's management accountability and controls are adequate and effective.

The staff at the Finance Board will continue to work to promote the safety and soundness of the Federal Home Loan Banks and build on the agency's accomplishments.



Ronald A. Rosenfeld
Chairman

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ABOUT THE FINANCE BOARD

The Finance Board is an independent agency established by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. It is the successor agency to the former Federal Home Loan Bank Board, which was established by the Federal Home Loan Bank Act of 1932 (FHLBank Act). The Finance Board's statutory mandate is to ensure that the Federal Home Loan Banks (FHLBanks) operate in a financially safe and sound manner, carry out their housing finance mission, and remain adequately capitalized and able to raise funds in the capital markets.

The FHLBanks are privately capitalized, government-sponsored enterprises that provide wholesale credit to members and certain nonmembers to be used for mortgage lending and related activities. In addition, the FHLBanks have a mandate to promote housing and community investment finance. The FHLBanks provide long-term, flexible financing to more than 8,100 member financial institutions around the country. In addition to its supervision of the FHLBanks, the Finance Board also has regulatory authority and supervisory oversight responsibility for the Office of Finance (OF), a joint office of the FHLBanks, which issues FHLBank System debt.

MISSION STATEMENT

To ensure that the FHLBanks are safe and sound so they can serve as a reliable source of liquidity and funding for the nation's housing finance and community investment needs.

VISION

To continue to earn the public's trust, the Finance Board is dedicated to the highest professional standards of accountability and independence to carry out its responsibilities for FHLBank supervision and housing finance mission oversight.

VALUES

The core values underlying the mission and vision of the Finance Board, which guide its organizational decisions and actions, are:

- Independence. The Finance Board is the arm's-length regulator of the FHLBanks and the OF.
- Accountability. The Finance Board is a steward of the public's trust and will use its resources efficiently and in the public interest.
- Responsiveness. The Finance Board aligns its actions with its mission and responds promptly, effectively, and creatively to emerging risks and opportunities in the financial system.

- Integrity. The Finance Board discharges its responsibilities fairly and impartially and adheres to the highest standards of ethical conduct.
- Excellence. The Finance Board strives for excellence in carrying out its responsibilities and recognizes the contributions of employees who demonstrate the highest professional standards in their work.

ORGANIZATION

The Finance Board is governed by a five-member board of directors. Four of the directors are appointed by the President and confirmed by the Senate and must have extensive experience or training in housing finance or a commitment to providing specialized housing credit. The fifth member is the Secretary of the U.S. Department of Housing and Urban Development. No more than three directors may be members of the same political party.

At least one appointed director must be from an organization with more than a two-year history of representing consumer or community interests in banking services, credit needs, housing, or financial consumer protections. The appointed members of the board of directors serve staggered seven-year terms. The President designates the chairperson of the board of directors from among these appointed members.

The Finance Board is organized into the following offices: the Office of the Board of Directors, the Office of Supervision, the Office of the General Counsel, the Office of Management, and the Office of the Inspector General.

The Office of the Board of Directors (Board) is responsible for setting the overall strategic direction of the Finance Board, and approves policies and regulations relating to the safety and soundness of the FHLBanks, their access to the capital markets, and the accomplishment of their congressionally defined housing finance mission. The board normally meets monthly in public sessions.

The Office of Supervision (OS) is responsible for the examination and supervision of the FHLBanks and the OF. The examinations focus on the FHLBanks' corporate governance, risk profile, risk management, and prudent operating practices relating to market, credit, and operational risk. The examinations also check for compliance with applicable laws, regulations, and policies. Our examination and supervisory responsibilities cover safety and soundness and affordable housing and community development.

The Office of General Counsel (OGC) provides legal support and guidance for the Finance Board. The Office of General Counsel provides legal support and guidance on interpretations of statutes and regulations to Finance Board officials. The office prepares all legal documents on behalf of the Finance Board and prepares opinions, regulations, and memoranda of law, and represents the Finance Board in judicial and administrative proceedings.

The Office of Management (OM) is responsible for the Finance Board's technology and information systems and administrative functions, such as finance and accounting, budgeting, human resources, personnel, payroll, contracting and procurement, facilities and property management, and records management.

The Office of the Inspector General (OIG) was established under FIRREA and operates in compliance with the Inspector General Act of 1978 and the 1988 amendments to that Act. The OIG conducts audits of the offices and functions of the Finance Board to ensure that the Finance Board functions as efficiently and effectively as possible. The OIG also provides leadership for activities designed to promote economy, efficiency, and effectiveness in the administration of the Finance Board and its relationship with the FHLBank System, and to prevent and detect waste, fraud, and abuse in programs and activities conducted by the Finance Board.

The Finance Board's headquarters office is located in Washington, D.C., where a majority of the agency's staff is located. The Finance Board also has examination staff stationed in each of the 12 FHLBank districts.

The Finance Board's budget for FY2005 was \$36.4 million with 146.8 full-time equivalent staff at fiscal year-end. Approximately 83 percent of the budget is devoted to the examination and supervision of the FHLBanks.

THE YEAR IN REVIEW

The agency's accomplishments for FY2005 were concentrated in five areas: (1) regulatory and supervisory policy initiatives; (2) safety and soundness examination and supervision; (3) risk monitoring and risk modeling; (4) community investment and Affordable Housing Program (AHP); and (5) organizational enhancements.

Regulatory and Supervisory Policy Initiatives. By regulation adopted in June 2004, the Finance Board required the FHLBanks to register a class of equity securities with the Securities and Exchange Commission (SEC) by August 31, 2005. Two FHLBanks, the FHLBank of New York and the FHLBank of San Francisco, met the deadline of August 31, 2005 for effective registration. Registration has been delayed by accounting and disclosure issues at the other ten FHLBanks. Those FHLBanks continue to work with the SEC and submit weekly progress reports to the Finance Board. Until they have registered, those FHLBank are subject to dividend restrictions as established by the Finance Board's Advisory Bulletin 05-07. Other initiatives in this area include supervisory guidance on risk modeling, risk management, disclosure, and capital management.

The Finance Board continued to develop a Data Quality and Timeliness Regulation, which will consolidate data reporting requirements from individual regulations into a Data Reporting Manual (Data Manual). The first two chapters of the Data Manual,

addressing call report data and membership data, were finalized in FY2005. Additional chapters, including AHP data, will be completed in 2006.

Safety and Soundness Examination and Supervision. The Finance Board examination program continues to fulfill its statutory mandate by, among other things, monitoring risk and exposure levels at the FHLBanks. The Finance Board conducts examinations and quarterly on-site visitations at each FHLBank and the OF. At the conclusion of each examination, a Report of Examination is prepared that summarizes examiners' findings and assigns a conclusion of the level of supervisory concern. A meeting is held with each FHLBank's board of directors to present the Report of Examination and discuss continuing matters of concern.

Examinations are risk-focused and effective tools in prompting action by the FHLBanks to enhance their risk management. The Finance Board has written agreements with two FHLBanks. These agreements constitute a formal supervisory and enforcement action on the part of the Finance Board and have resulted in substantial therapeutic benefits to these individual FHLBanks, as well as across the FHLBank System.

Risk Monitoring and Risk Modeling. In 2005, the agency continued to assess the integration of an enterprise data repository to standardize and link the Finance Board's data collection and management processes. This repository will facilitate the retrieval, manipulation, and analysis of data across platforms and systems, and significantly enhance the agency's off-site monitoring capabilities.

During FY2005, the Risk Modeling Division provided technical and analytical examination support using a variety of models and model review procedures to validate FHLBanks' risk modeling capabilities. The risk modelers independently verify the market values and market value sensitivities of the FHLBanks' financial positions. The risk modelers participate at the on-site examinations and, as warranted, quarterly visitations.

Community Investment and AHP. In FY2005, the Finance Board completed its horizontal review of the AHPs of the FHLBanks. The Finance Board issued a report of this System-wide review in March 2005. This review concluded that the FHLBanks have met their statutory obligations under the AHP and are a significant source of affordable housing financing in their districts. The report also concluded that there was room for improvement at each FHLBank. For example, the review identified shortcomings in management information systems to monitor projects awarded AHP funds and in the administration of the AHP set-aside program at certain FHLBanks.

Organizational Enhancements. In FY2005, a number of human resource initiatives were taken to support the Finance Board's focus on safety and soundness of the FHLBanks. Three teams of examiners were established, each concentrating on a portfolio of four FHLBanks. A portfolio manager leads each portfolio, and an examiner-in-charge (EIC) is designated for each FHLBank. The portfolio manager has the responsibility for managing the resources and conducting planning operations for his portfolio. The EICs

are the central point of contact for all communications with the FHLBanks and have the responsibility of managing the ongoing supervision of their FHLBank. The EIC is responsible for being aware of and keeping OS management informed about all activities at the FHLBank that have a bearing on supervisory and examination matters.

