

Statement of
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of the
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of the
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Mr. Chairman, Ranking Member Johnson, and Members of the Subcommittee, I appreciate the opportunity to speak to you today about the Federal Home Loan Banks. My name is Terry Smith, and I am President and CEO of the Federal Home Loan Bank of Dallas. I am also the current Chairman of the Bank Presidents Conference of the Federal Home Loan Banks (FHLBanks). Along with my colleagues, I am pleased to provide an update on the FHLBanks' activities and our progress implementing the FHLBank provisions of the Gramm-Leach-Bliley Act (GLB Act).

Overview of the FHLBanks

The FHLBanks were created in 1932 to support America's housing finance system. It was largely the FHLBanks' ability to raise long term debt in the capital markets and pass that funding along to their member financial institutions that encouraged the development of the 30 year fixed rate mortgage that is the predominant financing tool in the United States mortgage finance system today.

The FHLBanks continue to play a vital role in the nation's housing finance and community lending system. Our member institutions, primarily community banks and thrifts, use the FHLBanks' advances program to meet the mortgage and community lending needs of their local markets, and use our Affordable Housing Programs to make housing more affordable for thousands of low income families in those communities. These are our primary purposes, and we are proud of our accomplishments in carrying them out.

The FHLBank System, as it is sometimes called, is comprised of 12 individual FHLBanks, their 8,080 member institutions, and the Office of Finance which issues debt on behalf of the FHLBanks. Each FHLBank is a separate and distinct corporate entity with its own stockholder / member institutions and its own board of directors. While the FHLBanks issue debt collectively and are jointly and severally liable for the repayment of those debt obligations, there is no single controlling corporate entity with responsibility for or authority over the FHLBanks. The 12 FHLBanks operate independently under the authority granted by Congress through the Federal Home Loan Bank Act (Bank Act), as amended, and in accordance with the

regulations established by and under the regulatory oversight of the Federal Housing Finance Board (Finance Board).

The FHLBanks are cooperative institutions that operate within districts originally established by the Federal Home Loan Bank Board, the predecessor to the Finance Board. Each FHLBank's capital stock is owned only by its member institutions, and only a FHLBank's members (plus certain non-member housing associates such as state housing authorities) may conduct business with an individual FHLBank.

FHLBank members must meet certain statutory eligibility criteria. Each member must purchase the FHLBank's capital stock in order to become a member, and must maintain capital stock holdings sufficient to support its business activity with the FHLBank, either in accordance with the statutory formula or, for FHLBanks that have already implemented the capital plans required by the GLB Act, in accordance with the individual FHLBank's capital plan.

A FHLBank's capital stock cannot be issued to or held individually by members of a FHLBank's board of directors, its management, its employees or the public, and is not publicly traded. There is no market for FHLBank capital stock other than among FHLBank members. The price of a FHLBank's capital stock cannot fluctuate, and all FHLBank capital stock must be purchased, repurchased or transferred only at its par value. There are no stock options or other forms of stock-based compensation for FHLBank management, directors or employees.

Prior to the passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, the FHLBanks' membership was generally limited to thrift institutions (building and loan associations, savings and loan associations, savings banks, homestead associations, etc.) and a handful of insurance companies. FIRREA expanded eligibility for membership to include commercial banks and credit unions with a demonstrated commitment to housing finance. The GLB Act further refined FHLBank membership rules by making federally chartered thrifts voluntary members for the first time and eliminating the remaining statutory differences in the terms of access between thrift institutions and commercial banks and credit unions.

The combination of the FIRREA and GLB Act statutory changes, along with changes in the mortgage lending market, have caused FHLBank membership to expand exponentially in the last decade. As of June 30, 2003, the 12 FHLBanks had a total of 8,080 member institutions, which included 6,037 commercial banks, 1,273 thrift institutions, 693 credit unions, and 77 insurance companies.

As an indication of the role the FHLBanks play in today's financial system, the FHLBanks' 7,310 commercial bank and thrift institution members represent approximately 79 percent of all FDIC-insured institutions in the country. Reflecting the structure of the depository institutions industry, approximately 6,519 (or 89 percent) of those FDIC-insured members are Community Financial Institutions (CFIs), as defined by the GLB Act. (CFIs are FDIC-insured institutions with average total assets for the three years ended December 31, 2002 of \$538 million or less.) Altogether, approximately 7,493 member institutions (93 percent of all members) as of June 30, 2003 were community lenders with total assets less than \$1.0 billion.

