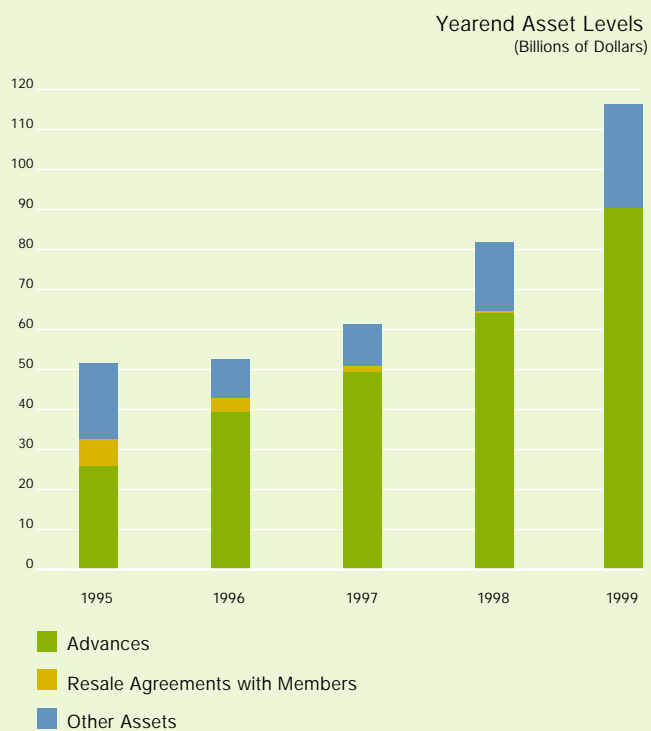


Statements contained in this report, including statements describing the objectives, projections, estimates, or predictions of the future of the Bank, may be "forward-looking statements." These statements may use forward-looking terms, such as "anticipates," "believes," "could," "estimates," "may," "should," "will," or their negative or other variations on these terms. The Bank cautions that, by their nature, forward-looking statements involve risk or uncertainty and that actual results could differ materially from those expressed or implied in these forward-looking statements or could affect the extent to which a particular objective, projection, estimate, or prediction is realized. These forward-looking statements involve risks and uncertainties including, but not limited to, the following: economic and market conditions; volatility of market prices, rates, and indices; political, legislative, regulatory, or judicial events; competitive forces; changes in investor demand for consolidated obligations and/or the terms of interest rate exchange agreements and similar agreements; timing and volume of market activity; and inflation.

**The Year in Review**

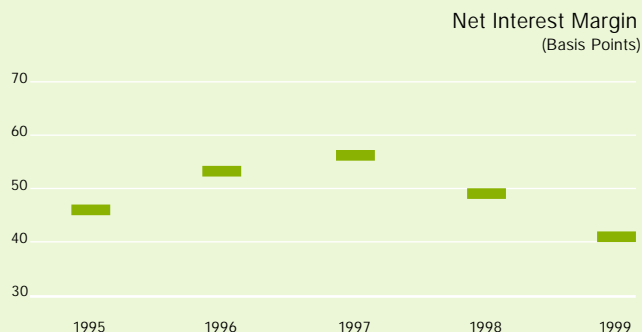
The Bank's advances and total assets grew in excess of 40% during 1999, to record levels of \$90.5 billion and \$115.9 billion, respectively. Advances increased \$26.5 billion, or 41%, and assets increased \$34.8 billion, or 43%. In addition to extending additional credit to members, the Bank increased short-term investment levels 65% during 1999, to \$16.2 billion, to support the overall growth of the Bank and in preparation for the potential increase in members' yearend liquidity needs.