During the past year we have added an examination specialist position to each portfolio. The examination specialist is a resource for the portfolio manager and EICs. These positions have been filled on an “acting” basis during FY2005, but they will be filled on a permanent basis in early FY2006. These examination specialists add another review and assessment of the reports of examination prior to their completion and issuance. In that way, the examination specialists will provide a level of quality assurance. They are also tasked with checking that the examination work papers are complete at the end of every annual examination, assisting in the planning process, helping to develop supervisory strategies, and coordinating the supervision of the portfolio of FHLBanks.

In an effort to improve its business processes and internal controls, the Finance Board’s accounting, procurement, and travel activities were outsourced to the Bureau of Public Debt’s Administrative Resource Center in 2005. Standardized reports are being developed to better monitor the agency’s actual expenses to budget. In addition, information technology enhancements were emphasized. Information security was enhanced with a focus on password controls, and information technology support was provided on-site during the examinations to improve efficiency. The Finance Board also revamped its external website to improve communications among the Finance Board, the FHLBanks, and other external sources.

Finally, the agency’s headquarters, which was previously housed in two locations, was consolidated and relocated to one new leased office space that is fully compliant with the Americans with Disabilities Act and other life safety standards.

CHALLENGES

KEY EXTERNAL FACTORS

Performance of the FHLBanks can be affected by conditions beyond their control. For example, macroeconomic developments affecting interest rates, national or regional economic activity can affect the economic performance of the FHLBanks. Other external factors with the potential to affect the FHLBanks include developments in capital and housing markets. Regulatory developments, including developments in accounting standards set by the Financial Accounting Standards Board and disclosure requirements set by the SEC, along with new legislation, have the potential to significantly affect the environment in which the FHLBanks must operate. Regardless of the source of the influences on FHLBank performance, the Finance Board must respond promptly to ensure the FHLBanks meet whatever challenges affect their performance.

Legislation: For much of the past year, the Congress has been debating new legislation that would establish a single agency as the regulator for all government-sponsored enterprises (GSEs) involved in the home mortgage market. This new agency would oversee the safety, soundness, and housing mission achievement of Fannie Mae, Freddie Mac, and the FHLBanks.

Developments in Banking and Financial Markets: The banking sector has been and will likely continue to experience significant consolidation. In addition, financial markets continue to evolve, with new products and services introduced on a regular basis. These developments have the potential to affect, both positively and negatively, the demand for FHLBank products and services, and the financial performance of the FHLBanks. As the industry changes, the supervisory focus of the Finance Board must also change to ensure that it continues to effectively supervise the FHLBanks. Recent matters attracting discussion include lender and assignee liability from predatory loans, standards of accountability for the officers and directors under the Sarbanes-Oxley Act of 2002, advance prepayment fees, the potential for housing price decreases in selected markets, increased foreclosure activity in areas affected by natural disasters, consolidation of the financial services industry, and increasing demands on institutions to improve management and control risks.

Staffing: In a competitive financial services environment where highly skilled personnel are in great demand, a continuing challenge for the Finance Board is retention of a highly competent work force and, as needs dictate, recruitment of additional examination, supervision and accounting staff with the requisite financial and technological skills to model, monitor, and assess the risks undertaken by the FHLBanks.

PROGRAM PERFORMANCE OVERVIEW

The Finance Board evaluates its program performance within a structured planning, budgeting and performance management process. In its FY 2003-2008 Strategic Plan, the agency established three strategic goals that guide its operation. The strategic plan is available on the agency's website (www.fhfb.gov). For each strategic goal, the agency established strategic objectives that describe how the strategic goal will be accomplished. While some of the objectives are easily measured, e.g., whether or not the FHLBanks meet or exceed their required capital ratios, others are more subjective. Accordingly, the Finance Board has adopted for each objective a number of annual performance goals and accompanying annual performance measures to determine the degree to which the strategic objectives, and ultimately the strategic goals are achieved. The nested structure of strategic goals, objectives, and annual performance goals and measures is listed in the table below.

Strategic Goal	Strategic Objectives	Annual Performance Goal	Annual Performance Measure
<p>1. Supervision program effectively fosters safe and sound operations at each FHLBank.</p>	<p>1.1 The FHLBanks operate safely and soundly.</p>	<p>1.1 Maintain an effective risk-based examination program.</p>	<p>1.1a Conduct all safety and soundness activities, including annual examinations, quarterly reviews, and off-site monitoring on a timely basis.</p>
			<p>1.1b Assess effectiveness of corrective actions at annual on-site safety and soundness examinations, quarterly reviews or more frequently, as appropriate.</p>
	<p>1.2 The FHLBanks meet or exceed their minimum capital requirements.</p>	<p>1.2 Each FHLBank satisfies its applicable capital requirements and prudently manages capital and earnings.</p>	<p>1.2a Each FHLBank continuously meets or exceeds its minimum capital requirement.</p>
			<p>1.2b Each FHLBank implements or makes progress in implementing its capital structure plan.</p>
	<p>1.3 The FHLBanks raise funds efficiently and are role models for transparency and accountability.</p>	<p>1.3a The FHLBanks maintain a triple A credit rating for their consolidated obligations.</p>	<p>1.3a Conduct semi-annual assessment of FHLBank System cost of funds and maintain ratings for consolidated obligations and FHLBank credit ratings at regulatory requirements.</p>
		<p>1.3b Each FHLBank's and the FHLBank System's financial disclosures comply with applicable laws, rules, and regulations.</p>	<p>1.3b Conduct on-site examination of the OF and review annual and quarterly financial reports issued by the FHLBank System and each FHLBank.</p>
<p>2. Ensure that the FHLBanks serve the nation's housing finance and community investment needs.</p>	<p>2.1 The FHLBanks facilitate the housing finance activities of their members.</p>	<p>2.1 The FHLBanks adhere to public policy principles and safety and soundness requirements when supporting affordable housing and promoting community development.</p>	<p>2.1a Advances of each FHLBank are in compliance with the FHLBank Act and Finance Board regulations.</p>
			<p>2.1b Acquired member assets program is responsive to the needs of members, and supports the nation's housing finance system.</p>
	<p>2.2 The FHLBanks support affordable housing and promote community investment.</p>	<p>2.2 Perform effective operational risk-based examination of the Affordable Housing Programs at each FHLBank.</p>	<p>2.2a Conduct examinations of the Affordable Housing and Community Investment Programs at each FHLBank.</p>
			<p>2.2b Assess effectiveness of corrective actions at annual on-site examinations or at periodic reviews.</p>
			<p>2.2c Review FHLBank Community Lending Plans, annually, and FHLBank member Community Support Statements, biennially.</p>

Strategic Goal	Strategic Objectives	Annual Performance Goal	Annual Performance Measure
			2.2d Appoint public interest directors, including community interest directors to board of directors of each FHLBank.
3. Use supervisory, managerial, and legal resources to support effective, efficient, and responsive FHLBank supervision, regulation, and housing oversight.	3.1 The Finance Board takes appropriate and timely regulatory and advisory actions.	3.1 Regulations and advisory actions are reviewed, revised, and supplemented to ensure relevance, transparency, and issue-oriented supervisory guidance.	3.1a Review, revise and supplement Finance Board regulations, where appropriate.
			3.1b Respond to new business activity notices filed by the FHLBanks within 60 days.
	3.2 The Finance Board prudently allocates resources to fulfill its mission effectively and efficiently.	3.2 Fiscal, physical, and human resources are used efficiently and effectively to fulfill the Finance Board's fiduciary responsibilities.	3.2a Align budgeted resources including staff and information technology with projected workloads and business priorities.
			3.2b Business continuity and contingency plans are maintained and tested.

THE FHLBANKS OPERATE SAFELY AND SOUNDLY

STRATEGIC GOAL 1: *Supervision program effectively fosters safe and sound operations at each FHLBank.*

In FY2005, the Finance Board met all six of its annual performance measures, along with the four performance goals, thereby ensuring that the strategic objectives were met. In this way, the Finance Board was successful in achieving strategic goal 1 of ensuring that the supervision program effectively fosters the safe and sound operations at each FHLBank. The examination program was enhanced to promote sound risk management at the FHLBanks, principally through the issuance of advisory bulletins on risk management and on examination conclusions, which identify an institution as satisfactory, fair, marginal, or unsatisfactory.

While only two of the 12 FHLBanks registered with the SEC by the regulatory deadline, the other ten FHLBanks are working diligently to become registrants. The delay in registering with the SEC has arisen primarily because of a SEC decision with respect to certain accounting rules that are at odds with the FHLBanks' previous interpretations. The Finance Board's regulation requiring the FHLBanks to register with the SEC is part of its efforts to ensure that the FHLBanks raise funds efficiently and are role models for transparency and accountability. The Finance Board's efforts on this front and the FHLBanks' efforts to become registrants further the objectives of enhanced disclosure and accountability, consistent with strategic objective 1.3.

