Introduction

All areas of an FHLBank's operations, including asset structure, capitalization, earnings, liquidity and internal compliance and control structure are directly influenced by the institution's board of directors and senior management. An FHLBank's board of directors and senior management must have a clear understanding of the interrelationships among the FHLBank's activities and how they affect the prudential operation of the institution and its ability to fulfill its housing finance and community lending mission. The board of directors and senior management must also be familiar with the external environment and how factors outside the FHLBank may affect the operations of the institution.

Corporate governance begins with engaged, capable, and experienced directors and senior management, a coherent strategy and business plan, and clear lines of responsibility and accountability. The board of directors oversees the development of the overall business strategy for the FHLBank and the decisions made by senior management in the pursuit of strategic objectives. The board of directors assesses both the appropriateness of the strategy and decisions and the success with which they are implemented. Senior management, with input and approval by the board of directors, develops the business strategy, makes significant decisions to implement that strategy, and oversees day-to-day decisions and actions by subordinate staff, to ensure that these decisions support the long-term objectives and policies as determined by the board of directors.

The achievement of the strategic and operational objectives of the FHLBank must be supported by the development and maintenance of a strong system of internal controls and effective risk management. An effective internal control and risk management environment is essential to provide reasonable assurance that assets are adequately safeguarded, critical information is relevant, reliable and timely, and resources are utilized in an effective and efficient manner, as well as to evaluate compliance with management policies, standards, laws, regulations and sound fiduciary principles.

The assessment of the quality of corporate governance of an FHLBank by its board of directors and senior management should be ongoing throughout the examination process as the examiners perform an evaluation of all critical activities of the FHLBank. While the board of directors and senior management are collectively responsible for management of the FHLBank, it is important to recognize the differences between the duties and responsibilities of the board of directors and senior management. These differences are particularly important in evaluating the various processes and systems established to direct and control an FHLBank's operations. A description of the key duties and responsibilities of the board of directors and senior management, generally, is set forth below.

Board of Directors Responsibilities-General

Under Section 7 the FHLBank Act, the management of each FHLBank is vested in its board of directors. In the broadest sense, the board of directors of an FHLBank determines the strategic direction for the institution, formulates policies and provides supervision over the affairs and senior management of the FHLBank. It is also responsible for promoting the FHLBank's welfare and mission, even when the promotion of these interests may conflict with the interests of member institutions, including the interests of members whose representatives serve as directors of the FHLBank. The board of directors may delegate oversight of day-to-day activities to senior management, but cannot delegate its fiduciary duty to manage the institution nor its responsibility for the consequences of unsound or imprudent policies and practices.

The duties of FHLBank directors are set out in Section 917.2 of the Finance Board's regulations. Each director has the duty to:

1) Carry out his or her duties as director in good faith, in a manner such director believes to be in the best interests of the FHLBank, and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances;

2) Administer the affairs of the FHLBank fairly and impartially and without discrimination in favor of or against any member;

3) At the time of appointment or election, or within a reasonable time thereafter, have a working familiarity with basic finance and accounting practices, including the ability to read and understand the FHLBank's balance sheet and income statement and to ask substantive questions of management and the institution's internal and external auditors; and

4) Direct the operations of the FHLBank in conformity with the requirements of the FHLBank Act and the Finance Board's regulations.

In making an overall assessment of the adequacy of oversight by an FHLBank's board of directors, examiners should evaluate the competence of the board of directors and its effectiveness in directing the affairs of the FHLBank. Specific responsibilities include, but are not limited to, those that follow below.

1) Hire and retain competent executive management

It is a primary duty of the board of directors of an FHLBank to ensure that the chief executive officer (CEO) and other members of senior management have the necessary skills, knowledge, and experience to manage the FHLBank's affairs in a sound and responsible manner. An FHLBank's board of directors or designated board committee should be actively involved in the selection of a CEO. Selection criteria should include technical competence, character, education and experience in the financial services industry or other related fields.

The board's policies should address the CEO selection process, as well as the board's plans for management succession in the event of a loss of the CEO and other key senior management.

The ongoing evaluation by the FHLBank's board of directors of the CEO and senior management is critical to the success of the institution. A CEO's performance and compensation should be tied to and measured against clearly defined duties and responsibilities, as well as standards of performance and measurable performance targets. Performance standards and targets should be directly linked to the FHLBank's success in implementing its strategic and operational plans, including the achievement of both long- and short-term financial performance goals, maintenance of a safe and sound condition, and the carrying out of its housing finance and community lending mission. All significant areas of an FHLBank's operations should be covered, including investments, loans, asset and liability management, profitability, strategic planning and risk management.

An effective board of directors establishes a process for monitoring the CEO's success in satisfying applicable performance standards and achieving performance targets, as well as for evaluating the performance of the CEO. The board or a committee thereof should monitor the CEO's performance throughout the year and provide periodic assessments. The board or a committee of the board should conduct a formal review of the CEO's performance at least annually.

An FHLBank's board of directors is responsible for taking disciplinary action, including dismissal, against the CEO or members of senior management who prove unable to meet the performance standards and targets or who commit violations of law, breaches of fiduciary duty or otherwise place the FHLBank or its reputation at risk. Failure by the board of directors to act deliberately yet decisively when the need arises may constitute a serious breach of the board's fiduciary responsibilities.

2) Establish a risk management structure

The risk management process is intended to identify an FHLBank's exposure to risk and determine whether risks are appropriately managed to ensure they are consistent with the desired risk profile established for the FHLBank by the board of directors and senior management. A qualitative and quantitative evaluation of all material risks and the system of controls for managing them should be reflected in an annual risk assessment as required by Section 917.3 of the Finance Board's regulations.

There are three components to the risk management process: (i) risk identification, reporting and analysis; (ii) risk control; and (iii) risk treatment. Risk identification, reporting and analysis requires a review of all aspects of an FHLBank's current and future operations to determine where there is potential exposure to loss and reporting of identified risks to management and the board of directors of the FHLBank. Risk control is a function of the strength of the FHLBank's internal controls, policies, and procedures. Risk treatment is the selection of appropriate measures or methods to manage a particular risk, such as a hedge.

An effective board of directors must have a fundamental understanding of the FHLBank's business activities and associated risks. While the members of the board may not be expert in the risks attendant to all of an FHLBank's activities, they must ensure that such expertise is available to them and that the FHLBank's risk management system undergoes appropriate reviews by suitably qualified professionals.

The board of directors is responsible for taking reasonable steps to ensure that management has established strong management information systems (MIS) to accurately identify, measure, monitor, and control risks. The system should:

1) Facilitate the assessment and management of risks within the FHLBank, including their identification, monitoring, measurement, and limitation;
2) Provide management with an adequate decision support system by providing information that is timely, accurate, complete, relevant, and consistent;
3) Deliver complex or technical information to multiple users throughout the FHLBank;
4) Provide a means to monitor the achievement of the organization's goals and objectives;
5) Reduce expenses related to labor-intensive manual activities; and
6) Allow for communication with employees and customers.

An FHLBank's board of directors has primary responsibility for establishing and maintaining a robust risk management process for the institution. The FHLBank's safe and sound operation is dependant upon identification and management of its risk exposures. Examples of specific risk management responsibilities of the board of directors include:

a) Establishing a sound risk management culture and overall risk tolerances for the FHLBank;
b) Reviewing and approving policies, standards, and procedures that clearly quantify acceptable risk and that define responsibility and authority;
c) Evaluating and approving compensating policies and controls to mitigate risks;
d) Reviewing deviations and exceptions that exceed established risk standards and limits;

e) Reviewing current and potential litigation and other legal claims initiated or asserted by the FHLBank, or by third parties against the institution, including an evaluation on the potential impact of any adverse determination upon the FHLBank's financial condition and performance;
f) Requiring independent audits of the key risks and internal controls, policies and procedures that are applicable to the FHLBank environment;
g) Ensuring that corrective action is taken to eliminate material exceptions, issues or deficiencies reported by the FHLBank's external or internal auditors or regulatory examiners;
h) Reviewing and approving of the FHLBank's strategic and operational plans;
i) Formally delegating to management of the authority to formulate and implement the FHLBank's strategic and operational plans;
j) Specifying content and frequency of reports provided to the FHLBank's board of directors;
k) Ensuring sound staffing and compensation practices, as well as a positive working environment that emphasizes the importance of regulatory and policy compliance in the FHLBank's achievement of its strategic and operational objectives and employees' success and longevity at the institution;
l) Performing an annual evaluation of the performance of the CEO;
m) Evaluating the degree and consistency of the FHLBank's compliance with applicable laws and regulations; and
n) Taking reasonable steps to ensure that the FHLBank's financial statements are transparent and accurate.