Net interest income increased by \$55.7 million, or 17%, to \$387.0 million, primarily as a result of the growth in advances, money market investments, and member capital. The Bank's net income also included a one-time gain of \$10.5 million from the reversion of surplus assets from the spin-off/termination involving the Bank's cash balance plan. In addition, the sale of the Bank's San Francisco office building resulted in a gain of \$24.1 million. A portion of this gain, \$4.6 million, was recognized in 1999, and the remaining \$19.5 million was deferred and will be amortized to other income over the remaining term of the Bank's 10-year leaseback of the space the Bank occupies. These factors, partially offset by a decrease of \$22.6 million in advance prepayment fees, resulted in net income of \$332.6 million, an increase of \$38.5 million, or 13%, for the year. The return on equity (ROE) was 6.87%, 67 basis points lower than in 1998, primarily as a result of lower average interest rates and lower profit spreads on advances. The higher earnings of the Bank and of the other 11 Federal Home Loan Banks (FHLBanks) in the aggregate lowered the Bank's Resolution Funding Corporation (REFCORP) effective assessment rate relative to the prior year. These results enabled the Bank to pay an annual dividend of 5.36% for 1999 and retain earnings of \$34.0 million.

**Results of Operations**

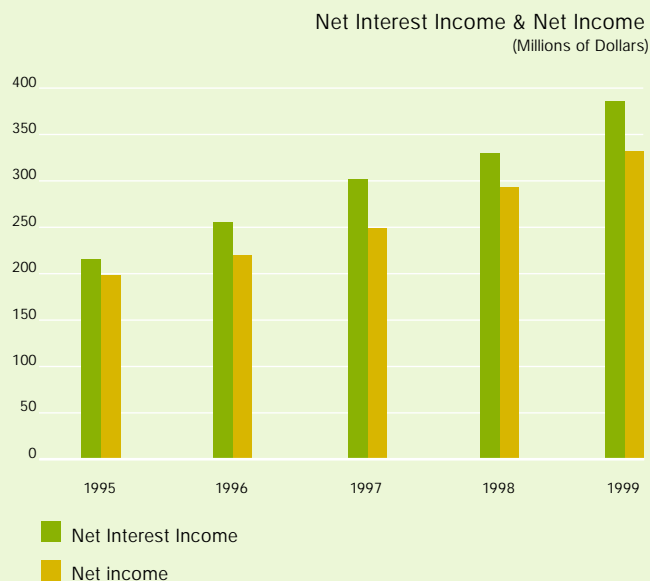
**Net Interest Income.** Net interest income rose \$55.7 million, or 17%, to \$387.0 million in 1999. Average interest-earning assets increased \$26.9 billion, while the net interest margin decreased by 8 basis points, to 41 basis points in 1999 from 49 basis points in 1998. This decrease was primarily due to lower profit spreads on advances resulting from increased competition in the capital markets, lower earnings on invested capital as a result of lower average interest rates during 1999, and an increase in the ratio of assets to capital. The average yield on interest-earning assets in 1999 was 5.35%, compared to 5.68% in 1998, a decrease of 33 basis points. The average cost of interest-bearing liabilities decreased 29 basis points, to 5.23% in 1999 from 5.52% in 1998.



**Non-Interest Income.** Non-interest income consists primarily of prepayment fees collected from members, fees earned on letters of credit, lease income net of related expenses from the Bank's office building in San Francisco (before the building sale), and recognized gains from the spin-off/termination involving the Bank's cash balance plan and the sale of the Bank's office building. Non-interest income decreased to \$20.0 million in 1999 from \$30.4 million in 1998. Prepayment fees decreased to \$2.1 million in 1999 from \$24.7 million in 1998, as \$0.5 billion of advances were prepaid in 1999, compared to \$5.2 billion in 1998. The one-time gain from the spin-off/termination involving the Bank's cash balance plan totaled \$10.5 million, and recognized gains from the sale of the Bank's building totaled \$4.6 million in 1999, partially offsetting the lower prepayment fees.

**Non-Interest Expense.** Non-interest expense increased to \$75.8 million in 1999 from \$67.7 million in 1998, primarily because of a \$3.6 million increase in the Bank's operating expenses and a \$4.3 million increase in the Bank's statutory contribution to the Affordable Housing Program (AHP), which resulted from higher earnings in 1999.