THE FHLBANKS FULFILL THEIR HOUSING FINANCE MISSION

STRATEGIC GOAL 2: *Ensure that the FHLBanks serve the nation's housing finance and community investment needs.*

During FY2005, the Finance Board met three out of the four performance measures in support of this strategic goal, specifically related to supervision of FHLBanks' advances, acquired member assets, affordable housing and community investment programs, and review of FHLBanks' community lending plans. However, the Finance Board, with due consideration of the potential conflict of interest inherent in appointing representatives to the boards of directors of institutions it regulates, did not appoint public interest directors to the boards of directors at the FHLBanks to fill expired terms in 2005. The Finance Board instead will consider soliciting recommendations from the FHLBanks of qualified persons with skills and capabilities that could address any gaps that might exist in their boards of directors. If warranted, the Finance Board may make such appointments as are necessary in the future pending adoption of statutory changes to the composition of the FHLBanks' boards of directors, such as have been recommended by the Finance Board.

The FHLBanks subsidize the cost of affordable owner-occupied and rental housing. The subsidy may be in the form of a grant or a below-cost or subsidized interest rate on an FHLBank advance to a member. An in-depth review of the AHPs at the FHLBanks found that these programs have been carried out in compliance with statutory and regulatory requirements. The review also identified areas in which program implementation could be improved.

During 2005, the Finance Board made considerable progress in reviewing and revising the regulation governing the AHPs at the FHLBanks. Many of the lessons learned during the in-depth review of the AHPs, as administered at the FHLBanks and as regulated by the Finance Board, informed our review and revision of the AHP regulation.

MANAGEMENT OF FINANCE BOARD RESOURCES

STRATEGIC GOAL 3: *Use supervisory, managerial, and legal resources to support effective, efficient, and responsive FHLBank supervision, regulation, and housing oversight.*

The Finance Board met all four annual performance measures associated with this goal. In FY2005, the Finance Board disseminated advisory bulletins that discussed SEC registration of debt, the Affordable Housing Set-Aside Program, regulatory reporting under certain accounting standards, standards for management and board risk management oversight, and internal market risk models.

In 2005, the Finance Board hired 35 additional full-time staff, principally bank examiners. In addition, the Finance Board continued to use external contractors to perform administrative functions, such as information technology support. During 2005, the

Finance Board contracted with the Department of the Treasury's Bureau of Public Debt to provide financial management and travel related service support.

The agency continued to enhance its data management and information systems to improve data integrity and consistency across the FHLBank System. The AHP database is being updated to ensure that it is a repository for the information needed to perform examination, supervision and oversight functions. This database will be used for reporting purposes by the end of the 2006 calendar year.

Finally, the agency's headquarters relocated to new, leased office space. This space is fully compliant with the Americans with Disabilities Act and other life safety standards that had presented additional challenges in the previous office space.

FINANCIAL PERFORMANCE OVERVIEW

As of September 30, 2005, the financial condition of the Finance Board was sound. There are sufficient funds to meet program needs and adequate controls in place to ensure that obligations do not exceed budget authority.

FINANCIAL HIGHLIGHTS

The Finance Board draws its financial resources from assessments of the twelve FHLBanks. It receives no appropriations, and its funds are not subject to apportionment. The FY2005 budget authority was \$36.5 million. In FY2005, approximately 60 percent of the agency's budget was allocated to salaries and benefits. The remaining 40 percent was used for technical assistance for the agency's information technology and risk management systems, and for staff travel and operating expenses.

The FY2005 budget represented an increase in budget authority of over \$5.3 million or 17 percent over FY2004. This primarily reflects the expansion of agency examination resources to more fully support the Finance Board's supervisory program, including new positions and consulting services related to enhancements of the agency's risk modeling capabilities.

MANAGEMENT ACCOUNTABILITY AND CONTROL

In accordance with applicable requirements of 31 U.S.C. § 3512, and Office of Management and Budget Circular A-123 (rev. June 21, 1995), the Finance Board provides this statement of reasonable assurance that the agency's management accountability and controls are adequate and effective, and there are no material weaknesses to report. The objectives of the system of management accountability and control of the Finance Board are to provide reasonable assurance that:

- Programs achieve their intended results;

- Resources are used consistent with agency mission;
- Programs and resources are protected from waste, fraud and mismanagement;
- Laws and regulations are followed; and
- Reliable and timely information is obtained, maintained, reported and used for decision making.

The concept of reasonable assurance recognizes that the cost of management control should not exceed the benefits expected to be gained, and that the benefits consist of reductions in the risks of failing to achieve the stated objectives. Estimates and judgments are required to assess the expected benefits and related costs of control procedures. Furthermore, errors or irregularities may occur and not be detected because of inherent limitations in any system of management accountability and control, including those limitations resulting from resource constraints and other factors. The statement of assurance and determination are based on the following:

- An independent outside audit of the Finance Board's financial statements, which provided an unqualified opinion and found no weaknesses involving the Finance Board's internal control structure determined to be material.
- An internal evaluation that included input from senior program and management officials and the OIG, covering the period from October 1, 2004, through September 30, 2005, which found no weaknesses determined to be material and concluded that the Finance Board's management accountability and controls are achieving their intended objectives.
- Comments of the OIG regarding the internal evaluation process and the Finance Board's management accountability and controls.

The Finance Board is committed to a strong internal control program. The agency employs sound financial management techniques; has developed oversight procedures; and emphasizes the importance of a strong risk management and internal control program to meet its statutory, regulatory and fiduciary responsibilities.

In last year's report, the OIG identified the most significant management and performance challenge as reducing the security vulnerabilities of the in-house PeopleSoft Financial System. To address the challenge, in July 2005, the Finance Board contracted with the Department of the Treasury's Bureau of Public Debt, one of the four Centers of Excellence identified by the Office of Management and Budget (OMB), to provide financial management and accounting services for the Finance Board. Through this partnership, the Finance Board maintains responsibility and oversight of its financial activities and reaps the benefits of government-wide best practices.

MEASURING AND REPORTING PERFORMANCE

This section presents information on the program-specific performance of the Finance Board during FY2005. This discussion of performance includes an overview of the agency's key initiatives and some of our major accomplishments. Program-specific performance results for Finance Board goals and measures, along with the results of all program evaluations or studies completed during FY2005, are also presented.

PERFORMANCE MEASUREMENT SYSTEM

The Finance Board's performance measurement system centers around three strategic goals for the agency, as outlined in its FY2003-2008 Strategic Plan. The strategic goals represent the agency's mission and reflect the overall outcomes to be achieved. The Finance Board has adopted a number of annual performance goals and accompanying annual performance measures that can be used to determine the degree to which the strategic objectives, and ultimately the strategic goals are achieved. The performance measures, performance goals, and strategic objectives constitute the agency's performance management system.

The agency will conduct the triennial update of its Strategic Plan and review its performance measures in FY2006. The Finance Board is continually endeavoring to determine effective ways to measure and report, and ultimately improve, its performance. The update of the Strategic Plan during FY2006 will present another opportunity to ensure that the Finance Board develops and implements effective practices in performance measurement, reporting, and management.

ALIGNING RESOURCES TO GOALS

Collectively, the outcome-based performance goals are the key indicators for successful progress in achieving the agency's strategic goals. The performance goals and their associated measures reflect the agency's move toward more outcome-based performance. Agency programs and activities are planned, managed, monitored, and assessed according to contributions to the achievement of these performance goals, with safety and soundness of the FHLBank System as the primary consideration. On-going program evaluations will form the basis to identify whether existing programs are successfully achieving the goals or whether revised or new initiatives are needed.

ANNUAL GOALS AND MEASURES

STRATEGIC GOAL 1: Supervision program effectively fosters safe and sound operations at each FHLBank.

STRATEGIC GOAL 1 RESULTS: The Finance Board has identified three strategic objectives to assist in determining whether the agency has met its safety and soundness strategic goal. These measures define the effectiveness of the Finance Board’s oversight of the FHLBanks. The goal of the Finance Board’s regulatory efforts is to encourage the events described in the objectives below.

Strategic Objectives	2002	2003	2004	2005
1.1 The FHLBanks operate safely and soundly.	Achieved	Achieved	Achieved	Achieved
1.2 The FHLBanks meet or exceed their minimum capital requirements.	Achieved	Achieved	Achieved	Achieved
1.3 The FHLBanks raise funds efficiently, and are role models for transparency and accountability.	Achieved	Achieved	Achieved	Achieved

ANNUAL PERFORMANCE GOALS

To support its strategic objectives in meeting strategic goal 1, the Finance Board has four annual performance goals, each with accompanying performance measures to indicate the achievement of those goals.