As noted previously, every member institution has made a voluntary decision to belong to a FHLBank. Among other things, that means that the FHLBanks must offer, and continue to provide, a membership value proposition that members perceive as adding value to their institutions. The value the FHLBanks provide our members is a blend of the modest dividends we pay on members' capital stock investment, the value of access to stand-by liquidity from the FHLBanks, availability of short and long term funds at attractive rates, and access to other products that make a community lending institution better able to profitably serve the credit needs of its community.

The FHLBanks' primary product offerings include traditional advances (fully secured loans to member institutions) and the more recently introduced Acquired Member Asset (AMA) programs. Advances represent the core of the FHLBanks' business, providing a source of funds members can use to support mortgage lending and, for CFIs, other community banking assets. The AMA programs, through which the FHLBanks acquire mortgage loans originated by member institutions under risk-sharing rules and other parameters established by Finance Board

regulations, provide a secondary market alternative for those loans. In addition, the FHLBanks offer favorably priced advances for members' special community lending activities under their Community Investment Cash Advances (CICA) programs, and competitive grant programs that provide funds for housing for low-income families under Affordable Housing Programs (AHP) established following FIRREA.

Implementation of Gramm-Leach-Bliley Legislative Changes

Since the enactment of the GLB Act in November 1999, a principal focus of the FHLBanks has been the implementation of the FHLBank provisions contained in Title VI of that Act. The modifications to the Bank Act made by the GLB Act represented the culmination of many years of effort to reform the FHLBanks, particularly the membership rules and capital structure. The main purposes of the FHLBank provisions were to establish a system of universal voluntary membership, provide for a more permanent capital structure to accommodate voluntary membership, equalize the terms of access to the FHLBanks for all types of institutions eligible for membership, and to expand the types of collateral that community banks can pledge to secure advances. I am pleased to report that the FHLBanks are in the last stages of implementing those changes and fulfilling that purpose.

Before FIRREA, the membership of the FHLBanks was comprised almost entirely of thrifts that were required to be members by terms of their charter or deposit insurance. FIRREA authorized commercial banks to become voluntary members, but most thrifts continued as mandatory members. In addition, the terms of access to the FHLBanks for newly eligible institutions, including capital stock purchase requirements, differed from the requirements for thrift institutions. It quickly became evident that this disparate treatment was inconsistent with the cooperative structure of the FHLBanks and was not needed to ensure that thrift institution members had adequate access to the FHLBanks. As a result, the FHLBanks and their members urged Congress to amend the Bank Act to provide for universal voluntary membership and equal terms of access.

The system of total voluntary membership has been successfully implemented. All members now have the same rights to access FHLBank products and services. In particular, the higher capital stock purchase requirements for advances to commercial banks and credit unions based on their different asset mix have been eliminated, which has enabled community bank members better access to advances and, in turn, to better serve the credit needs of their customers. And, although FHLBank membership is now voluntary for all, only a handful of institutions whose business model did not benefit from FHLBank membership have taken the opportunity to withdraw from membership.

Community banks historically have had a somewhat different customer base than thrift institutions, often spreading their lending activity among the various types of loans needed in the community, such as mortgage, small business and small farm loans. In recognition of this fact and in order to allow the FHLBanks to better serve their members' needs, the GLB Act authorized the FHLBanks to make advances to CFIs secured by small business and small farm loan collateral. The FHLBanks have successfully and responsibly implemented this new authority, acting prudently as secured lenders to assign appropriate lending values to the new collateral and maintain their record of never having suffered a credit loss on an advance to a member. As a result, the new collateral authority has enabled community bank members to better serve their communities.

In order to implement universal voluntary membership, while at the same time providing for capital with more permanence, the GLB Act outlined a new capital structure for the FHLBanks. The major differences include authorization to issue two classes of capital stock – Class A stock redeemable with six months notice and Class B stock redeemable with five years notice – and implementation of new leverage, risk-based and total capital requirements. This new framework adds permanence to the FHLBanks' capital structure by requiring them to maintain sufficient Class B stock plus retained earnings to meet the new risk-based capital requirements.