Operating expenses increased 10% in 1999, primarily as a result of a \$2.7 million increase in salaries and benefits. In addition, occupancy expenses increased \$0.5 million as a result of the sale of the Bank's office building and subsequent leaseback of space the Bank occupies. However, because average assets increased 40% in 1999, the Bank's ratio of operating expenses to average assets declined to 4.0 basis points in 1999 from 5.1 basis points in 1998.

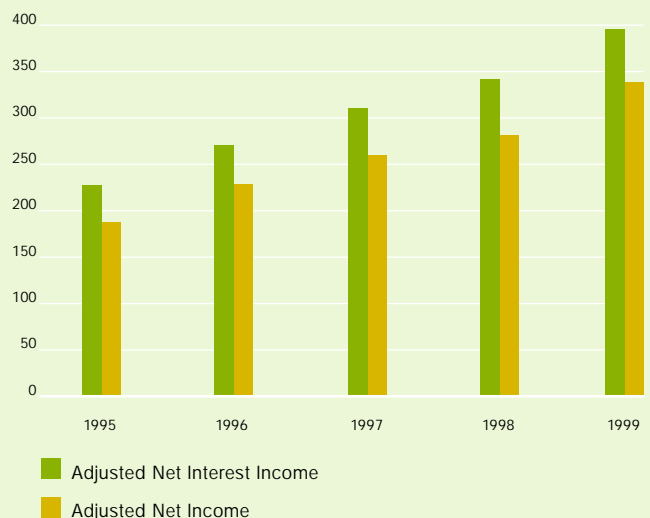


**Adjusted Financial Performance.** The Bank also calculates adjusted financial performance measures that are used by the 12 FHLBanks to provide a more meaningful comparison of the

FHLBanks' financial results over time. These measures reflect earnings before advance prepayment fees, extraordinary gains and losses associated with the early retirement of debt, and other nonrecurring gains and losses related to financial instruments, net of the current amortization of prior period prepayment fees, gains and losses on debt retirement, and other nonrecurring transactions. These adjustments are made in order to recognize prepayment fees, debt retirement gains and losses, and other nonrecurring transactions over the periods remaining through the related instruments' original maturity dates.

Adjusted net interest income rose to \$394.0 million in 1999 from \$339.9 million in 1998, a 16% increase. This improvement contributed to a 20% increase in adjusted net income, to \$337.1 million in 1999 from \$279.9 million in 1998. Adjusted ROE decreased by 22 basis points, to 6.96% in 1999 from 7.18% in 1998, primarily because of lower average interest rates during 1999, which resulted in lower earnings from invested capital.

Adjusted Net Interest Income & Adjusted Net Income  
(Millions of Dollars)



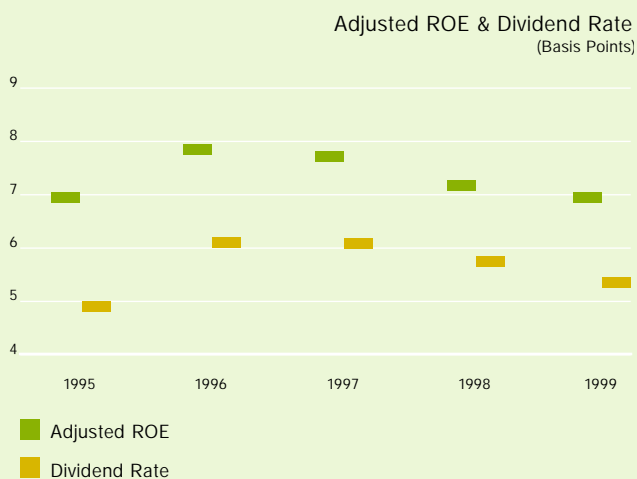
**REFCORP and AHP Assessments.** Through 1999, the 12 FHLBanks combined were required to pay \$300 million per year toward the interest charges on REFCORP debt. These REFCORP payments were recorded as distributions of capital. Initially, each FHLBank was assessed an equal percentage, up to 20%, of its annual net income. If the 20% assessment was not sufficient to pay the full \$300 million, the "shortfall" was allocated among the FHLBanks according to each FHLBank's share of total System advances during the previous year to members of the Savings Association Insurance Fund. (See "Revised REFCORP Assessment" on page 20 for a discussion of the impact the Federal Home Loan Bank System Modernization Act of 1999 will have on the REFCORP assessment