Annual Performance Goal 1.1: Maintain an effective risk-based examination program.

Annual Performance Goal 1.2: Each FHLBank satisfies its applicable capital requirements and prudently manages capital and earnings.

Annual Performance Goal 1.3a: The FHLBanks maintain a triple A credit rating for their consolidated obligations.

Annual Performance Goal 1.3b: Each FHLBank’s and the FHLBank System’s financial disclosures comply with applicable laws, rules, and regulations.

ANNUAL PERFORMANCE GOAL RESULTS

Annual Performance Goal 1.1: Maintain an effective risk-based examination program.

Annual Performance Measures	2002	2003	2004	2005
1.1a Conduct all safety and soundness activities, including annual examinations, quarterly reviews and off-site monitoring on a timely basis.	Achieved	Achieved	Achieved	Achieved

Annual Performance Measures	2002	2003	2004	2005
1.1b Assess effectiveness of corrective actions at annual on-site safety and soundness examinations, quarterly reviews or more frequently, as appropriate.	Achieved	Achieved	Achieved	Achieved

Annual Performance Measure 1.1a: Safety and Soundness Activities. The Finance Board conducted on-site safety and soundness examinations at all twelve FHLBanks. At the end of each examination, a “conclusion” was reached for each FHLBank that is based upon the level of credit, market, and operational risk undertaken, the adequacy of its risk management practices, its financial condition and operating performance, the adequacy of its capitalization, the quality of its corporate governance and administration of its affordable housing or community investment program.

In June 2004 and December 2004, the Finance Board entered written agreements with the boards of directors of the FHLBank of Chicago and Seattle, respectively. These agreements address certain shortcomings with the FHLBanks’ risk management, corporate governance and financial condition that were identified by the Finance Board through its supervisory program. Both FHLBanks have made progress toward addressing the Finance Board’s supervisory concerns, but remain subject to the provisions of these written agreements.

Annual Performance Measure 1.1b: Corrective Actions. During the course of an examination, the Finance Board may identify a significant supervisory or compliance issue that poses a risk to the FHLBank. When this happens, the Finance Board requires the FHLBank to develop a plan to correct the violation or weakness. The Finance Board conducts on-site visits at least quarterly at each FHLBank to monitor progress in addressing any supervisory findings. Follow-up activities occur more frequently, as needed, such as for FHLBanks subject to a written agreement.

Annual Performance Goal 1.2: Each FHLBank satisfies its applicable capital requirements and prudently manages capital and earnings.

Annual Performance Measures	2002	2003	2004	2005
1.2a Each FHLBank continuously meets or exceeds its minimum capital requirements.	Achieved	Achieved	Achieved	Achieved
1.2b Each FHLBank implements or makes progress in implementing its capital structure plan.	Achieved	Achieved	Achieved	Achieved

Annual Performance Measure 1.2a: Capital Requirements. In FY2005, all the FHLBanks exceeded their minimum capital requirements.

Annual Performance Measure 1.2b: Capital Structure Plan. In 2002, the Finance Board required each FHLBank to submit a plan that established a new capital structure for the Bank. Among other things, the structure must satisfy certain minimum capital standards and establish the amount of FHLBank stock that must be held by its members to ensure that the FHLBank remains in compliance with such standards. The Finance Board has approved all the capital structure plans, and to date, ten of the twelve FHLBanks have implemented their new capital structure. The FHLBanks of Chicago and New York have not yet implemented their new capital plans. The FHLBank of New York is expected to implement its new capital structure by the end of calendar year 2005.

Annual Performance Goal 1.3a: The FHLBanks maintain a triple A credit rating for their consolidated obligations.

Annual Performance Measure	2002	2003	2004	2005
1.3a Conduct semi-annual assessment of FHLBank System cost of funds and maintain ratings for consolidated obligations and credit ratings at regulatory requirements.	Achieved	Achieved	Achieved	Achieved

Annual Performance Measure 1.3a: FHLBank System Cost of Funds Ratings. The FHLBanks raise funds in the capital markets through the issuance of consolidated obligations, for which they are jointly and severally liable. The ability of the FHLBanks to issue consolidated obligations at rates slightly above the rates on the obligations of the U.S. Treasury is important to their ability to efficiently fund their operations. To measure the efficiency of the FHLBanks in raising funds, the agency conducted two reviews of the FHLBanks’ funding costs relative to those of the U.S. Treasury and other GSEs engaged in housing-related activities.

Collectively, the FHLBanks are required to obtain from a nationally recognized statistical rating organization (NRSRO), and at all times maintain, a current credit rating on their consolidated obligations. S&P and Moody’s have rated long-term FHLBank consolidated obligations “AAA” and “Aaa,” respectively, and short-term consolidated obligations “P-1” and “A-1+,” respectively, their highest ratings. Each of the FHLBanks has received an individual issuer credit rating of at least “AA” or “Aa,” respectively, the second highest such rating awarded by S&P and Moody’s. The credit ratings of the FHLBanks and the consolidated obligations were reviewed during the examination process for each of the 12 FHLBanks.

Annual Performance Goal 1.3b: Each FHLBank’s and the FHLBank System’s financial disclosures comply with applicable laws, rules, and regulations.

Annual Performance Measure	2002	2003	2004	2005
1.3b Conduct on-site examination of the OF, and review annual and quarterly financial reports issued by the FHLBank System and each FHLBank.	Achieved	Achieved	Achieved	Achieved

Annual Performance Measure 1.3b: Examination of the Office of Finance. The Finance Board conducts an annual on-site examination of the OF. While on site, examiners: (i) follow up on issues identified through pre-examination analysis and planning; (ii) test systems, controls, and reports for adequacy and accuracy, including the internal audit function; (iii) assess the risk profile and operational soundness; (iv) identify issues that may affect the risk or operating profile; (v) evaluate the quality of corporate governance; and (vi) test for compliance with laws, regulations, and policies, including sales suitability practices by participating underwriters and broker-dealers. The FY2005 examination of the OF was conducted in December 2004.

In 2005, each FHLBank was required to file a registration statement covering a class of equity securities with the SEC and ensure its effectiveness under section 12(g) of the Securities Exchange Act of 1934 (1934 Act). Only two FHLBanks met the deadline for registering their securities with the SEC. The remaining FHLBanks must resolve certain accounting issues before they can complete the filing process with the SEC and subsequently issue audited financial statements. These FHLBanks are required to make weekly reports to the Finance Board concerning their progress in completing the SEC registration process. In addition, the Finance Board continues to monitor the FHLBanks’ filings and communications with the SEC.

The OF prepares and issues a combined FHLBank System-wide annual report and three quarterly financial reports (FHLBank System Combined Reports) using financial information submitted by the FHLBanks. The scope, form, and content of the FHLBank System financial reports must be consistent with requirements of Regulations S-K and S-X of the SEC. Prior to completing the registration process with the SEC, the financial statements of each FHLBank must be accepted by the SEC. Six of the 12 FHLBanks are in the process of restating their financial statements. Once each of the FHLBanks’ audited financial statements are filed with the SEC, the annual FHLBank System Combined Report for 2005 will be prepared by the OF.

STRATEGIC GOAL 2: Ensure that the FHLBanks serve the nation’s housing finance and community investment needs.

STRATEGIC GOAL 2 RESULTS: The Finance Board has identified two strategic objectives that support strategic goal 2, and define the Finance Board’s responsibilities in overseeing the housing finance mission of the FHLBanks. The goal of the Finance Board’s regulatory efforts is to encourage the events described in the objectives below:

Strategic Objectives	2002	2003	2004	2005
2.1 The FHLBanks facilitate the housing finance activities of their members.	Achieved	Achieved	Achieved	Achieved
2.2 The FHLBanks support affordable housing and promote community investment.	Achieved	Achieved	Achieved	Achieved

ANNUAL PERFORMANCE GOALS

In addition to the strategic objectives, the Finance Board has two annual performance goals for serving the nation’s housing finance and community investment needs:

Annual Performance Goal 2.1: The FHLBanks adhere to public purpose principles and safety and soundness requirements when supporting affordable housing and promoting community development.

Annual Performance Goal 2.2: Perform effective operational risk-based examinations of the AHPs at each FHLBank.

ANNUAL PERFORMANCE GOAL RESULTS

Annual Performance Goal 2.1: The FHLBanks adhere to public purpose principles and safety and soundness requirements when supporting affordable housing and promoting community development.