3) Develop and maintain an understanding of the FHLBank's business environment

An FHLBank's directors should have an understanding of the FHLBank's business environment and the legal and regulatory framework within which the FHLBank operates, as well as of their duties as FHLBank directors. Directors should be familiar with applicable laws and regulations so that they may determine that the FHLBank has appropriate policies and procedures in place to maintain compliance with them. Through interaction with FHLBank management, as well as independent inquiry, directors are required to remain informed regarding FHLBank System issues and FHLBank matters. Moreover, as described previously, Section 917.2 of the Finance Board's regulations requires that each director have a working familiarity with basic finance and accounting policies, including the ability to understand the FHLBank's financial statements and ask substantive questions of management and the FHLBank's internal and external auditors.

An effective tool to assist new board members in the discharge of their duties is an orientation program. That program should explain the operation of the FHLBank and the business environment and legal and regulatory framework in which the FHLBank operates. The orientation program also should clearly emphasize the responsibilities of board members both individually and as a group as well as provide ethics training for new directors.

The board of directors should conduct a survey of director skills to assist in the development of programs that enable any director that does not have a working familiarity with basic finance and accounting to gain such knowledge within a reasonable time after being elected or appointed to the board. Educational programs covering FHLBank activities, risks, hedging, modeling, emerging issues, and legal/regulatory updates also should be provided regularly.

By virtue of their positions, FHLBank directors have a fiduciary duty of loyalty to the FHLBank on whose board of directors they sit. When acting in their capacity as FHLBank directors, they must place the interests of the FHLBank before their own interests or those of the institution's members, including the interests of a member with which they are employed or are otherwise affiliated, where those interests diverge. FHLBank directors are responsible for dealing fairly with the FHLBank in business transactions and for ensuring that their personal or other business interests do not influence their decisions as directors. An FHLBank director should not participate in any decision by the FHLBank's board of directors to enter into a transaction between an FHLBank and the director, or between an FHLBank and a member with which the director is employed or otherwise affiliated.

Directors must structure their dealings with the FHLBank to comply with legal requirements and avoid even the appearance of a conflict of interest. Likewise, they must administer the affairs of FHLBank fairly and impartially, without discrimination in favor of or against any member. In addition, directors must take reasonable action to prevent FHLBank employees from abusing their positions with the FHLBank. The board of directors should adopt a written code of conduct including ethical conduct applicable to FHLBank directors, management and subordinate employees, including provisions setting forth requirements for confidentiality of information, employee treatment and safety, and conflicts of interest. Part 915 of Finance Board's regulations establishes specific requirements for the FHLBank's conflicts of interest policy.

4) Establish an effective board of directors structure to oversee the activities of the FHLBank

The stewardship responsibilities of FHLBank directors include the establishment of an effective organizational structure that ensures that relevant and accurate information concerning the FHLBank's activities is brought to its attention. These responsibilities include the authorization committees to perform specific tasks and supervise certain phases of the FHLBank's operations. All committees should have written charters that clearly address their mission, authority, responsibility, and duration. Standing committees address continuing areas of responsibility, such as a loan committee or an audit committee, while *ad hoc* committees may be established to accomplish special projects, allowing in-depth consideration of one-time issues.

Each board committee must keep minutes of its meetings documenting the discussions of each item considered at the meeting and, if applicable, procedures that should be established to address issues or concerns without the presence of FHLBank senior management, including the convening of executive sessions. Committees must report regularly to the full board of directors. The board may rely upon information provided to it by committees, but the full board retains responsibility for all decisions.

Section 918.7 of the Finance Board's regulations requires FHLBank boards of directors to meet a minimum of six times per year. However, above that minimum, boards should meet as frequently as the business and affairs of the FHLBank require. Board meeting packages should focus directors' attention on important issues or concerns. Priorities should be clear and requested board action, identified. Explanatory materials should accompany relevant data and information.

The board or directors should identify the type and frequency of reports necessary to oversee the FHLBank's financial performance and activities. The FHLBank's information technology should be aligned with the board's expectations and requirements and be able to provide relevant, accurate, and useful reports in a timely manner. Key performance reports enable the board to evaluate the FHLBank's financial performance in accordance with the FHLBank's strategic goals and mission, financial trends, risk profile, compliance with established risk tolerances and standards, and the adequacy of its risk management processes.

The board of directors should ensure that an accurate record of its actions is maintained in the form of minutes of each board and committee meeting, including any executive sessions and any telephonic meetings, and fully executed forms of director consent for any actions taken by unanimous written consent in lieu of meeting. Minutes should document the board's review and discussion of all agenda items. The minutes also should record the attendance/absence of each director and abstentions by any director from any vote.

Examiners should review the minutes of board of directors and committee meetings, as well as typical packages sent to board members in preparation for the meeting, to determine if directors are receiving appropriate information to make informed decisions. Examiners also should assess whether board meeting frequency is appropriate to oversee the FHLBank's activities.

Section 917.7 of the Finance Board's regulations requires the board of directors of each FHLBank to establish an audit committee of the board. The audit committee is responsible for monitoring, overseeing, and evaluating the extent to which an FHLBank's management, internal audit function, and the external auditors successfully carry out their duties and responsibilities to maintain the FHLBank's processes for controlling its operations, ensure the reliability and integrity of the organization's accounting, financial reporting and disclosure practices, and ensure that all issues reported by the organization's internal audit function external auditor, and other outside auditors have been satisfactorily resolved.

The specific duties and responsibilities of an FHLBank's audit committee include, but are not limited to, the following:

1. Directing senior management to maintain the reliability and integrity of the FHLBank's accounting policies and financial reporting and disclosure practices;
2. Reviewing the basis for the FHLBank's financial statements and the external auditor's opinion rendered with respect to such financial statements and ensuring that policies are in place that are reasonably designed to achieve disclosure and transparency regarding the FHLBank's true financial performance and governance;
3. Conducting oversight of the FHLBank's internal audit function by:
    a. Reviewing the scope of audit services required, significant accounting policies, significant risks and exposures, audit activities and findings;
    b. Monitoring the adequacy and timeliness of internal audit follow-up on findings;
    c. Assessing the performance, and determining the compensation, of the audit director; and
    d. Reviewing and approving the audit director's work plan.
4. Conducting oversight of the external audit function by:
    a. Approving the external auditor's annual engagement letter;
    b. Reviewing the performance of the external auditor; and
    c. Making recommendations to the board of directors regarding the appointment, renewal, or termination of the external auditor.
5. Providing an independent, direct channel of communication between the board of directors and the internal and external auditors;
6. Conducting or authorizing investigations into matters within the audit committee's scope of responsibilities;
7. Providing reasonable assurance that senior management has established and is maintaining an adequate internal control system by:
    a. Reviewing FHLBank's internal control system and the resolution of identified material weaknesses and reportable conditions in the internal control system; and
    b. Reviewing FHLBank's programs and policies designed to provide reasonable assurance of compliance with applicable laws, regulations, and policies and monitoring the results of the compliance efforts.
8. Reviewing the policies and procedures established by senior management to assess and monitor implementation of the FHLBank's strategic business plan and the operating goals and objectives;
9. Reporting its findings to the FHLBank's board of directors;

10. Determining the extent to which the FHLBank's internal and external auditors review the security for computer systems, facilities, and backup systems;
11. Evaluating responses by management to audit findings and reports and monitoring management implementation of audit recommendations; and
12. Monitoring compliance with FHLBank's conflict of interest policy and oversight of investigations of conflicts of interest and unethical conduct.