beginning in 2000.) The Bank's REFCORP assessment in 1999 totaled \$47.7 million, 14.3% of the Bank's net income, compared to an assessment of \$48.5 million in 1998, 16.5% of the Bank's net income. High earnings for the System as a whole in both 1999 and 1998 enabled the FHLBanks to meet the \$300 million annual assessment without a shortfall allocation.

Annually, the FHLBanks must set aside for their AHPs, in the aggregate, the greater of \$100 million or 10% of each year's income before charges for the AHP but after capital distributions to REFCORP. To the extent that the aggregate 10% calculation is less than \$100 million, the shortfall is allocated among the FHLBanks based on the ratio of each FHLBank's income before AHP and REFCORP to the sum of the net incomes before AHP and REFCORP of the 12 FHLBanks. There was no shortfall in 1999 and 1998. The Bank set aside \$31.7 million for the AHP in 1999, compared to \$27.4 million in 1998, reflecting the higher earnings recognized by the Bank in 1999.

The Bank's total REFCORP and AHP assessments equaled \$79.4 million in 1999, compared with \$75.9 million in 1998, resulting in an effective "tax" rate on preassessment income of 22%, compared to 24% in the prior year.

**Dividends.** In 1999, the Bank paid \$254.5 million in dividends, an average annual rate of 5.36%. In 1998, dividends totaled \$220.9 million, an average annual rate of 5.76%. All dividends except fractional shares were paid in the form of capital stock. Although the total amount the Bank paid in dividends was higher in 1999, the dividend rate declined by 40 basis points because of lower average interest rates, which resulted in lower earnings on invested capital, and the retention of earnings in 1999.



The Bank is required by Finance Board dividend policy to retain in restricted retained earnings that portion of income from prepayment fees that, if allocated on a pro-rata basis over the maturity of the advances prepaid, would be allocated

to future dividend periods. In addition, other gains and losses related to the termination of interest rate exchange agreements and early retirement of consolidated obligations are similarly treated. These restricted retained earnings will be transferred to unrestricted retained earnings on a pro-rata basis over the original terms of the prepaid advances, interest rate exchange agreements, or consolidated obligations. Retained earnings restricted in accordance with this policy totaled \$10.7 million and \$14.4 million at December 31, 1999 and 1998, respectively.

To provide financial flexibility and in anticipation of the possible effect of implementing SFAS No. 133 (see "Recently Issued Accounting Standard" on page 19), the Board of Directors authorized the transfer of certain amounts from unrestricted retained earnings to restricted retained earnings in 1998 and 1999. During the fourth quarter of 1998, the Bank transferred \$16.3 million, the amount of unrestricted retained earnings as of September 30, 1998, to restricted retained earnings. In addition, during 1999, the Bank transferred, net of applicable assessments, the one-time gain of \$8.1 million from the spin-off/termination involving the Bank's cash balance plan and recognized gains totaling \$3.5 million from the sale of the Bank's office building to restricted retained earnings. Retained earnings restricted by the Board of Directors totaled \$27.9 million and \$16.3 million at December 31, 1999 and 1998, respectively.

In addition to the retained earnings restricted by the Board of Directors, earnings of \$22.3 million in 1999 and \$3.1 million in 1998 were also retained in unrestricted retained earnings. If the Bank had paid the retained earnings restricted by the Board of Directors and the unrestricted retained earnings in dividends, the Bank's dividend rate would have been 6.08% for 1999 and 6.10% for 1998.

**Financial Condition**

Total assets grew 43% during the year, to \$115.9 billion at December 31, 1999, from \$81.1 billion at December 31, 1998, and average total assets rose 40% in 1999, to \$95.9 billion from \$68.6 billion in 1998.