Annual Performance Measures	2002	2003	2004	2005
2.1a Advances of each FHLBank are in compliance with the FHLBank Act and Finance Board regulations.	Achieved	Achieved	Achieved	Achieved
2.1b Acquired member assets program is responsive to the needs of members, and supports the nation’s housing finance system.	Achieved	Achieved	Achieved	Achieved

Annual Performance Measure 2.1a: Review advances. The FHLBanks make secured advances to their members to provide funds for residential housing finance and to provide funds to community financial institutions for small businesses, small farms, and small agricultural businesses. As part of the annual on-site examination, Finance Board

examiners evaluate the FHLBanks' advance and collateral policies and practices to ensure compliance with the FHLBank Act and Finance Board regulations. Between annual on-site examinations, the agency monitors the size and composition of each FHLBank's advance portfolio on a quarterly basis from data submitted by the FHLBanks. Also, the FHLBanks must submit a new business activity notice to the Finance Board before initiating any new advance activity or accepting collateral that entails new risks.

The Finance Board examined the advance portfolios of each FHLBank as part of its 2005 annual on-site examination, and monitored the size and composition of the portfolios on a quarterly basis. The annual survey of the types of collateral securing FHLBank advances was completed in the third quarter of 2005. All new business activity notices submitted by the FHLBanks were also reviewed.

Annual Performance Measure 2.1b: Review acquired member asset program. Acquired Member Assets (AMA) is the comprehensive term for programs through which the FHLBanks acquire whole, single-family, residential mortgage loans or loan pools either by purchasing closed loans or funding loans at time of closing. As part of the annual on-site examination conducted at each FHLBank, the Finance Board evaluates compliance of each FHLBank's AMA program and activities with the requirements of its regulations.

In 2005, examiners evaluated AMA programs and program loans as part of the annual on-site examination of each FHLBank. The examinations focused on: (1) risk exposures to the FHLBanks; (2) purchase or funding of predatory loans, manufactured housing, and/or cooperative housing loans; (3) credit enhancement calculation; and (4) data collection coding errors.

Performance Goal 2.2: Perform effective operational risk-based examinations of the Affordable Housing Programs at each FHLBank.

Annual Performance Measures	2002	2003	2004	2005
2.2a Conduct examinations of the Affordable Housing and Community Investment Programs at each FHLBank.	Achieved	Achieved	Achieved	Achieved
2.2b Assess effectiveness of corrective actions at annual on-site examinations or at periodic reviews.	Achieved	Achieved	Achieved	Achieved
2.2c Review FHLBank Community Lending Plans annually, and FHLBank member Community Support Statement biennially.	Achieved	Achieved	Achieved	Achieved
2.2d Appoint public interest directors, including community interest directors to board of directors of each FHLBank.	Achieved	Achieved	Achieved	Not Achieved

Annual Performance Measure 2.2a: AHP Examinations. The Finance Board supports the affordable housing and community investment objectives of the FHLBank Act by maintaining an effective program of annual on-site examinations for the AHP, Community Investment Program and, as applicable, other Community Investment Cash Advance programs. In FY2005, the Finance Board completed on-site reviews of all FHLBank AHPs.

On March 15, 2005, the Finance Board issued “The Report of the Horizontal Review of the Affordable Housing Programs of the FHLBanks.” Currently, key findings from this report are being considered in the revision of the AHP regulation.

Annual Performance Measure 2.2b: Corrective Actions: During the course of an examination, the Finance Board may identify a significant supervisory or compliance issue that poses a risk to the FHLBank. When warranted, the Finance Board will require the FHLBank to develop a plan to correct the violation or weakness. The EICs hold discussions quarterly with the FHLBanks that have outstanding supervisory issues.

Annual Performance Measure 2.2c: FHLBank Community Lending Plans. Each FHLBank is required to adopt an annual community lending plan that requires the institution to: (i) conduct market research in its district; (ii) describe the manner in which it will address identified credit needs and market opportunities in its district for targeted community lending; (iii) consult with its advisory council and its members, housing associates, and public and private economic development organizations in its district in developing and implementing the plan; and (iv) establish quantitative community lending performance goals for that year. The Finance Board also solicits and reviews community support statements of each FHLBank member approximately once every two years. The Finance Board reviewed the community lending plans for the FHLBanks and reviewed the community support statements of 3,170 FHLBank members.

Annual Performance Measure 2.2d: Public Interest Directors. The FHLBank Act specifies that the board of directors of each FHLBank be comprised, generally, of eight directors elected by the institution’s members and six directors appointed by the Finance Board. At least two of the directors of each FHLBank appointed by the Finance Board are required to be chosen from organizations with more than a two-year history of representing consumer or community interests on banking services, credit needs, housing, or financial consumer protections. The Finance Board, with due consideration of the potential conflict of interest inherent in appointing representatives to the boards of directors of institutions that the Finance Board regulates has postponed such appointments to fill expired terms in 2005. The Finance Board instead has informally solicited recommendations from the FHLBanks of qualified persons with skills and capabilities that could address any gaps that might exist in their boards of directors. If warranted, the Finance Board may make such appointments as are necessary in the future, pending adoption of statutory changes to the composition of the FHLBanks’ boards of directors, such as those recommended by the Finance Board.

STRATEGIC GOAL 3: Use supervisory, managerial, and legal resources to support effective, efficient, and responsive FHLBank supervision, regulation, and housing oversight.

STRATEGIC GOAL 3 RESULTS: The Finance Board has identified two strategic objectives in support of this goal. These are top-level objectives that define the Finance Board’s success in managing its resources to carry out its mission.

Strategic Objectives	2002	2003	2004	2005
3.1 The Finance Board takes appropriate and timely regulatory and advisory actions.	Achieved	Achieved	Achieved	Achieved
3.2 The Finance Board prudently allocates resources to fulfill its mission effectively and efficiently.	Achieved	Achieved	Achieved	Achieved

ANNUAL PERFORMANCE GOALS

In addition to the strategic goal, the Finance Board has two performance goals for management of the Finance Board’s resources:

Annual Performance Goal 3.1a: Regulations and advisory actions are reviewed, revised, and supplemented to ensure relevance, transparency, and issue-oriented supervisory guidance.

Annual Performance Goal 3.1b: Fiscal, physical, and human resources are used efficiently and effectively to fulfill the Finance Board’s fiduciary responsibilities.

PERFORMANCE GOAL RESULTS

Annual Performance Goal 3.1a: Regulations and advisory actions are reviewed, revised, and supplemented to ensure relevance, transparency, and issue-oriented supervisory guidance.

Annual Performance Measures	2002	2003	2004	2005
3.1a Review, revise and supplement Finance Board regulations, where appropriate.	Achieved	Achieved	Achieved	Achieved
3.1b Respond to new business activity notices filed by the FHLBanks within 60 days.	Achieved	Achieved	Achieved	Achieved

Annual Performance Measure 3.1a: Regulations. In 2005, the Finance Board continued to develop and issue anticipatory, results-oriented supervisory guidance to the FHLBanks. Guidance was provided in response to the evolving activities and operations of the FHLBanks, developments in the financial markets, and recently identified supervisory issues and best practices. In this connection, the agency continued to identify and incorporate effective practices in regulatory supervision into its supervisory guidance. Supervisory guidance and advisory initiatives undertaken by the Finance Board in 2005 are described below.

Regulatory Initiatives. The Finance Board continued to develop a Data Quality and Timeliness Regulation, which will consolidate data reporting requirements from individual regulations into a Data Reporting Manual (Data Manual). The first two chapters of the Data Manual, addressing call report data and membership data, were finalized in FY2005. Additional chapters, including AHP data, will be completed in 2006.

The Finance Board is also preparing revisions to its AHP regulation for eventual notice and comments. These revisions are designed to enhance the program descriptions, remove unnecessary administrative requirements, and simplify the monitoring process for affordable housing projects.

Supervisory Guidance. The Finance Board issued Advisory Bulletins which address SEC registration of debt; the Affordable Housing Set-Aside Program; regulatory reporting under certain accounting standards; standards for management and board risk management oversight; and internal market risk models.

Annual Performance Measure 3.1b: New Business Activity. Finance Board regulations require a FHLBank that intends to engage in a “new business activity” to file a notice of its intent with the Finance Board. Within sixty days after receipt of a notice that meets the requirements of the regulations, the agency responds to the FHLBank. In 2005, the Finance Board responded to two of the three new business activity notifications from the FHLBanks within 60 days. The third notice was withdrawn by the FHLBank before the Finance Board could respond to it.

Annual Performance Goal 3.2: Fiscal, physical, and human resources are used efficiently and effectively to fulfill the Finance Board’s fiduciary responsibilities.