An FHLBank's audit committee is required to adopt, and the board of directors approve, a formal written charter that specifies the scope of the committee's powers and responsibilities, as well as its structure, processes, and membership requirements.

The charter must provide the following:

a. That the audit committee have the responsibility to select, evaluate and where appropriate, replace the audit director and ensure that the audit director be removed only with the approval of the audit committee;
b. That the internal auditor or audit director report directly to the audit committee on substantive matters and that the auditor or audit director be accountable to the audit committee and board of directors; and
c. That both the internal and external auditors have unrestricted access to the audit committee without the need for any prior management knowledge or approval.

The audit committee and board of directors must review, assess the adequacy of, and, where appropriate, amend, the audit committee's charter on an annual basis, amend the charter at other times as appropriate, and re-adopt and re-approve, respectively, the audit committee charter not less than every three years.

Examiners should perform a close evaluation of the audit committee's processes since the inability of the FHLBank's external or internal audit function to identify significant internal control deficiencies indicates potential weaknesses in the FHLBank's corporate governance and external/internal audit function.

Management Responsibilities-General

There is a direct relationship between the overall safety and soundness of an FHLBank and the quality of its management. In assessing management, examiners should consider management's qualifications, its fulfillment of its duties and responsibilities, and its performance related to strategic goals and objectives. In addition, examiners should consider whether management has established satisfactory risk controls over operations and business, and complied with applicable laws and regulations.

While the board of directors and management must work in concert to ensure the safe and sound operation of the FHLBank, each has its own distinct role and responsibilities to fulfill. The CEO and other members of the senior management team must have the expertise necessary to assist the board in managing the FHLBank. All members of the senior management team should possess the same fundamental qualifications as the CEO: integrity, financial and management experience, technical competence, and character. Effective senior management must also possess and demonstrate the leadership qualities necessary to coordinate and organize resources and guide and motivate personnel to achieve the institution's objectives.

Senior management of an FHLBank should regularly advise the board of directors as to the FHLBank's activities and corresponding risks to ensure that directors are fully informed about activities and potential operational or financial problems. This advisory role is critical to the success of the board of directors since the board is removed from the day-to-day operations of the FHLBank and accurate, relevant, useful, and timely information is necessary for sound decision-making by the board.

Senior management of an FHLBank is also responsible for implementing any corrective actions specified by the board of directors. This includes management's willingness and ability to take timely corrective action in response to audit, review, and examination findings and recommendations. Supervisory authorities look to management to implement corrective action directed by the board and regulatory requirements. Procedures should be established to ensure continuing compliance with applicable law, regulation and Finance Board policy, as well as those of the FHLBank. A corrective action must be responsive to the cited criticism, and implementation of appropriate action must be timely and effective.

Examples of specific senior management responsibilities include, but are not limited to, the following:

1. Develop strategic and operational plans and risk management policies for approval by the board of directors;
2. Implement strategic and operational plans and risk management policies following approval by the board of directors;
3. Assess and implement an effective internal control environment and risk management process to address and monitor critical processes and mission activities of the FHLBank;
4. Establish procedures and controls to address compliance with key laws and regulations applicable to the FHLBank;
5. Develop and implement management information systems that adequately address the FHLBank's business environment and risk profile;
6. Develop written policies, procedures, and standards to address critical processes and mission activities and controls of the FHLBank;
7. Establish procedures to identify, report, assess and correct deviations from key standards, risk tolerances, and controls in a timely manner; and
8. Implement timely corrective action on significant control deficiencies and issues that

were reported by the FHLBank's external or internal auditors, and governmental authorities.

Senior management must ensure that all FHLBank functions are carried out in accordance with policies established by the board of directors and that the FHLBank has adequate systems in place to effectively monitor and manage risks. In addition, senior management must ensure that the FHLBank maintains internal risk controls appropriate for its size, activities, and business and that the FHLBank's MIS produces information that is timely, accurate, and complete.

The responsibilities of senior management also include maintaining an organizational structure that clearly assigns responsibility, authority, and relationships, establishing adequate performance incentives and personnel management systems; and hiring middle managers with appropriate professional skills, experience, and integrity.

In making an overall assessment of FHLBank's senior management, examiners should evaluate whether senior management has provided adequate guidance in the critical activities of the institution and has established adequate processes to manage, monitor, and control key risks. Specific responsibilities include, but are not limited to the following:

Management processes

Examiners must assess the effectiveness of the board of directors' and senior management's oversight of the FHLBank and evaluate the quality of their decision-making processes. In making such an assessment, examiners should evaluate the processes established by the FHLBank's board of directors and senior management to manage the organization. Those processes include strategic planning, policies and procedures, internal control systems, MIS, and human resource management. The examiner's review should focus on the level of involvement of directors and senior management in these processes.

a) Strategic and operational planning. Strategic and operational planning is an organized and continuous process ensuring that projections of the future operating environment influence current decisions. In its simplest terms, strategic and operational planning is the process of determining where the FHLBank is, where the board of directors and senior management believe it should be, and how the board and senior management plan to get there. Planning can be divided into two components: strategic planning, which is an ongoing process that focuses on long-term deployment of resources to achieve goals and operational planning, which concentrates on short-term actions that flow logically from the strategic plan and are revised periodically, and includes an annual operating budget.

   Well-developed and executed strategic business plans represent projections about the future of the FHLBank. In order to be effective, planning must be dynamic and well-supported. Projections must be revised periodically as circumstances change and new strategies must be devised to meet stated objectives. The board of directors' and senior management's attention to this area and the extent to which plan objectives are met are two of the best indicators of board and management capability. The most important ingredient in an effective planning process is the commitment and involvement of the FHLBank's board of directors and senior management to this process.

Effective planning provides other benefits for the FHLBank. By minimizing the element of surprise and maximizing the institution's ability to manage change effectively, planning provides an approach to decision-making that best assures the continuing and consistent health and growth of an FHLBank. Effective planning also provides a basis for monitoring and measuring the performance of the institution.

The quality of the strategic business plan is dependent on the effectiveness of the planning process. While the planning process is continuous, it begins with the formulation of the board of directors' overall philosophy and vision for the FHLBank's future. Planning that is integrated into the management process can assist managers in accomplishing their work and benefit the entire organization. Frequently, deficiencies noted in the plan are the result of flaws in the planning process. Attention to details in the design and implementation of the plan should reduce the risk of failure. The following elements enhance planning and should be incorporated into the planning process:

1. Complete endorsement from both senior management and the board of directors;
2. Full participation at the board of directors and all management levels; the planning process should identify who should be involved, determine the appropriate form and timing of the involvement, provide an opportunity for participation, and ensure that participation occurs;
3. A planning policy that is formally documented and outlines the steps for completing the planning process;
4. Assigned responsibilities for developing and implementing the plan;
5. Effective communication of expectations and planned actions to those responsible;
6. An adequate information system that provides management and the board of directors with timely, accurate, consistent, and appropriate information needed to allow for monitoring performance in accordance with the strategic business plan;
7. Measurable goals, objectives, strategies, and action plans;
8. Contingency plans that identify probable emergency or contingency conditions and their expected impact;

9. Flexibility to reflect changes to the institution's operational environment;
10. Review and follow-up to determine completeness, consistency, and accuracy; the board should review and approve the final plan;
11. Effective implementation, including prudent decision-making, commitments of resources, and consistent and clearly stated performance standards based on planned goals and objectives; and
12. Formalized monitoring and control systems that evaluate progress against the plan and identify weaknesses in the implementation of the plan.