**Advances.** Member advances outstanding increased 41% in 1999, from \$64.0 billion at December 31, 1998, to \$90.5 billion at December 31, 1999, a new all-time high for the Bank. This growth, which continued a trend that began in 1996, caused average advances to members to increase 41% compared to the prior year, to \$74.7 billion in 1999 from \$52.9 billion in 1998. Strong member asset growth, combined with the Bank's competitive pricing strategies, caused members to increase their Bank borrowings, primarily with long-term adjustable rate advances. While many members lengthened maturities and

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Average Balance Sheets

For the Years Ended December 31, 1999 and 1998

(Dollars in millions)	1999			1998		
	Average Balance	Interest Income/Expense	Average Rate	Average Balance	Interest Income/Expense	Average Rate
<b>Assets</b>						
Interest-earning assets:						
Interest-bearing deposits in banks	\$ 1,306.2	\$ 68.5	5.24%	\$ 208.6	\$ 11.4	5.48%
Resale agreements*	2,091.2	110.9	5.31	1,220.0	67.9	5.56
Federal funds sold	6,813.9	354.5	5.20	4,782.7	258.5	5.40
Investments held to maturity*	9,128.3	524.8	5.75	8,061.7	486.5	6.03
Advances to members*	74,689.3	3,970.1	5.32	52,876.0	2,987.4	5.65
Loans to other FHLBanks	8.2	0.4	4.87	11.1	0.6	4.98
Total interest-earning assets	94,037.1	5,029.2	5.35	67,160.1	3,812.3	5.68
Other assets	1,878.3	—		1,468.7	—	
Total Assets	\$95,915.4	\$5,029.2	5.24%	\$68,628.8	\$3,812.3	5.55%
<b>Liabilities and Capital</b>						
Interest-bearing liabilities:						
Consolidated obligations:						
Bonds*	\$76,170.9	\$3,962.1	5.20%	\$53,523.3	\$2,937.4	5.49%
Discount notes*	12,253.8	666.1	5.44	9,232.5	527.7	5.72
Deposits	237.2	11.5	4.87	292.1	14.9	5.11
Borrowings	48.0	2.5	5.14	19.2	1.0	5.14
Total interest-bearing liabilities	88,709.9	4,642.2	5.23	63,067.1	3,481.0	5.52
Other liabilities	2,364.4	—		1,662.8	—	
Total Liabilities	91,074.3	4,642.2	5.10	64,729.9	3,481.0	5.38
Total Capital	4,841.1	—		3,898.9	—	
Total Liabilities and Capital	\$95,915.4	\$4,642.2	4.84%	\$68,628.8	\$3,481.0	5.07%
Net Interest Income		\$ 387.0			\$ 331.3	
Net Interest Margin**			0.41%			0.49%
Total Average Assets/Capital Ratio	19.8x			17.6x		

\* Interest income/expense and average rates include the effect of associated off-balance sheet items.

\*\* Net interest margin is net interest income divided by average interest-earning assets.

locked in funding over yearend in preparation for the Year 2000 rollover, the century date change was apparently not a predominant factor in overall advances growth in 1999. The Bank's largest members accounted for most of the increase during the year; in all, 121 members increased their advance borrowings from yearend 1998 to yearend 1999.

**Investments.** The Bank invests in both short- and long-term instruments to maintain liquidity and provide additional earnings. The short-term investment portfolio is primarily composed of Federal funds sold, resale agreements, and commercial paper. In determining the amount of assets to invest in each class of securities, the Bank considers the yield, liquidity, and credit quality of each instrument. The long-term

investment portfolio, which is composed of mortgage-backed securities (MBS), provides the Bank with higher returns than those available in the short-term money markets. These long-term investments generally have more interest rate risk than the short-term investments; however, the majority of these investments are either funded by long-term debt or hedged with interest rate exchange agreements that reduce the interest rate risk. Most of the fixed and adjustable rate MBS in which the Bank invests are guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae and are collateralized by residential mortgages. To a lesser extent, the Bank invests in publicly-registered AAA-rated non-agency MBS that are also collateralized by residential mortgages. These MBS are subject to prepayment risk, and the adjustable rate MBS are subject to

interest rate cap risk. The Bank has managed these risks by (i) funding the fixed rate MBS with non-callable and callable debt, and (ii) purchasing adjustable rate MBS that are structured with interest rate exchange agreements, which create a synthetic, floating rate asset with a lifetime interest rate cap but without periodic interest rate caps. This structure provides the Bank with a stable income stream over a wide range of interest rates.