Annual Performance Measures	2002	2003	2004	2005
3.2a Align budgeted resources with projected workloads and business priorities.	Achieved	Achieved	Achieved	Achieved
3.2b Business continuity and contingency plans are maintained and tested.	Achieved	Achieved	Achieved	Achieved

Annual Performance Measure 3.2a: Resources. The increasing size and complexity of the FHLBanks and the successful mission fulfillment by the Finance Board requires continuing augmentation of its staff with high-achieving professionals in various disciplines and the maintenance and support of a highly qualified, skilled, and diverse workforce. In 2005, the Finance Board hired 35 additional full-time staff, including 16 examiners, 16 other professional, and three administrative or support staff. In addition, the Finance Board contracted with the Department of the Treasury's Bureau of Public Debt to provide financial management and travel related services.

In 2005, the agency continued to enhance its data management and information systems to improve data integrity and consistency across the FHLBank System. A risk-exposure data standard, which will improve data integrity and consistency across the FHLBank System, was developed and shared with the FHLBanks. The standard is under review pending feedback from the FHLBanks. In addition, the AHP database is being comprehensively restructured to reflect data requirements in the revised AHP regulation. The FHLBanks will be able to use the AHP database for reporting purposes by the end of the 2006 calendar year.

The agency's headquarters relocated to new, leased office space that is fully compliant with the Americans with Disabilities Act and other life safety standards.

Annual Performance Measure 3.2b: Continuity and Contingency Plans. The Continuity of Operations Plan (COOP) for the Finance Board is designed to ensure continuity of essential Finance Board functions under all emergency circumstances. The COOP identifies the essential functions that must be continued under any circumstances, and the policy and procedures for activating the program. The major components of the COOP include identification of essential functions; delegations of authority; orders of succession; communications processes; vital records, files and databases required and available during an emergency; and a testing, training and exercise program that includes monthly, quarterly and annual testing of the COOP's different components.

The COOP was tested in FY2005 through an exercise using established activation procedures, requiring all emergency personnel to report to the Emergency Operations Center, and testing of programs to ensure that essential functions could be performed. The COOP was also updated to comply with recent directives from the Department of Homeland Security's, Federal Emergency Management Agency that were issued as a result of government-wide audits and testing.

PROGRAM EVALUATION

The Finance Board monitors its progress in implementing its goals regularly through its financial accounting and budget system, other internal tracking and reporting mechanisms, and internal staff and management meetings. The accounting and budgeting system tracks agency costs against budgeted resources for various agency functions. This

allows the efficiency of current agency programs and activities to be considered when making allocations of agency resources. The agency's annual financial statements are prepared in accordance with generally accepted accounting principles and are subject to an annual audit by an independent accounting firm.

Audits conducted by the Office of the Inspector General and the U.S. General Accounting Office are other means used to determine the quality and effectiveness of agency programs and operations. In addition, the effectiveness, clarity, and adaptability of the Finance Board's regulations and their consistency with current agency priorities and objectives is assessed through the agency's ongoing efforts to identify provisions that should be amended or eliminated because they are no longer relevant, do not achieve their intended purpose, are unreasonably burdensome, or are too complex or ambiguous.

AUDITOR'S REPORT AND FINANCIAL STATEMENTS

APPENDICES



Federal Housing Finance Board

October 31, 2005

MEMORANDUM

TO: Ronald A. Rosenfeld
Chairman

FROM: Edward Kelley
Inspector General

SUBJECT: Finance Board Management Challenges

In accordance with OMB Circular A-136, I am providing my summary of the most serious management and performance challenge facing the Finance Board and my assessment of the agency's progress in addressing those challenges. My position is based on the audit work we have performed in OIG to date.

MANAGEMENT CHALLENGE – The primary mission of the Finance Board is to ensure the safety and soundness of the Federal Home Loan Bank System whose mission is to support affordable housing in the United States. The Finance Board's regulatory success is dependant on the agency's ability to: monitor the activities of the twelve Federal Home Loan Banks and the Office of Finance; timely identify activities that threaten their safe and sound operations; and timely take actions to protect the system.

The agency's examination and supervisory function has a critical role in helping to ensure the success of its mission. However, recent problems that have occurred in several Federal Home Loan Banks raise questions as to whether the examination and supervisory function: 1) has an adequate number of staff, 2) has staff that possess the appropriate knowledge, skills and abilities, 3) has staff that are provided with adequate guidance, and 4) has adequate monitoring capability.

AGENCY PROGRESS – The Finance Board has taken very positive steps towards enhancing the examination and supervision functions. The Finance Board has taken commendable steps in hiring more examiners. However, we have not assessed the effectiveness of the agency's hiring strategy. The Finance Board has also focused on achieving a risk based examination approach.

If you have any questions or I can be of any assistance, please contact me at extension 2544.



Federal Housing Finance Board

Date: October 27, 2005

To: Edward Kelley
Inspector General

From: Stephen M. Cross
Director, Office of Supervision

Subject: Response to the Your Memo Regarding the Office of Inspector General Survey of the Office of Supervision

This memorandum serves as the Office of Supervision's response to your October 7, 2005 memorandum to me regarding the Office of Inspector General's (OIG) draft report on its survey of the Office of Supervision (OS). As you stated in your memo, the survey is being used as a basis for the OIG's decision to conduct six audits of OS's examination process, human resources functions, and promulgation of advisory bulletins.

The Office of Supervision is responsible for the examination and supervision of the FHLBanks and the Office of Finance (OF). The examinations focus on the FHLBank's corporate governance, risk profile, risk management, and prudent operating practices relating to market, credit, and operational risk. The examinations also check for compliance with applicable laws, regulations, and policies. Our examination and supervisory responsibilities cover safety and soundness and affordable housing and community development.

I will provide comments concerning each of the six potential audits outlined in your memorandum of October 7, 2005. The discussion in this memorandum may assist in providing you some perspective and context that was not available during the survey process.

I. Risk-Based Examination Focus

When I first arrived at the Finance Board as its Director of Supervision in 2002, we had a total of 10 examiners. Examinations at that time were essentially compliance audits. The focus of examinations was to determine whether or not the FHLBanks and the OF were adhering to applicable laws and Finance Board regulations and policies. Changes to the OS were necessary if the Finance Board was to meet its statutory responsibilities to ensure that the FHLBanks operate in a financially safe and sound manner. The breadth and depth of those necessary changes were substantial.

It was clear that we needed more good people, and we needed them quickly. We needed to shift the focus of our examination and supervision from compliance-based to risk-based. We embarked on an incremental recruiting and hiring strategy to attract experienced and appropriately talented people – examiners and non-examiners. We shifted the focus of examinations from exception-based compliance audits to full reviews of the FHLBanks that focused on the areas of greatest risk facing the institutions. In addition to adding people, we needed to make organizational changes to better integrate the supervisory process throughout OS. We are now more effective in our supervision of the FHLBanks and in taking supervisory actions in response to shortcomings identified through the supervisory program.

Organization

Over the past three years, we have organized OS around its primary mission of assuring the safety and soundness of the FHLBanks and OF and assuring the FHLBanks fulfill their affordable housing and community investment responsibilities. We have integrated all divisions into the supervisory process. All divisions participate in the examination process, and all staff is encouraged to visit the FHLBanks during examinations to gain an understanding of how each staff member's responsibilities contribute to the supervision of the FHLBanks.

For fiscal year 2006, we have continued our efforts to enhance the operation of OS. A new management and administration division was established to coordinate and oversee our planning, training, and administration. We have also established a policy division, which will be the focal point for supervisory and regulatory policy development.

Staffing

To enhance the identification and evaluation of the relevant risk exposures of the FHLBank System, we have tripled our examination staffing resources. Our recruiting focused on hiring experienced professionals with technical knowledge of the banking and mortgage markets. This has enabled us to conduct in-depth reviews of high-risk areas, *e.g.*, corporate governance, financial accounting, market risk management, acquired member assets, information technology, etc.

We have increased the number and skills of staff in OS in a manner that is prudent: enough to make a meaningful difference in the quality of our supervision and examination, while still being “manageable” in any given period. Accordingly, we have added from 5 to 12 examiners in each fiscal year’s budget request beginning in FY 2003. We have hired only those candidates exhibiting the best combination of education, training, experience, and judgment. At times, this has resulted in our having vacant positions, but I firmly believe our high standards have been in the long-term best interests of the Office of Supervision and the Finance Board.

At this point, our need for additional examiners has nearly been met. I believe that we are approximately at our needed examiner strength level. That is not to say we do not have unmet needs or that those needs will not grow in the future. The most pressing of our technical needs is for accounting staff. There is a nationwide need for financial accountants throughout the private and regulatory sectors, owing in no small part to developments associated with accounting for derivatives and increased corporate accountability standards imposed by the Sarbanes-Oxley Act of 2002. We are working with the Office of Management to determine the best strategies for meeting the need for accounting staff.