The success of business planning is dependent on strategic planning for all significant areas of the FHLBank's operations, and includes effective planning and utilization of human resources and MIS.

b) Policies and procedures. Policies and procedures are an essential ingredient in any management system. The FHLBank Act and Finance Board regulations require the FHLBanks to adopt policies and procedures for all key critical activities of the institution. The extensiveness of an FHLBank's policies and procedures governing any function or activity should depend upon the significance of the function or activity, and the degree of risk its presents, as well as the organization of the FHLBank. Examiners should consider both the costs and the benefits of requiring the adoption of more extensive policies and procedures when assessing these.

Evaluating the FHLBank's policy-making process involves assessing policies and procedures of the FHLBank as a whole, as well as policies and procedures of specific FHLBank activities and operations. The review of the FHLBank's policy-making process should be closely coordinated with the examiners' reviews of other areas of examination interest at the FHLBank. Significant deficiencies in specific policies or procedures may result in adverse financial or other conditions and generally indicate weaknesses in the FHLBank's policy-making process.

Policies are guides for achieving the established objectives and strategies of the institution. Procedures are the steps taken to implement policies. Both policies and procedures are necessary to ensure sound business practices. The board of directors is responsible for formulating sound policies. The board must ensure that policies and procedures are appropriate for the FHLBank and consistent with strategic goals, objectives, and risk tolerances. Senior management is responsible for implementing the board's policies through the development of procedures.

Although the board of directors usually delegates the day-to-day conduct of the FHLBank's business to senior management, the board is fully and ultimately accountable for the consequences of unsound or imprudent policies and the lack of policy guidance.

The purpose of policy-making is to provide guidance to FHLBank staff for making decisions and taking actions. Policies prescribe a course of action that is expected to achieve a particular goal. The anticipated effects of those goals on the organizational structure, financial condition and performance, product and service offerings, and marketing, as well as consistency with FHLBank's strategic direction and risk tolerance limits, should be considered in policy development.

Policies provide for future planning, taking into account the unique characteristics of the FHLBank and the board of director's goals and objectives. Policies must establish responsibility for managerial decisions and provide a mechanism for the necessary coordination between different departments within the institution. The board of directors must provide a clear framework of policies within which executive management must operate and administer the FHLBank's activities. Policies should be stated in broad terms to allow for varying situations, and periodically reevaluated and modified when necessary.

Policies generally should incorporate the following six principal elements:

1. Purpose and objective – the purpose of the policy should be clearly defined. The policy should also define the objectives that are to be accomplished.
2. Operating parameters – the policy should specify the parameters within which management and staff are expected to operate. The parameters should be consistent with Finance Board regulations, federal and state law, and Generally Accepted Accounting Principles. The parameters should also ensure the safety and soundness of the FHLBank, adequately control risk, and be compatible with the FHLBank's risk profile.
3. Authorities delegated to management – the authorities delegated to management should be clearly defined, consistent with the risk profile of the FHLBank, and within the operating parameters, regulations, and laws.
4. Authorities retained for board of directors approval or action – the authorities not delegated to senior management and retained by the board of directors should be clearly stated in the policy.
5. Process for addressing exceptions – the policy should provide a clearly defined process to address exceptions to the operating parameters.
6. Reporting requirements – the policy should describe what is to be reported to the board of directors, the frequency and content of the reports, and the individual responsibilities for preparing the reports.

Procedures detailing the planned implementation of policies should be developed and include steps for obtaining appropriate board approval for exceptions. Procedures should be reevaluated and modified when necessary. Procedures should be consistent with adopted policies and generally establish the following:

1. Purpose and objective;

2. Tasks to be performed;
3. Responsibilities of positions involved;
4. Appropriate departmental interactions;
5. A clear sequence of actions or steps to be taken to accomplish the objectives of the procedures and provide adequate controls; and
6. Sufficient detail to provide adequate direction to intended users.

The board of directors and senior management are responsible for ensuring that policies and procedures are thoroughly understood at all levels of the FHLBank. Without adequate communication, polices and procedures may not be properly implemented.

c) Internal controls. Internal controls represent measures undertaken by FHLBank management to enhance the likelihood that established objectives and goals will be achieved. FHLBank management should ensure that it plans, organizes, directs, and controls a sufficient number of actions to reasonably assure that the organization's goals and objectives will be achieved. Internal controls may be preventive (to deter undesirable events from occurring), detective (to detect and correct undesirable events which have occurred), or directive (to cause or encourage a desirable event to occur).

FHLBank senior management is responsible for the identification and evaluation of the institution's risk exposures and establishing an effective and efficient internal control environment that promotes the following:

1. Reliability and integrity of financial and operational information;
2. Effectiveness and efficiency of operations;
3. Safeguarding of assets; and
4. Compliance with laws, regulations and contracts.

The internal control environment represents the collective effect of various factors that establish, enhance, or mitigate the effectiveness of specific management processes. The evaluation of the internal controls provides the examiner a basis for assessing FHLBank management's effectiveness in overseeing the activities of the institution.

The evaluation of the internal control environment is a key factor in assessing a board of directors' and senior management's oversight of the FHLBank's activities. Examiners should consider the following factors when performing this assessment:

1. Management philosophy and operating style. Management's philosophy and operating style encompass a broad range of characteristics applicable to both the board of directors and executive management which could affect the

internal control environment. Specific examples include the approach to taking and monitoring the FHLBank's risks exposures, attitudes and actions with respect to financial reporting, adequacy of and compliance with policies and procedures, and emphasis on planning, budget, earnings, housing finance and community investment activities, and other financial and operating goals.

2. Organizational structure. Organizational structure provides the overall framework for the internal control needed to ensure effective planning, organizing, directing and controlling of the FHLBank's activities. The institution's size, diversity, and complexity of operations affect the level of control required. An organizational structure also includes consideration of the form and nature of an FHLBank's major business units and related management functions and reporting relationships. In addition, an organizational structure should provide the framework for the assignment and responsibility within the FHLBank in an appropriate manner.

3. Methods of assigning authority and responsibility. Methods of assigning responsibility affect the understanding of reporting relationships and responsibilities established within the FHLBank. Specific methods of assigning responsibility include consideration of:

   a) Policies regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct;
   b) Assignment of responsibility and delegation to address matters that relate to organizational goals and objectives, operating functions and regulatory requirements;
   c) Employee job descriptions delineating specific duties, reporting relationships and constraints;
   d) Performance standards; and
   e) Computer systems documentation indicating the procedures for authorizing transactions and approving system changes.

   In assessing the methods of assigning authorities and responsibilities, consideration should be given to how certain duties are assigned. Generally, no one person should have the authority to perform or approve all aspects of a particular function. For example, the duties associated with the requisition, approval, recording and reconciliation of a particular transaction should not be assigned to the same employee. Also, duties should be periodically rotated and/or performed by other employees during leave of absences. Limiting and rotating duties can control the ability of one person to make significant errors or perpetrate significant irregularities without timely detection.

4. Human resources management (HRM). HRM focuses on effective personnel management and involves placing and employing personnel in an

organization's structure through selection, appraisal, compensation, and development programs. HRM is not an isolated element of organizational management and it is integral to other corporate processes such as planning, organizing, directing and controlling. An effective HRM program should include the following:

a) Board of directors-approved personnel policies and practices that address the FHLBank's ability to employ competent personnel to accomplish the FHLBank's goals and objectives. Personnel policies and practices should address compliance with laws and regulations, hiring, evaluating, training, promoting, compensating and retaining employees, as well as providing the necessary resources to enable them to properly discharge their responsibilities.

   An FHLBank should have a board of directors-approved equal employment opportunity (EEO) policy that addresses the following practices:

   1. Hiring and disciplinary action;
   2. Compensation, assignment, or classification of employees;
   3. Transfer, promotion, layoff, or recall;
   4. Job advertising and recruitment;
   5. Testing;
   6. Use of company facilities;
   7. Training and apprenticeship programs;
   8. Fringe benefits;
   9. Pay, retirement plans, and disability leave; and
   10. Other terms and conditions of employment.