The GLB Act created a series of statutory deadlines for adoption of new capital regulations by the Finance Board and adoption and implementation of new capital plans by the

individual FHLBanks. All of the relevant deadlines have been met and the FHLBanks are well on their way to implementing their new capital plans. In fact, six FHLBanks have already implemented their new capital plans, I believe another FHLBank will implement its plan later this year, and the remaining five FHLBanks will implement their plans by mid-2005. Each FHLBank has developed its capital plan in consultation with its members and in accordance with the Finance Board's regulations. The plans have been well received thus far, with only a very few members exercising their right to withdraw from membership before implementation.

In general, the provisions of the GLB Act have been very positive for the FHLBanks and their members. These changes have had, and will continue to have, a positive impact on the Banks' ongoing ability to fulfill their statutory role, and to do so safely and soundly.

Federal Home Loan Banks Financial Profile

Reflecting the expansion of their membership base, the overall growth in the banking industry, and increased usage of FHLBank advances and AMA programs, the 12 FHLBanks have grown considerably in the last decade. As of June 30, 2003, the FHLBanks had combined total assets of \$809 billion. The FHLBanks' balance sheets were supported by nearly \$38 billion of capital, of which more than \$36 billion represented capital stock contributed by member institutions. The FHLBanks' aggregate capital-to-assets ratio was 4.7 percent at June 30, with capital ratios for individual FHLBanks ranging from 4.2 to 5.6 percent.

Of the FHLBanks' total assets, \$596 billion (74 percent) represented direct funding of member assets through advances and AMA. The FHLBanks' aggregate advances were \$506 billion at June 30, representing 63 percent of their combined balance sheets, and AMA were \$90 billion, accounting for about 11 percent of the FHLBanks' aggregate assets. The remaining \$209 billion (26 percent) of the FHLBanks' balance sheets were comprised primarily of various highly rated investments that the FHLBanks hold to maintain a ready supply of liquidity to satisfy member demand for advances and AMA, and to supplement earnings to keep advances rates low and maintain adequate returns on members' capital stock investment. Approximately \$78 billion of the FHLBanks' investments were in short term instruments such as federal funds sold or

commercial paper used by the FHLBanks to warehouse liquidity to meet members' credit needs and the FHLBanks' other day-to-day obligations.

The FHLBanks also maintain longer term investment portfolios that provide a source of standby liquidity and supplement earnings so the FHLBanks can provide advances and other credit products at attractive rates. At June 30, 2003, the FHLBanks' longer term investment portfolio represented about 16 percent of their total assets and included \$23 billion in securities issued by the U.S. government or U.S. agencies, approximately \$6 billion of securities issued by state or local housing agencies to support their housing finance activities, and approximately \$98 billion of mortgage-backed securities. The FHLBanks' mortgage-backed securities have been purchased in accordance with Finance Board guidelines not to exceed three times an individual FHLBank's total capital. These securities are all issued by the U.S. government or U.S. agencies, or rated triple-A when they are purchased by the FHLBanks.

After weathering the storm of the thrift crisis of the late 1980s and its aftermath, the FHLBanks have been consistently profitable throughout the past decade. Although actual earnings and rates of return have fallen with the decline in interest rates over the last three years, this reduction in earnings is a natural and expected result of the way the FHLBanks are structured and how they operate. Because the FHLBanks are wholesale institutions investing primarily in fully secured advances, high credit quality mortgage loans or highly rated investment securities, they operate on very narrow interest spreads between their cost of funds and the yields on their assets. It is typical for a FHLBank to have a net interest spread (the difference between the cost of its liabilities and the yield on its assets) of about 20 basis points (0.20 percent). By way of comparison, a commercial bank might have an interest spread closer to 400 basis points (4.0 percent). Given the FHLBanks' small interest spreads, a much greater proportion of the FHLBanks' earnings are derived from the investment of capital than is the case for commercial banks.

Before paying dividends to members, the FHLBanks' earnings from these and other sources must cover the FHLBanks' operating expenses and assessments. These assessments include the expenses of the Finance Board and the FHLBanks' obligations to contribute 20

percent of their earnings toward the payment of interest on REFCORP bonds issued in the early 1990s to help finance the cost of resolving the thrift institution crisis, and an additional 10 percent to fund their own regional AHP.