Our need for additional examination staff and resources may change in the future. One program we are exploring is a “dedicated examiner” program. In a “dedicated examiner” program, one or more examiners would be assigned full time to a particular FHLBank. Should we institute such a program, we would need additional examination staff.

The most notable among our staffing changes have been the designation of portfolio managers and examiners-in-charge, the establishment of quality assurance positions within the director’s division, and the establishment of a training coordinator. Details on these changes are provided below.

Designation of Portfolio Managers and Examiners-In-Charge

We have set up three teams of examiners, each concentrating on a portfolio of four FHLBanks. A portfolio manager leads each portfolio, and an examiner-in-charge (EIC) has been designated for each FHLBank. The portfolio manager has the responsibility for managing the resources and conducting planning operations for that portfolio. The EICs are the central point of contact for all communications with the FHLBank and have the responsibility of managing the ongoing supervision of his or her FHLBank. The EIC is responsible for being aware of and keeping OS management informed about all activities at the FHLBank that have a bearing on supervisory and examination matters. The EIC is also charged with developing the supervisory strategy for his or her FHLBank. These strategies, developed during the fourth quarter of the calendar year, serve as the organizing vehicle for the supervision of the FHLBank during the subsequent year.

During the past year we have added an examination specialist position to each portfolio. The examination specialist is a resource for the portfolio manager and EICs. These positions have been filled on an “acting” basis during fiscal year 2005, but they will be filled on a permanent basis in the next 30-45 days. These analysts will add another review and assessment of the reports of examination prior to their completion and issuance. In that way, the examination specialists will provide a level of quality assurance. They will also be tasked with checking that the examination work papers are complete at the end of every annual examination, assisting in the planning process, helping to develop supervisory strategies, and coordinating the supervision for the portfolio of banks.

Quality Assurance Function

We have budgeted for two quality assurance staff to be added to the director’s cost center this fiscal year. These staff will be charged with leading reviews of work papers and supervisory and policy development processes throughout the Office, along with broader, more conceptual reviews to ensure that the Office is functioning as effectively and efficiently as possible. The quality assurance staff in the director’s cost center will serve as project managers for specific quality assurance reviews and will be supported by other staff detailed on a temporary basis to work with them on specific quality assurance projects.

Establishment of a Training Coordinator

We have budgeted for a training coordinator to be hired during the current fiscal year. This individual will be responsible for conducting an assessment of the specific training needs of OS staff according to their job responsibilities, areas of specialization, education, experience, and developmental goals. The creation of this position will formalize and bring coordination to our training and development.

Establishment of the FHLBank Analyst Program

At the end of 2003, we decided to create four new full-time FHLBank analyst positions. Prior to this change, the FHLBank analyst responsibilities were part-time collateral duties for certain financial analysts, policy analysts, and economists on our staff. These new analysts each have responsibility for monitoring developments at their assigned FHLBanks, monitoring the monthly and quarterly call reports for the FHLBanks in their portfolios, and conducting studies of financial developments affecting the FHLBanks. The FHLBank analysts are a dedicated staff with the responsibility to uncover emerging trends and bringing these to the attention of the EIC. The analysts also prepare formal semiannual “Vulnerabilities” memoranda that identify and analyze the three or four areas at each FHLBank that present the most risk to that institution over the next six to 12 months.

Designation of Specific AHP and Community Investment Examination Staff

When I arrived at the Finance Board, we had no staff specializing in conducting AHP and Community Investment examinations. We now have seven full-time AHP and Community Investment examiners. During the last fiscal year, we moved our Affordable Housing and Community Investment examiners to the Supervision and Examination division, where they have been assigned to work on specific portfolios. We are in the process of selecting an AHP and Community Investment national expert examiner to coordinate the efforts of the AHP and Community Investment examiners across the three portfolios. This national expert will aid in ensuring that examinations of these programs are consistent across the FHLBanks and respond rapidly and appropriately to emerging issues.

Beyond staffing-related changes, we have established other practices to ensure that our examinations and supervision of the FHLBanks are calibrated to the risks facing the FHLBanks and the FHLBank System. Among the changes we have implemented are the following.

“All Hands” meetings

Since 2003, we have had, at least annually, meetings of all OS staff. These “All Hands” meetings are designed to achieve a number of objectives:

- Provide an opportunity for OS staff to meet OS senior management and other OS staff;
- Provide an opportunity for OS staff to hear the views of outside speakers on current topics of interest; and
- Provide a forum for OS staff to provide input on ways we can improve our operations.

Coordination within the Office of Supervision and with the Office of General Counsel

As part of the examination process, the portfolio managers and the EICs coordinate their reviews with other professionals within the Office of Supervision. These professionals have been assigned to be responsible for their areas of expertise at specific Banks, such as FHLBank analysts, risk modeling staff, and attorneys from the Office of General Counsel.

The FHLBank Analysis division and the Risk Modeling division have each assigned staff to individual FHLBanks. The modelers, like the FHLBank analysts, have certain deliverables that are required as part of each annual examination, along with a responsibility to provide assistance for quarterly reviews and other on-going supervisory matters. Finally, the Office of General Counsel has assigned its attorneys to specific FHLBanks, with the responsibility of being a resource to the examination team for consultation on legal and regulatory matters.

Meetings with external auditors

The portfolio managers and the examiners-in-charge meet with the external auditors to address any potential issues or concerns that may require further review and/or emerging issues that should be considered in determining the scope of the quarterly reviews or annual examination.

Supervisory strategies, quarterly visitations, and examination planning

Each year, examiners-in-charge are required to complete a supervisory strategy that identifies key areas of risk at their FHLBanks and addresses the timeframe and the focus of the supervision of the FHLBank during the year. The supervisory strategy may change based on the results of examinations, quarterly visitations, and coordination with other areas within the Office of Supervision, but it serves as a risk-based framework for the supervision and examination of the FHLBank. The EIC has the ability, and the responsibility, to solicit input from analysts, modelers, accountants, and attorneys when planning the supervisory strategy, annual examination, quarterly visitations, and ongoing supervision of the FHLBank. The EIC also coordinates supervisory activities with financial analysts, accountants, modelers and attorneys as the need arises.

The EICs also conduct quarterly on-site visitations of their FHLBanks. The scope of the visitation includes discussions with executive management on current performance, emerging issues and strategies, follow-up on previously reported examination findings or other issues and concerns that were identified by the risk modelers and analysts. The quarterly visitation is a critical element of the supervisory process. It allows the examiners-in-charge to keep current on the risks of the FHLBanks and gives them information that may be used to update the supervisory strategy. As appropriate, the visitation includes analysts, modelers, accountants, and other staff.

The EICs are responsible for the planning of the annual examination and allocation of resources to those examinations. The scope of an examination reflects an assessment of the risks and vulnerabilities of the assigned FHLBank. Decisions on examination scope are based on information that is obtained on an on-going basis, *e.g.*, quarterly visitations and coordination with other functions within OS, meetings with external auditors, and the results of prior examinations.

Examination emphasis

The examination process requires a thorough assessment of corporate governance, internal controls and the independent testing that is performed by the external and internal auditors. Examiners are responsible for identifying and evaluating the governance objectives, risks, tolerances, processes and internal controls for their assigned areas. In completing their assessments, the examiners evaluate:

- The degree to which the activities and internal controls reflect the goals and parameters established by the board and executive management in the

corporate governance process, e.g., strategic/business planning, risk assessment, risk management policy;

- The adequacy of internal controls to inform and support the governance processes, management, and decision making;
- The adequacy of governance processes to address all material risks of the FHLBank's activities and risk profile; and
- The adequacy of independent testing that is performed on the internal control environment by the external and internal auditors.

Communication with FHLBank management

Throughout the examination, the examiner-in-charge meets with executive management to discuss the examination approach and any relevant issues or concerns needing to be addressed and/or clarified. Examiners meet regularly throughout the examination with FHLBank staff responsible for areas under examination.

Evaluation of identified findings

All potential findings are evaluated by the examination team to determine whether the issue or concern warrants reporting to senior management and/or the board of directors. Examination staff uses the following elements to evaluate potential findings:

- Criteria – A statement of the standards against which the deficiency is measured;
- Condition/facts – A statement of the condition to demonstrate the existence of the deficiency and its materiality;
- Cause – The probable cause of the deficiency, e.g., weakness in internal controls, corporate governance and internal audit coverage;
- Effect – The potential or actual results that have occurred; and
- Action – The proposed corrective action.

Before the submission to FHLBank management and/or inclusion in the Report of Examination (ROE), all findings are reviewed by the examiner-in-charge for accuracy and materiality. Additional reviews are performed by the portfolio manager and the examination specialist.