   Examiners should verify that compliance with the FHLBank's EEO policy and operating practices is evaluated by the FHLBank's internal auditors and periodic reports are made to the board of directors as to the status of policy compliance. Examiners should be alert to any current or potential litigation or other claims implicating the FHLBank's EEO policy that may indicate weaknesses in the institution's risk management, governance and internal control structure.

b) Employee performance accountability that requires management to evaluate and review job performance, usually through a performance evaluation system. Evaluating and reviewing performance provides an internal control to promote, monitor, and evaluate adherence to policies, procedures, laws and regulations. The process also allows for the detection and correction of weaknesses in operating systems and records and provides management with a means of establishing and maintaining control over delegated duties.

5. <u>External influences.</u> External influences are influences established and exercised by parties outside the FHLBank that affect the institution's operations and practices. These influences include the Finance Board and external auditors. While external influences are outside the FHLBank's authority, such influences can heighten management's consciousness of, and attitude toward, the conduct and reporting of the FHLBank's activities. They may also affect management's attitude toward compliance with law, regulation and policy. Outside parties may also prompt management to establish specific internal control structure policies or procedures.

   External influences also can adversely affect the effectiveness of internal controls. For example, competitive pressures may result in lending staff relaxing or even circumventing certain credit standards. Additionally, key officers or employees may take inappropriate actions when their personal financial interests (bonuses, performance awards) depend unduly upon short-term operating results or financial condition of the FHLBank. Examiners should be alert to circumstances outside the FHLBank that may lead employees, officers, and even directors, to pursue activities and actions that could adversely affect the interests of the FHLBank.

6. <u>Management Information Systems.</u> MIS comprises the system(s) that the FHLBanks employ to obtain, generate, and report information needed to make decisions, plan, monitor, and oversee the institution's risk exposures and activities effectively. MIS incorporates both automated and manually operated systems, as well as the manner in which information flows through the institution and is reported to the board of directors and management.

   The board of directors is responsible for determining the FHLBank's information needs and the most effective means of fulfilling them. Consequently, the board should communicate its expectations as to the reporting of information to management through formal written policies. The policies should identify what information is to be reported, with what frequency, and when. In addition, sufficient policy direction should be in place to ensure that the information is accurate, complete, and presented in usable format. Policies also should address the extent to which automation and integration of the various information sources and systems should be employed to enhance reliability, usability, and efficiency.

   Direction by an FHLBank's board of directors should specifically address the information needed to monitor and oversee the FHLBank's risk exposures and activities. Monitoring and oversight is required to ensure that the FHLBank is progressing toward stated objectives and that failure to comply with or weaknesses in operating standards and risk tolerances are identified and corrected. The board should periodically assess the adequacy of MIS meeting these objectives. The review should determine whether MIS provides sufficient information to:

a) Review and assess performance relative to the strategic business plan and policy objectives;
b) Evaluate compliance with the operating policies, delegated authorities, and reporting requirements outlined in policies;
c) Assess compliance with laws, regulations, and sound business practices;
d) Determine the financial condition and performance of the institution;
e) Determine the condition of the loan portfolio, other major assets, as well as liabilities;
f) Identify and evaluate operational deficiencies that increase the risk of loss or reduce efficiencies; and
g) Evaluate the status or corrective actions on previously identified weaknesses.

Examiners should evaluate the specific information needs and reporting requirements for each area of the FHLBank. The amount of information and frequency of reporting should be dependent upon the risk exposures and overall effect on the safety and soundness of the institution.

7. <u>Litigation and other legal matters</u>

Current or threatened litigation, or other legal claims, can pose significant costs to the FHLBanks. Whether legal issues give rise to unenforceable contracts, lawsuits, adverse judgments, forgone business opportunities, loss of mission/strategic focus, or diminished reputation, they can disrupt the operations of an FHLBank, possibly reducing earnings and capital and damaging the FHLBank's image in the marketplace. FHLBank boards of directors and senior management must properly assess and manage the risks associated with litigation and other legal matters.

Litigation exposure can result from either FHLBank-initiated or third-party-initiated litigation. FHLBank-initiated litigation results when the institution's management initiates legal proceedings and may involve proceedings to enforce the FHLBank's contract rights, recover debts or obligations; foreclose on property; or recover damages caused by insiders or third parties. In some cases, FHLBank-initiated litigation gives rise to countersuits. Third-party litigation occurs when an action has been threatened or commenced against an FHLBank and may involve allegations of errors, omissions, violations of law, or damages.

Examiners should assess the potential impact of current or threatened litigation or other legal claims upon the financial condition, performance and reputation of the FHLBank, as well as determine whether the issues indicate weaknesses with the FHLBank's risk profile, governance and internal control structure.

8. External and internal audit programs. External and internal audit programs are integral components of an FHLBank's internal control environment. Internal audit is an independent appraisal function that contributes to the effectiveness and improvement of risk management, control, and governance systems. The objective of internal auditing is the evaluation of the adequacy and effectiveness of the internal control structure. These evaluations are used by management at all levels in the effective discharge of their responsibilities.

   The role of an FHLBank's internal audit function is to assist management in attaining the FHLBank's goals by providing an independent and objective assurance and consulting service designed to add value and improve operations through independently reviewing and evaluating the effectiveness of operations and controls and by providing objective analyses and constructive recommendations. Management retains full control over the implementation of these recommendations.

   The responsibility of the internal audit function extends beyond that of external auditors with respect to the reliability and integrity of information. External auditors are primarily concerned with the internal control structure relevant to a financial statement audit, which includes an evaluation of the FHLBank's ability to record, process, summarize, and report financial data consistent with the assertions in the financial statements, while the internal audit function is also concerned with controls over the effectiveness, economy, and efficiency of management decision-making processes that do not relate to a financial statement audit.

Regulatory Environment

The primary authorities governing, or relevant to, the structure, duties and responsibilities of FHLBank boards of directors and senior management are set forth below. The discussion below does not address the application of authorities other than the FHLBank Act and the regulations, interpretations and issuances of the Finance Board to the FHLBanks. The examiner should ensure that the application of such authorities to an FHLBank has been considered by the FHLBank and its legal counsel.

1) Federal Home Loan Bank Act.

Section 7 of the FHLBank Act states that "…the management of each FHLBank shall be vested in its board of directors," and that "the board of directors shall administer the affairs of the bank fairly and impartially without discrimination in favor or against any member borrower...." Section 7 also addresses the size and composition of the board of directors, the selection of directors, directors' terms, and director compensation. *(See* discussion of Section 7 in FHLBank Environment, below.)

2) ***Rules and Regulations of the Federal Housing Finance Board,*** which include the following parts and sections relevant to board of directors and senior management oversight:

Part 915 of the Finance Board regulations sets forth the responsibilities of the FHLBanks and Finance Board in the election and appointment of FHLBank directors as well as director eligibility requirements.

Part 917 of the Finance Board regulations addresses the powers, responsibilities and accountability of FHLBank boards of directors and senior management by prescribing standards for a corporate governance framework.

Part 918 of the Finance Board regulations requires each FHLBank to annually adopt a written compensation policy that adheres to standards prescribed in the regulation.

Part 933 of the Finance Board regulations requires each FHLBank board of directors to submit a capital structure plan to the Finance Board that complies with Parts 931 and 932.

Part 951 of the Finance Board regulations requires, among other things, the board of directors of each FHLBank to adopt a written affordable housing program (AHP) implementation plan that contains the information specified in Section 951.3.

Section 955.6 of the Finance Board regulations establishes risk-based capital requirements applicable to acquired member assets (AMA) acquired by FHLBanks that have not yet converted to their capital structure plans under Part 933.

Section 956.4 of the Finance Board regulations establishes risk-based capital requirements applicable to certain investments acquired by FHLBanks that have not yet converted to their structure capital plans under Part 933.