As interest rates have fallen (particularly short term interest rates such as the federal funds rate which is now at 1.0 percent), the return on a FHLBank's investment of its capital has necessarily fallen as well. If a FHLBank could completely insulate itself from interest rate risk by perfectly match funding all of its assets and maintaining a constant interest spread as interest rates fall, it would expect its rate of return on invested capital to fall about 75 basis points (0.75 percent) for every 100 basis point (1.0 percent) reduction in interest rates.

Because of this dynamic, the FHLBanks' earnings and rates of return generally rise and fall with the level of interest rates, and our dividend rates follow suit. In the case of the Dallas Bank, we paid dividends at an average rate of 6.36 percent in 2000 when the average federal funds rate was about 6.25 percent, while we expect to pay dividends at an annual rate of 2.0 percent in the third quarter of this year, with the federal funds rate at 1.0 percent.

Our experience indicates that this result fits very well with our members' investment expectations. Members do not invest in FHLBank capital stock with the expectation of earning equity investment returns. Rather, members' investment in FHLBank capital stock represents a very low risk asset with explicit returns in the form of dividend payments that fluctuate with market interest rates, and overall benefits that include the value of access to FHLBank funding. The FHLBanks do not attempt and are not expected to produce rates of return comparable to other equity investments.

Corporate Governance of the FHLBanks: The Role of the Board of Directors

Congress established a unique ownership and governance structure for the FHLBanks, which has served the FHLBanks well in the past and continues to do so. The most critical feature of this structure is that the FHLBanks are wholly owned by their members/customers. In addition, the boards of directors of the FHLBanks are truly independent of management. No

member of management may serve as a director of a FHLBank, and management is precluded by regulation from recruiting directors or participating in the election of directors.

The Bank Act provides that a majority of each FHLBank's directors be elected by its member institutions from among officers and directors of those institutions. Members vote for directors representing member institutions from their states. The FHLBanks' members currently elect approximately 57 percent of the FHLBanks' directors in this way, with the remaining directors being appointed by the Finance Board.

Not only are members assured of the ability to elect the majority of their FHLBank's directors, the Bank Act also provides that no member may cast a number of votes greater than the average number of shares all the members in its specific state are required to hold. This prevents large members holding relatively large amounts of a FHLBank's capital stock from dominating director elections and, in practice, means that the majority of each FHLBank's elected directors generally represent the small institutions that make up the great majority of all members.

The statutory framework that controls the composition of the FHLBanks' boards of directors ensures that each FHLBank's board of directors will have a balance of interests represented. With no members of management on the board of directors, directors are in a position to independently oversee management actions. The members that contribute capital and benefit from the FHLBank's products and services are assured a majority of the directors. The director election voting preferences for small members ensure that larger members cannot dominate the board of directors and that a FHLBank's policies will not be detrimental to small members. Finally, the large contingent of appointed directors ensures that the FHLBanks will appropriately consider their public policy obligations.

Finance Board regulations require that the FHLBanks' boards of directors not only fulfill the typical corporate director duties of care and loyalty, but that they also carry out specific responsibilities. These duties include, but are not limited to, the responsibility to select and oversee management, the responsibility to ensure the establishment and maintenance of an

adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, and a member products policy that details the Bank's credit and pricing policies, and the responsibility to approve the FHLBank's annual operating budget and quarterly dividends.

In carrying out their responsibilities, the boards of directors typically establish and act through committees. Finance Board regulations require each FHLBank's board of directors to have an audit committee with very specific regulatory responsibilities, including direct oversight of the FHLBank's internal and external audit functions. The boards of directors also typically establish other committees to facilitate their oversight of management. Committees vary from FHLBank to FHLBank, but typically include risk management, human resources and housing oversight functions. The various elements of the FHLBanks' corporate governance structure combine to provide boards of directors that are active, knowledgeable, and engaged, and that are fully aware of their responsibilities and take them seriously.