Examination findings and conclusion

During 2005, the five categories (unsafe and unsound practice or condition, violation, weakness, referral, and recommendation) of “Findings” that were used in the ROE were revised, and an overall conclusion (satisfactory, fair, marginal, or unsatisfactory) was introduced. This has enhanced the consistency of the examiners’ communications with FHLBank boards of directors and senior managers regarding the level of supervisory concern about the FHLBank’s activities and the risk profile of the FHLBank.

II. Revision of the examination manual

In September 2003, we began our efforts to revise the examination manual. The purpose behind those revisions is to establish risk-based work programs to provide a clearer understanding of each FHLBank’s risk profile, a more risk-focused examination process, and a more risk-based focus on the review of corporate governance, internal controls, and the independent testing performed by the external and internal auditors.

The revision of our examination manual has been an ongoing process for at least two years. While I expect an initial draft of the revised safety and soundness portion of the manual to be released by the end of the calendar year, I am not at all satisfied with the delays in this project’s completion. Owing to the delays with this project, and the fact that the existing examination manual has *not* been risk focused, I have given our examiners the authority to use their judgment in adopting examination manuals from other agencies, principally the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, as they are more risk-focused than is our 1998-era examination manual. The percentage of OS staff using the examination manual will increase once the new manual is released.

It is important to understand that an examination manual is a guide, not a “cook book,” for conducting examinations. FHLBank practices change and evolve with emerging technologies, industry practices, supervisory and regulatory guidance, and market forces. The ongoing evolution of the financial industry dictates that an examination manual be a living document and that examiners not rely solely on a manual in his or her review of FHLBank operations. We have hired experienced examiners because they bring their best judgment to bear when presented with novel situations. One cannot examine a complex financial institution with assets of \$45 to \$200 billion using a punch list.

Also, while the FHLBanks and the OF may find it useful to see our examination manual to get insight at the way we conduct our examinations, the manual is not produced for the FHLBanks nor for OF. It is produced for use by OS staff. The FHLBanks and the OF will have access to the examination manual, but they should not be relying on the examination manual for direction as to how to conduct their operations.

The AHP and Community Investment portion of the revised manual will follow the now in-process revision of the Affordable Housing Program regulation. Preliminary work is beginning.

III. Call Report System

We are in the process of planning revisions of the Call Report System (CRS) to ensure that it will remain accurate, up-to-date, and capable of reporting the type of information necessary to continue our oversight, supervision, and examination of the FHLBanks. This revision process is being coordinated with the Office of Finance's implementation of its Financial Reporting System (FRS). That said, we have not been silent on the need for the FHLBanks to submit timely and accurate data to CRS. The existing system has extensive "edit checks" that do not permit submission of data that fail any check. In addition, in 2003, we issued Advisory Bulletin 03-13, which, among other guidance, advised the FHLBanks that "[S]ubmission of late or inaccurate call reports may lead to subsequent supervisory actions by the Finance Board..." That advisory bulletin set forth the regulatory deadlines for the submission of the monthly and quarterly call reports. In addition, in 2004 and early 2005 we worked with the Office of General Counsel and proposed changes to our regulations to improve our information collection authorities.

The current call report is used both for supervisory purposes and by the Office of Finance to prepare the combined financial report. There are many items in the call report that are principally or exclusively used by the Office of Finance. In both designing and updating the existing call report system, the process has sought input of the FHLBank comptrollers. As a group, the comptrollers are slow to make decisions, and have changed their decisions about the presentation and "geography" of several items related to Statement of Financial Accounting Standards No. 133. I would note, however, that the Finance Board now has the capability in-house to make call report changes much more rapidly than when it had to rely on a contractor for this purpose. As a recent example, the call report changes required to incorporate Statement of Financial Accounting Standards No. 150 were implemented in a very timely fashion, contrary to the representation in the draft OIG report of its survey of the OS.

IV. Early Warning System

Our approach to risk modeling has not been the development of an "early warning system" *per se*, but rather an effort to ensure, as with other supervisory programs, that we can evaluate the competence of the FHLBanks' risk modeling and risk management systems and staff. The risk management models in the FHLBanks are used by the FHLBanks to measure and assist in managing interest-rate risk. Our approach has been to independently value specific instruments at each FHLBank and compare those valuations with those generated by the FHLBank model. We use these independent valuations, along with reviews of overall FHLBank modeling technologies, structures, assumptions, and extensive discussions with FHLBank modeling staff, to form our ultimate conclusion as to the degree of confidence we place in FHLBank modeling and risk measurement.

Beyond models, we have three processes in place for early warnings. First, the EIC visits the respective FHLBank no less frequently than once per quarter. Second, the FHLBank analysts are charged with uncovering emerging trends at specific FHLBanks and

throughout the FHLBank System. Third, we devote considerable attention and analysis to the ratio of the market value of equity to the book value of equity (MVE/BE). We believe this ratio is a reliable indicator of future profitability at an FHLBank.

V. Advisory Bulletins

An important tool for us to influence the risk-taking activities of the FHLBanks is the issuance of supervisory guidance in the form of advisory bulletins. Our approach to developing advisory bulletins has been, and will continue to be, an inclusive one that is more often than not the *result* of observations and analysis of FHLBank operations. Advisory bulletins constitute *guidance* to the FHLBanks and to our examiners that outline what our examiners will be looking for on a given matter or issue. During its annual examination, the FHLBank may offer to Finance Board examiners its rationale for deviating from guidance offered in an advisory bulletin.

An example of the development of one advisory bulletin will illustrate how advisory bulletins are not developed in a vacuum. During the year before the issuance of AB-03-08, which stressed the need for FHLBanks to develop capital management and retained earnings policies, our examination findings were critical of the low level of retained earnings at the FHLBanks. We were critical of the fact that dividends represented a priority over retained earnings, and the safety and soundness implications of this prioritization. During an FHLBank directors' conference, I delivered a presentation on this topic, and, during that presentation, I alerted them to the upcoming advisory bulletin on retained earnings.

More substantively, our advisory bulletins provide guidance, but do not establish regulatory requirements. For example, the aforementioned advisory bulletin on retained earnings does not set a prescriptive minimum level for retained earnings at the FHLBanks. Rather, it stresses that the FHLBanks should develop policies that guide their overall capital management, and set an appropriate level of retained earnings given the risk profile of the institution. We also stressed the need for appropriate analytical support for whatever capital management, retained earnings, and dividend policies the FHLBank implemented.

While the specific circumstances may differ depending on the guidance provided, the standard process for developing and issuing advisory bulletins is similar to the specific one described above. We normally give the FHLBanks an opportunity to hear about issues addressed in forthcoming advisory bulletins and the reasoning for them. However, regardless of FHLBank or staff opinion, it would be inappropriate to get the "approval" of the FHLBanks before issuing an advisory bulletin. Advisory bulletins set supervisory guidance and serve as a vehicle to ensure that supervisory expectations are fully transparent. The Finance Board is the FHLBanks' regulator, and the Finance Board has an obligation to act independently and proactively to issue advisory bulletins that are constructive and foster the safe-and-sound operations of the FHLBanks or prompt the FHLBanks to better fulfill their housing finance mission.

If necessary, we are prepared to amend advisory bulletins after their issuance. That typically would happen as we learn about implementation or other issues that we did not contemplate when the bulletins were issued. Each advisory now lists one or more principal contacts so that the FHLBanks or other interested parties can obtain clarifications or offer comments on an advisory bulletin following publication. While we have, on occasion, had useful conversations as a follow-up to the issuance of such guidance, we have not had to substantively amend an advisory bulletin in response to comments received.

VI. Training

As noted above, we plan to post a training coordinator position in the next few months.

Each year during the budget planning process, each person on the staff is asked to indicate the nature and extent of training that he or she would like to take in the upcoming fiscal year. Taking this information into account, OS prepares a training budget. While I cannot say that every training request is granted, the vast majority of requests are indeed granted. It is the responsibility of each person in OS to be proactive in (1) assessing his or her training needs and (2) presenting a proposal for training courses to meet those needs. In the three years I have been the OS director, we have never exhausted our training budget. The funds are there to meet reasonable training requests.

Conclusion

I appreciate the opportunity you provided to read the Office of Inspector General's draft report on its survey of the Office of Supervision. I share your commitment to risk-focused examination and supervision, an up-to-date system of supervisory guidance and controls for our work, enhancements to the call reporting system, and off-site monitoring programs. I also share your commitment to training.

Your survey did not include the senior management of the Office of Supervision. Consequently, your survey may not have surfaced the many steps that we are taking to enhance supervision, make examinations more risk-focused, enhance our examination manual, improve call reports, anticipate emerging risks, issue appropriate supervisory guidance, and offer training to our staff. I offer this memorandum, therefore, to provide you with a perspective and context that may not have been considered during that survey process, which I hope can enhance your audit planning.