Section 966.9(b)(1) of the Finance Board regulations requires, among other things, written quarterly certifications from the president of each FHLBank as to compliance with the liquidity requirements set forth in Section 11(g) of the FHLBank Act and the Financial Management Policy For The Federal Home Loan Bank System adopted by Finance Board or any Finance Board regulation (*see* Section 932.8).

Part 980 of the Finance Board regulations requires the FHLBanks not undertake any new business activities, as defined in the regulation, except in accordance with the procedures set forth in Part 980 of the Finance Board regulations.

Part 989 of the Finance Board regulations establishes audit and related requirements applicable to financial statements of the FHLBanks, Office of Finance and Financing Corporation.

Part 998 of the Finance Board regulations requires each FHLBank, among other things, to register a class of its equity securities pursuant to the provisions of Section 12(g) (1) of the Securities Exchange Act of 1934 and thereafter to comply with the periodic disclosure requirements of that act.

3) Advisory Bulletins of the Federal Housing Finance Board that provide supervisory guidance relating to the topic of oversight by the board of directors and senior management are the following**:**

Advisory Bulletin 01-4, dated February 14, 2001, provides guidance on the avoidance by FHLBank boards of directors and staff of conflicts of interests. In addition to Finance Board regulations, FHLBanks should consider authoritative industry guidance and guidance provided by other bank regulators.

Advisory Bulletin 01-8, dated October 4, 2001, provides guidance regarding asset review, classification and reporting.

Advisory Bulletin 02-2, dated February 13, 2002, provides guidance regarding the annual report required from each FHLBank under Section 917.5 that analyzes and describes the FHLBank's performance in achieving quantitative performance goals for products related to multi-family housing, small business, small farm and small agri-business lending.

Advisory Bulletin 02-3, dated February 13, 2002, and Advisory Bulletin 03-2, dated February 10, 2003, provide guidance on the considerations that FHLBank boards of directors should address in the formulation of their business continuity plans.

Advisory Bulletin 02-5, dated April 8, 2002, provides guidance on the role of the internal auditor in an FHLBank's development of its annual risk assessment.

Advisory Bulletin 02-6, dated April 9, 2002, provides guidance on the quarterly liquidity certification that the president of each FHLBank is required to file with the Finance Board under Section 966.9(b)(1).

Advisory Bulletin 02-7, dated August 27, 2002, provides guidance on unsecured credit reporting requirements by the FHLBanks.

Advisory Bulletin 02-8, dated October 7, 2002, provides guidance on the manner in which an FHLBank should respond to the placement by an NRSRO of an unsecured credit counterparty on “credit watch” for a potential rating downgrade.

Advisory Bulletin 03-1, dated January 3, 2003, provides guidance on the acceleration of filing dates for FHLBank System combined financial reports and FHLBank call reports.

Advisory Bulletin 03-03, dated March 6, 2003, provides guidance to the FHLBanks that permits expanded disclosure in their financial statements under certain circumstances. .

Advisory Bulletin 03-4, dated March 18, 2003, provides guidance on what FHLBanks should include in capital plan amendment submissions for Finance Board approval. The Advisory Bulletin also explains the amount of time that will likely be necessary to complete the Office of Supervision’s review of the FHLBank’s submission.

Advisory Bulletin 03-5, dated April 16, 2003, provides guidance on annual risk assessments required by Section 917.3(c).

Advisory Bulletin 03-6, dated May 9, 2003, provides guidance regarding the FHLBank’s use of NRSRO models for certain loans that may be secured by real property located in Georgia and instructs FHLBanks to evaluate the possible effect that state laws on abusive or predatory practices may have on other assets.

Advisory Bulletin 03-7, dated May 9, 2003, provides guidance regarding requirement in Section 932.5(c) that each FHLBank that that has implemented its capital structure plan under Part 933, annually conduct an independent validation of its internal market risk model.

Advisory Bulletin 03-08, dated August 18, 2003, provides guidance regarding capital management and retained earnings. Among other things, the Advisory Bulletin requires the board of directors of each FHLBank to maintain a complying formal retained earnings policy and to annually assess the adequacy of its retained earnings in the manner described therein.

Advisory Bulletin 03-09, dated October 3, 2003, provides FHLBanks with a uniform methodology for calculations of duration-of-equity in “designated low-rate environments,” as defined in the Advisory Bulletin.

Advisory Bulletin 03-13, dated December 1, 2003, provides guidance to the FHLBanks on providing financial information to the Office of Finance for inclusion in the FHLBank System combined financial reports the Office of Finance prepares.

Advisory Bulletin 04-01, dated March 10, 2004, provides guidance on FHLBank use of service organizations to perform critical activities for the FHLBank's operations, particularly AMA programs.

Advisory Bulletin 04-2, dated May 13, 2004, establishes a minimum standard for minutes of board of directors and board committee meetings, including all general and executive sessions and board committee meetings.

Advisory Bulletin 04-5, dated September 29, 2004, provides guidance on interest rate risk management. Among other things, the Advisory Bulletin describes the policies, procedures, and internal controls, as well as risk measurement monitoring and reporting systems, that an FHLBank should maintain to measure and manage its interest rate risk exposure.

Advisory Bulletin 05-04, dated April 21, 2005, provides guidance related to regulatory reporting and REFCORP and AHP assessment calculations in connection with the adoption of Statement of Accounting Standards Number 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity."

Advisory Bulletin 05-05, dated May 18, 2005, provides guidance as to the risk management oversight responsibilities of the board of directors and senior management.

Advisory Bulletin 05-06, dated June 10, 2005, provides guidance on the process through which an FHLBank may obtain approval to make changes to a previously approved internal market risk model.

Advisory Bulletin 05-08, dated August 25, 2005, provides guidance concerning the Finance Board's assessment of required FHLBank anti-predatory lending mortgage purchase and advance policies. The Advisory Bulletin sets out required contents for such policies and processes for their establishment and dissemination to members.

Advisory Bulletin 06-02, dated March 20, 2006, provides guidance on the documentation and validation of quantitative financial models by the FHLBanks and Office of Finance. The Advisory Bulletin establishes standards for governing policies, documentation, validation programs and market value reporting.

Advisory Bulletin 06-03, dated July 18, 2006, provides guidance on the circumstances under which an FHLBank may disclose "unpublished information," as defined in Part 911, in SEC filings.

4) ***Regulatory Interpretations of the Federal Housing Finance Board*** are the following:

2000-RI-6, Accounting Issues: Independent Auditor's Review of Quarterly Financial Information, dated June 23, 2000, is an interpretation of the Section 985.6(b)(1) that, among other things, requires each FHLBank and the combined FHLBanks to comply with an SEC rule requiring quarterly reviews by independent auditors of financial information the FHLBanks provide to the preparer of the FHLBank System's combined quarterly financial reports, as well as of the resulting financial reports.

2000-RI-24, Accounting Issues: Audit Committee Disclosures, dated September 19, 2000, notes adoption of an SEC rule requiring companies' inclusion in their proxy statements of audit committee reports and certain disclosures set forth in the rule. The Regulatory Interpretation requires FHLBanks to include in their annual reports the report of their audit committees and certain disclosures set forth in the Regulatory Interpretation.

5) ***Sarbanes-Oxley Act and regulations and interpretations of the Securities and Exchange Commission thereunder.***

   The statute was enacted in response to various corporate scandals, and addresses various corporate governance requirements that relate to the responsibilities of corporate boards of directors, the external and internal audit function, and the quality of a corporation's internal controls and the accuracy of its financial reporting.

6) ***Foreign Corrupt Practices Act of 1977*** makes it unlawful for a U.S. and certain foreign persons to make a corrupt payment to a foreign official for the purpose of obtaining or retaining business for or with, or directing business to, any person. The Act also requires companies whose securities are listed in the United States to make and keep books and records that accurately reflect the transactions of the companies and to devise and maintain an adequate system of internal accounting controls.