Regulatory Oversight of the FHLBanks

The combination of this governance structure and the regulatory oversight provided by the Finance Board make the FHLBanks among the most intensively audited entities in the country. As noted above, each FHLBank has its own independent internal auditor, who actively and regularly audits all FHLBank operations and reports directly to the board of directors. In addition, each FHLBank's financial statements are reviewed by an outside accounting firm (currently PricewaterhouseCoopers). Finally, the Finance Board's "primary duty" under the Bank Act is "to ensure that the Federal Home Loan Banks operate in a financially safe and sound manner."

The Finance Board is not limited by funding constraints in carrying out its declared focus of ensuring the FHLBanks' safety and soundness because its funding is provided by assessments on the FHLBanks that are not subject to review or challenge by the FHLBanks. The Finance Board not only has regulatory authority over the FHLBanks that extends beyond that which is typically afforded a safety and soundness regulator – the GLB Act extended to the Finance

Board the regulatory enforcement powers of both the federal banking regulatory agencies and the Office of Federal Housing Enterprise Oversight (OFHEO) and – but also has wide-ranging authority over many aspects of FHLBanks’ operations.

Finance Board regulations govern every facet of the FHLBanks’ operations, from advances pricing to eligible collateral to risk management to capital plans to directors’ responsibilities to new business activities. The Finance Board also collects and monitors financial and risk management data from the FHLBanks each month, performs ongoing reviews of all aspects of the FHLBanks’ operations and conducts annual on-site examinations of all 12 FHLBanks. While the FHLBanks do not always enjoy being subjected to regulatory scrutiny, all believe that it is essential that the FHLBanks have a strong, independent regulator with the resources to ensure the FHLBanks’ safety and soundness.

Risk Management of the FHLBanks

As 12 independent institutions, all the FHLBanks are responsible for their own risk management activities. Each FHLBank has its own risk profile and approaches management of its risks in a slightly different way. However, there are a number of factors that are held in common across the FHLBanks that enable each FHLBank individually, as well as the Consolidated Obligations (COs) issued by the 12 FHLBanks collectively in the capital markets, to be rated triple-A.

The cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk profile, and in fact discourages FHLBanks from taking excessive risk. Just as FHLBank members do not expect equity investment returns on their capital stock investment in a FHLBank, they also do not expect equity investment risk in that investment. Members purchase FHLBank capital stock in order to obtain access to FHLBank funding products, and must maintain capital stock investments in the FHLBank as long as they maintain advances outstanding. That is, members provide the capital that supports their advances transactions with the FHLBanks. In that environment, members expect stability, reliability and consistency of returns and credit product pricing. These member expectations are

reflected in the oversight provided by each FHLBank's board of directors, a majority of which is comprised of directors representing and elected by member institutions.

In large part due to the incentives created by the FHLBanks' cooperative structure, risk aversion and conservative risk management practices are ingrained in the corporate culture. That same conservative approach to risk management is also reflected in both the legal restrictions and the Finance Board's regulatory regime. For instance, the Bank Act and the Finance Board's implementing regulations clearly describe and mandate the various limitations on the types of collateral the FHLBanks may accept to secure advances. Regulations limit the types, amounts and required credit ratings on both short and long term investments the FHLBanks make with surplus funds. Finance Board regulations include separate additional restrictions on the aggregate amount, ratings, and characteristics of mortgage-backed securities the FHLBanks may purchase and hold.

In addition, Finance Board regulations require that each FHLBank maintain a Risk Management Policy, reviewed at least annually and re-adopted at least every three years by its board of directors, which identifies specific risk management practices and limits for the individual FHLBank. These practices and limits are monitored by the FHLBanks' internal audit departments, which report their findings directly to the FHLBanks' boards of directors. The Finance Board also monitors FHLBank compliance with these and other regulatory requirements through monthly call reports, constant off-site monitoring, and annual on-site examinations.

The FHLBanks are also subject to very conservative capital requirements imposed by statute in the GLB Act and by Finance Board regulations implementing those statutory requirements. These requirements specify that FHLBanks must have total capital equal to at least 4.0 percent of their total assets, and must have sufficient permanent capital (as defined by the GLB Act) to meet a risk-based capital regime established by Finance Board regulation.