7) ***Reports and other issuances of the Basel Committee on Banking Supervision (Basel Committee).*** The Basel Committee is a committee of banking supervisory authorities established by the central bank Governors of the Group of Ten countries in 1974. It includes senior representatives of banking supervisory authorities and provides guidance and recommendations on sound supervisory standards worldwide, including those related to capital standards, risk management, internal controls, internal audit, corporate governance, and other areas central to the safe and sound operation of banks and other financial institutions.

8) ***Statements of Financial Accounting Standard adopted by the Financial Accounting Standards Board*** establish standards of financial accounting and reporting governing the preparation of financial reports and are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants (AICPA).

9) ***Regulations and interpretations of the Securities and Exchange Commission.*** The SEC is the federal agency that is principally responsible for enforcing the federal securities laws and regulating the United States securities markets. The federal securities laws require issuers of securities to disclose meaningful information about their business and financial condition.

10) ***Professional standards adopted by the American Institute of Certified Public Accountants Professional Standards.*** The AICPA is the national, professional organization for certified public accountants. Its mission is to provide members with the resources, information and leadership that enable them to provide professional services to benefit the public as well as employers and clients. In fulfilling its mission, the AICPA works with state certified public accountant organizations and gives priority to those areas where public reliance on certified public accountant skills is most significant.

11) ***Government Auditing Standards*** provides standards for audits of government organizations. The standards pertain to auditors' professional qualifications, the quality of the audit effort, and the characteristics of professional and meaningful audit reports.

12) ***Reports and other issuances of Committee of Sponsoring Organizations of the Treadway Commission***. The Treadway Commission is a private sector initiative established in 1985 and intended to provide guidance on improving the quality of financial reporting by focusing on corporate governance, ethical practices, and internal control.

13) ***Professional standards adopted by the Institute of Internal Auditors***. The Institute of Internal Auditors (IIA) was organized in 1941 to develop and promote the professional status of internal auditing. The organization provides certification, education, research and technological guidance for the profession. The IIA serves as the profession's resource on significant auditing issues worldwide.

FHLBank Environment

The FHLBank Act provides for the management of each FHLBank to be vested in the FHLBank's board of directors and states that each FHLBank is a body corporate. In addition to authorizing certain enumerated corporate and banking powers, the FHLBank Act grants each FHLBank all such incidental powers as are consistent with the provisions of the FHLBank Act and customary and usual in corporations generally. Attendant to the exercise of customary and usual corporate powers, FHLBank boards of directors are subject to the same general fiduciary duties of care and loyalty to which the board of directors of a state-chartered business or banking corporation would be subject.

The duties and responsibilities of an FHLBank director derive from a source different from that of a director of a state-chartered business or banking corporation. Each FHLBank is created in accordance with federal law to further public policy, and its statutory powers and purposes are not subject to change except by the Congress. An FHLBank's board of directors has neither the right nor the duty to alter the purpose of the FHLBank, whereas an ordinary corporate board of directors may approve mergers, consolidations and changes in the corporate charter that could alter the objectives and nature of the business of the corporation. The directors of an FHLBank are responsible for ensuring that the FHLBank achieves the statutorily-mandated mission of promoting housing finance and community lending, and meeting the FHLBank's statutory obligations of making contributions to its AHP and paying a portion of the interest on REFCORP obligations. The board of directors is also expected to ensure that the FHLBank operates in a financially safe and sound manner that is in compliance with law and policy.

In addition to establishing a distinct mission for the FHLBanks and a federally-derived source of duties and responsibilities for each FHLBank director, the FHLBank Act contains other provisions that may distinguish certain features of corporate governance at the FHLBanks from those encountered at a state-chartered business or banking corporation. Thus, Section 7 of the FHLBank Act governs the size and composition of FHLBank boards of directors, the manner of selection of board members, and the terms and compensation of directors. While such differences may influence the manner in which the principles of sound corporate governance, described previously, apply at the FHLBanks, they do not reduce the continuing application of these principles to the FHLBanks.

Examination Guidance

A work program for Board of Directors and Senior Management Oversight accompanies this narrative. What follows below are illustrative examples of attributes that should be considered by the examiner in completing the analyses required in that work program. The evaluation of the adequacy of the board of directors' and senior management's oversight and management of the FHLBank's business and activities should be coordinated with evaluations being conducted by examiners responsible for the review of other FHLBank functions and activities in order to avoid duplication of effort.

1) *Organizational structure and communication*

Evaluate the effectiveness of the FHLBank's organizational structure and reporting lines, the quality and timeliness of its management reporting, the appropriateness of its staffing and the expertise of its staff. This evaluation may include: the roles and responsibilities of board of directors committees; roles and responsibilities of management and management committees; board of directors and management reports; technical competence of staff; efficiency and effectiveness of the organizational structure; appropriateness of reporting lines; segregation of duties;

communication between business lines; approved and actual staffing levels; human resource policies; and information technology support. Specific examples include, but are not limited to, the following:

a) FHLBank's organizational documents, including organizational certificate and bylaws;
b) FHLBank's organizational chart and approved staffing charts;
c) Roles and responsibilities of business lines and managers;
d) Composition and role of formal and informal board of directors, management and staff committees, including membership, composition, expertise, duties and responsibilities, frequency of meetings, attendance, minutes, holding of executive sessions, periodic reporting, and other matters;
e) Adequacy of monitoring reports that are provided to the board of directors and management committees to enable them to formulate decisions and monitor the FHLBank's performance and compliance with established policies, procedures regulatory requirements and internal controls;
f) Adequacy of management information systems to identify, measure, monitor and control risks;
g) Human resource policies, including the establishment of performance objectives for management and staff;
h) Information technology project initiatives, standards and performance;
i) Status of development or implementation of new products, services and business activities;
j) Reporting and analysis of local and national economic conditions that may affect the FHLBank's business and operations; and
k) Reporting and analysis of FHLBank System and legislative issues that may affect the FHLBank's business and operations.

An examiner may gain insight into an FHLBank's internal communication and the decision-making process by observing management and working committee meetings during the examination. If possible, the examiner should consider attending portions of board of directors and board and management committee meetings during the examination. The examiner should arrange his or her attendance at any such meetings in advance with the presiding officer.

2) Board of Directors

Assess the abilities of the directors of the FHLBank and the effectiveness of the board of directors in establishing an appropriate strategic direction for the FHLBank, retaining capable senior management and overseeing management's performance in the safe, sound and lawful operation of the FHLBank and achievement of the its financial and mission-related goals and objectives.

This assessment may include: the degree of active involvement by the board of directors in determining a strategic direction for the FHLBank that promotes its long-term financial health, safety and soundness and statutory mission; formulating plans and policies in furtherance of that strategic direction; providing supervision over the affairs and senior management of the FHLBank; ensuring that the interests of the FHLBank are paramount, even where the promotion of these interests may conflict with the interests of member institutions (including the interests of members whose representatives serve as directors of the FHLBank); and ensuring that the CEO and other members of senior management have the necessary skills, knowledge, experience and sense of judgment to manage the FHLBank's affairs in a safe and sound manner. The following attributes may be considered in evaluating performance of the board of directors:

a) Mission statement of the FHLBank;
b) Definition of the risk tolerance philosophy for the FHLBank;
c) Adequacy of materials provided to the board of directors and board committees in preparation for board or committee meetings and minutes of such meetings *(see* Section 1, above);
d) Adequacy of established policies, procedures and internal controls to address potential conflicts of interest or undue influence by a director or senior officer upon decisions of the FHLBank's board of directors or any committees thereof, or upon the institution's activities (*see* Section 5, below);
e) FHLBank survey of director experience and skills to identify training needs; assess the adequacy of training programs provided to the board of directors for new director orientation and for assistance in understanding and monitoring the FHLBank's activities as well as for understanding the duties and responsibilities of FHLBank directors;
f) Adequacy of and compliance with the FHLBank's process for fulfilling its responsibilities related to the nomination of appointive directors under Part 915, including procedures for identifying potential appointive directors, assessing their eligibility and qualifications, and nominating them to Finance Board within the timeframes established in Section 915.10;
g) Board of directors oversight of FHLBank management's performance and compensation, including:
    i) The establishment and periodic review of performance goals for management that are specific and measurable and are consistent with the FHLBank's achievement of the goals and objectives contained in its strategic and operational plans as well as the requirements of laws and regulations and principles of safety and soundness;
    ii) The establishment and periodic review of compensation which is reasonable in view of an officer's performance and the condition, operating performance and risk profile of the FHLBank;
    iii) The establishment and periodic review of employment agreements (including any "golden parachute" provisions thereof) with members of management that are consistent with the performance and compensation standards established

by the FHLBank;

iv) The review of officer promotions to ensure that these are reasonable in light of professional qualifications and demonstrated performance of the individuals involved as well as reflective of the needs of the FHLBank.

h) The degree of the board of directors' involvement in the strategic and operational planning process, such as active participation in plan formulation or active dialogue with management on the management-generated plan (versus passive acceptance and approval of management-generated plan) (*see* Section 7, below); and
i) Oversight of the FHLBank's affordable housing and community investment activities.