The FHLBanks minimize credit risk by ensuring that advances are fully secured, that their investments are limited to issuers or securities that are highly rated at the time the investments are made, and that their AMA have appropriate risk-sharing features. No FHLBank

has ever suffered a credit loss on an advance to a member in the FHLBanks' 71 year history. As of June 30, 98 percent of the FHLBanks' investment securities have long term ratings of triple-A or the corresponding highest short term ratings. In addition, due in large part to the risk sharing structure of the AMA programs, the FHLBanks' loss experience on AMA assets has been very favorable.

Since each FHLBank's primary activity is to serve as a financial intermediary, the FHLBanks are also subject to market (or interest rate) risk. To the extent the individual maturities of a FHLBank's assets are not exactly matched by the individual maturities of its liabilities, the FHLBank's future earnings stream is subject to fluctuation due to changes in the relationship between yields on its assets and the cost of its liabilities. Complicating the picture is the fact that the FHLBanks hold assets (such as mortgage loans and securities) or have issued liabilities (such as callable debt) that can be repaid prior to their stated maturities. Further complicating the issue is the fact that the FHLBanks' narrow interest spreads do not provide a large margin of error.

To manage these risks, each FHLBank uses sophisticated financial models to continually assess the magnitude of the risk to the FHLBank's estimated market value or earnings from various changes in interest rates. This information is reported to the FHLBank's board of directors on a regular basis and to the Finance Board as often as monthly, and is summarized in the FHLBanks' combined financial statements.

Reflecting the FHLBanks' conservative approach to interest rate risk management, the 12 FHLBanks' "duration gaps," or (generally) the difference between the estimated average maturity of a FHLBank's assets and the estimated average maturity of its liabilities, ranged from negative 1.4 months to positive 1.6 months as of June 30, 2003. A duration gap of 1.6 months generally means that the weighted average expected maturity of a FHLBank's assets is 1.6 months longer than the weighted average expected maturity of its liabilities.

The FHLBanks use interest rate derivatives extensively to maintain their conservative interest rate risk profile. While much has been written about the potential risks that can be

created by the improper use of derivatives, the manner in which the FHLBanks use derivatives is a key component of their risk management activities. A couple of facts are germane to an understanding of the FHLBanks' use of derivatives.

First, Finance Board regulations prohibit the use of derivatives for speculative purposes. That means that every derivative instrument entered into by a FHLBank is designed to hedge (i.e., reduce) an identified risk. Second, a majority of the FHLBanks' interest rate derivative transactions are structured to exactly offset another specific transaction. For instance, a FHLBank may use an interest rate swap to convert the interest payments on a particular fixed rate advance to a floating rate, so that the net payment stream will float in a manner that matches the debt the FHLBank has issued to fund the advance. Similarly, much of the debt the FHLBanks issue is long term, fixed rate, and often callable. The FHLBanks typically convert a large portion of this fixed rate debt to floating rates by executing exactly offsetting interest rate swaps simultaneously with the issuance of the debt. Approximately 82 percent of the FHLBanks' outstanding derivatives as of June 30, 2003 represented these two types of transactions.

While the use of interest rate derivatives is critical to managing the FHLBanks' interest rate risk, derivatives can cause problems if not managed appropriately. The FHLBanks mitigate these risks in several ways. The appropriateness of the FHLBanks' derivatives activities for risk management purposes are validated internally by the use of internal valuation models, by internal audits that often employ external experts to validate a FHLBank's valuation model and hedging practices, by external audits of the FHLBank's derivative valuations, and through the Finance Board's annual on-site examination process.

The use of derivatives can also increase credit and operational risks that must be managed carefully. For instance, derivatives pose credit risk created by the potential for default by derivative counterparties. The FHLBanks mitigate this risk by engaging in derivatives transactions only with highly rated counterparties, and maintaining bilateral collateral agreements with each counterparty that require that the net fair value of derivatives positions be

calculated periodically and collateral exchanged to the extent that the FHLBank is exposed to risk of default beyond some small threshold.

It should be noted that the magnitude of the potential counterparty credit risk of a derivatives portfolio has little to do with the aggregate notional amount of the derivatives. The potential credit risk is represented by the net fair value of the portfolio of derivatives between a FHLBank and a particular counterparty. For instance, the aggregate notional amount of the FHLBanks' interest rate derivatives as of June 30, 2003 was \$694 billion. However, the net fair value of those derivatives represented a fair value loss to the FHLBanks (not including offsetting fair value gains on hedged instruments) of \$16 billion.