In order to fully the evaluate the effectiveness of governance by the FHLBank's board of directors, the examiner should consider interviewing the chairman of the board of directors, the chairman of the audit committee, and at least one other director who is an appointed director to evaluate their understanding of the FHLBank's business and operations (including its affordable housing and community investment activities), business strategy, legal environment, internal policies and processes to monitor compliance with such policies, and their duties and obligations as FHLBank directors.

3) Senior Management

Assess the abilities and performance of senior management staff and its performance in the safe, sound and lawful operation of the FHLBank and achievement of financial and mission-related goals and objectives. This assessment may include: the qualifications of management; the extent to which management has fulfilled its duties and responsibilities; management's performance in achieving financial and mission-related goals and objectives established in the FHLBank's strategic and operational plans; and the extent to which management adequately controls risks presented by the FHLBank's business and operations, as well as complies with laws and regulations. The following should be considered in evaluating this area:

a) Experience and technical competence;
b) Character and integrity;
c) Engagement and cooperation among business lines;
d) Depth and succession (*see* Section 1, above);
e) Consistency of action with corporate mission objectives, or "tone at the top";
f) Risk tolerance philosophy;
g) Compliance with the requirements of law and regulation, and as well as with prudent safety and soundness parameters (*see* Section 9, below);
h) Development of strategic and operational plans, and risk management policies (*see* Section 7, below);
i) Accountability for the achievement of strategic and operational goals, including

adequate review and discussion of the status of plan implementation at board of directors and committee meetings, and of any failure to achieve plan targets and of action proposed either to overcome obstacles to achievement or to revise plans (*see* Section 7, below);

j) Development and implementation of an effective internal control environment and risk management process appropriate for the size, activities and business risks of the FHLBank (*see* Section 6, below);
k) Development and implementation of management information systems that are adequate in light of the FHLBank's business environment and risk profile (*see* Sections 1, above, and 6, below);
l) Development of written policies, procedures and standards to address critical processes and mission activities (*see* Section 5, below);
m) Establishment of procedures to identify, report, assess and correct deviations from standards, risk tolerances and controls in a timely and effective manner (*see* Section 6, below);
n) Willingness and ability to take timely corrective action in response to audit, review and examination findings and recommendations (*see* Section 8, below);
o) Establishment of performance goals and objectives for the administration of employee salary and incentive programs (*see* Section 1, above);
p) Reliability and integrity of financial information (*see* Section 7, below);
q) Effectiveness and efficiency of operations (*see* Section 1, below); and
r) Supervision of and involvement in administration of the FHLBank's affordable housing and community investment activities.

4) Key policies, procedures and approved practices

Evaluate the adequacy of the FHLBank's key policies, procedures and approved practices, their implementation, and the FHLBank's compliance with these.

The following policies have a direct relationship to corporate governance activities and may be considered by the examiner in making this evaluation:

a) Board of directors governance policies;
b) Code of business conduct and ethics;
c) Conflicts of interest and indemnification policies;
d) Directors and senior management compensation, expenses and travel policies;
e) Equal employment opportunity policy;
f) Human resources policies, including the evaluation of hiring and employment practices that include employee-related issues, such as background checks, leave policies, disciplinary actions, staff turnover and salary surveys;
g) Management succession plans;
h) Retained earnings and dividend policies; and
i) Training policy.

The following policies are also be reflective of corporate governance strengths and weaknesses, but may receive primary review in connection with the examination of other FHLBank functions or activities**:**

a) Allowance for loan loss policy;
b) Anti-fraud policy;
c) Anti-predatory lending policy; and
d) Asset review and classification policy;
e) Business continuity plan;
f) Credit and collateral policies;
g) Information security policy;
h) Member product policy;
i) Market risk policies;
j) Model validation policy;
k) Policies governing the FHLBank's affordable housing and community investment activities; and
l) Vendors' risk policy.

5) Management and control processes

Assess the adequacy of the FHLBank's risk management, internal and external audit, information technology and general internal control processes. Specific examples include, but are not limited to, the following:

a) Adequacy of the annual risk assessment report and annual risk assessment process;
b) Effectiveness of the enterprise risk management structure and process;
c) Adequacy of the risk management policy;
d) Adequacy and appropriateness of delegations of authority;
e) Effectiveness of the internal audit program, including coverage of the board of directors' and senior management's oversight and management of the FHLBank's business and operations (refer to conclusions derived from the review of the FHLBank's internal and external audit functions);
f) Effectiveness of procedures implemented to periodically attest to the adequacy of the control environment, as required under the Sarbanes-Oxley Act;
g) Adequacy of evaluation and periodic testing of the FHLBank's internal control structure by the internal audit and external audit functions, outside consultants, risk management function, as well as through SAS 70 reports and self-assessments (refer to conclusions derived from the review of the FHLBank's internal and external audit functions);
h) Potential impact of pending or threatened litigation; and
i) Adequacy of testing of the FHLBank's business continuity plan.

6) Financial reporting and planning processes

Evaluate the accuracy and reliability of the FHLBank's financial statements, the effectiveness of its financial planning process and the adequacy of financial condition and performance. The following should be considered in evaluating financial management of the FHLBank:

a) Accuracy and reliability of financial statements, including issues and comments raised by the FHLBank's external auditors and the SEC (refer to conclusions derived from the review of the FHLBank's financial reporting operations);
b) Accounting expertise and philosophy;
c) Adequacy of financial condition and performance, including performance relative to internal targets and FHLBank System averages (refer to conclusions derived from the review of the FHLBank's financial condition and performance);
d) Adequacy and appropriateness of dividend and retained earnings policies;
e) Appropriateness of the business model and business plan;
f) Validity of the strategic plan and budget (refer to conclusions derived from the review of the FHLBank's strategic planning process); and
g) Strategies for the management of member and asset concentrations.

7) Responsiveness to previous examination and audit findings

Evaluate the promptness and effectiveness of actions by the FHLBank's board of directors and senior management to address findings made by regulatory authorities or the FHLBank's risk management function, internal and external audit functions, or outside consultants.

8) Compliance with laws, regulations and supervisory policies and guidance

Assess the adequacy of the FHLBank's compliance with laws, regulations and supervisory policies and guidance.

9) Assessment of Board of Directors and Senior Management Oversight

Summarize the results of the activity or function examined in a separate memorandum. The memorandum should clearly and specifically describe the basis and analysis for the assessment. The memorandum should discuss the quality and effectiveness of oversight by the board of directors and senior management (strong, satisfactory, supervisory concern, unacceptable) based upon the assessments made in Sections “1” through”8,” above.

In addition, the examiner should consider the implications of examiners' evaluations of market, credit, and operational risk, and risk management, financial condition and performance, and affordable housing and community investment administration when developing the memorandum. A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.

10) Items requiring follow-up at the next examination or visitation.

Identify key issues that have been communicated to management or the board of directors (oral or written) that require follow-up during the next on-site visitation.