Each FHLBank's credit exposure created by its derivatives portfolio is determined by netting the current fair value of the derivatives by counterparty, as provided in the FHLBanks' bilateral collateral agreements. After taking that step, the FHLBanks' total aggregate counterparty credit exposure was \$2.2 billion before taking into consideration collateral held to offset that exposure. After taking collateral into consideration, the FHLBanks' aggregate net exposure was \$435 million, about one-third of the FHLBanks' aggregate retained earnings. Of the FHLBanks' aggregate net exposure, \$125 million of the exposure was to triple-A rated counterparties, \$228 million to double-A rated counterparties, and \$82 million to single-A rated counterparties.

One of the primary operational risks related to derivatives is the risk of inaccurate accounting for those instruments, particularly since the implementation of Statement of Financial Accounting Standard 133, *Accounting for Derivatives and Certain Hedging Transactions* (SFAS 133) in 2001. That statement requires generally that derivatives be carried on the balance sheet at fair value, prescribes the appropriate income recognition for changes in fair value of derivatives, and specifies criteria that must be met in order for hedged instruments to qualify for hedge accounting.

The FHLBanks have gone to great lengths to apply SFAS 133 appropriately and ensure that all derivatives accounting complies with Generally Accepted Accounting Principles

(GAAP). Prior to implementation of the accounting standard, the FHLBanks' controllers formed an inter-FHLBank task force, which included representatives from the FHLBanks' external audit firm, to catalogue the various types of derivatives transactions on the books of the FHLBanks, identify the appropriate accounting treatment for each, and develop an accounting guide used across the 12 FHLBanks to ensure consistency. This task force has remained in place since the implementation of the standard to ensure ongoing accounting consistency and compliance with GAAP. In addition, the FHLBanks' external audit firm reviews each FHLBanks' derivatives accounting as part of its quarterly reviews and annual audits of their financial statements.

FHLBank Financial Reporting and Disclosure

There has been much discussion recently about the appropriate forum for the FHLBanks' financial reporting and disclosure. We believe that it is most important to focus carefully on the precise nature of the issue under consideration. All 12 FHLBanks are fundamentally committed to provide complete and state of the art disclosure consistent with the unique characteristics of the FHLBanks as established by Congress.

Under the FHLBanks' current financial reporting and disclosure regime, the FHLBanks' combined financial statements are required by Finance Board regulation to comply with most Securities and Exchange Commission (SEC) reporting requirements, except those specifically excluded by the regulation. The individual FHLBanks' financial statements are required to be consistent in form and content with the combined financial statements. Both the FHLBanks' combined statements and their individual financial statements comply with GAAP as certified by the FHLBanks' external auditor. In addition, all 12 FHLBanks are evaluating ways to enhance their financial reporting and disclosure in accordance with evolving best practices. As part of that consideration, for instance, it is my understanding that all 12 FHLBanks are currently preparing to voluntarily comply with the requirement for attestation of internal controls as set forth in Section 404 of the Sarbanes Oxley Act, and evaluating the applicability of other aspects of that legislation.

The matter under discussion is not disclosure, but rather the request by the Chairman of the Finance Board and others within the Administration that the FHLBanks voluntarily register with the SEC. The FHLBanks take these requests very seriously and have devoted a great deal of time and resources to considering the appropriate application of SEC standards -- designed for publicly traded companies -- to cooperatives whose capital stock is not traded, has a fixed value and is only held by member financial institutions. In order for our boards of directors to carry out their legal fiduciary duty, they must carefully consider the potential effects of voluntary registration on the FHLBanks, their members and the fulfillment of the FHLBanks' mission.

We are involved in ongoing discussions with SEC staff on how voluntary registration of the FHLBanks would be implemented. While some key threshold issues appear to have been resolved in a workable way, other important issues remain to be resolved, as does the form of the agreement between the FHLBanks and the SEC that would memorialize the resolution of those issues.

Conclusion

Over its long history, the Federal Home Loan Banks have played a vitally important role in supporting their member financial institutions' ability to meet the housing finance and credit needs of their local communities. The FHLBanks remain economically strong today and continue to serve a vital function for their financial institution members and the communities they serve.