During 1998, the Bank adopted a plan to expand its investment portfolio to enhance earnings and provide greater financial flexibility. The MBS investment limit was increased from 200% of capital to 300% of capital. The target investment level for non-MBS investments was increased from 100% of capital to approximately 300% of capital.

The Bank's MBS portfolio increased 24% in 1999, to \$7.0 billion, or approximately 130% of capital, at December 31, 1999, from \$5.7 billion, or approximately 156% of capital, at December 31, 1998. The increase in the Bank's capital and the lack of available MBS investments that met the Bank's risk and return profiles resulted in balances below the targeted level.

The Bank's non-MBS investment portfolio increased 65% during the year, to \$16.2 billion, or approximately 298% of capital, at December 31, 1999, from \$9.8 billion, or approximately 222% of capital, at December 31, 1998. Federal funds sold increased \$3.7 billion, interest-bearing deposits with banks increased \$1.3 billion, commercial paper investments increased \$1.0 billion, and resale agreements increased \$0.3 billion.

*Borrowings.* The Bank funds its assets through the use of FHLBank consolidated obligation bonds and discount notes, which are the joint and several obligations of the 12 FHLBanks. These instruments financed 92% and 91% of average total assets in 1999 and 1998, respectively. Consolidated obligation bonds are long-term, while discount notes are short-term instruments. The Bank uses interest rate exchange agreements to change the effective interest rate terms on many of its consolidated obligation bonds and discount notes.

To fund the Bank's asset growth, total consolidated obligations outstanding increased 45% in 1999, to \$107.4 billion at December 31, 1999, from \$74.0 billion at December 31, 1998. Average consolidated obligations in 1999 were \$88.4 billion, 41% above the \$62.8 billion average in 1998.

To meet the specific needs of certain investors, fixed and adjustable rate consolidated obligation bonds may contain embedded call options or other features that result in complex coupon payment terms. When such consolidated obligations are issued, the Bank simultaneously enters into interest rate exchange agreements with features that offset the complex features of the bonds and, in effect, convert the bonds to con-

ventional adjustable rate instruments tied to an index, such as LIBOR. During 1999 and 1998, the Bank used fixed rate callable bonds that were usually offset with interest rate exchange agreements with a call feature mirroring the option embedded in the callable bond. This combined structure enables the Bank to meet its funding needs at costs not generally attainable solely through the issuance of callable debt.

*Capital and Capital Ratios.* Each member is required to purchase Bank stock based on the amount of its residential mortgage loans, its total assets, or its outstanding Bank advances. Average capital during 1999 was \$4.8 billion, a 24% increase from \$3.9 billion in 1998. This increase was net of redemptions of capital stock totaling \$575.5 million, which primarily resulted from the Bank's new mandatory surplus capital stock redemption policy that went into effect in April 1999. Surplus capital is defined as any excess stock holdings above 115% of a member's statutory capital stock requirement, excluding stock dividends earned and credited for the current year. In accordance with this policy, the Bank redeemed \$413.4 million in surplus capital stock during 1999. Fifty-one new members purchased capital stock in 1999, and a number of members purchased stock to support additional borrowings during the year.

The Bank's ratio of capital to total assets was 4.69% and 5.47% at December 31, 1999 and 1998, respectively. Finance Board regulations generally allow the FHLBank System to issue debt (senior unsecured liabilities, composed primarily of consolidated obligations and deposits) up to 20 times capital (leverage ratio). To facilitate Year 2000-related lending by the FHLBanks, the Finance Board temporarily increased the leverage ratio limit for the FHLBanks to 25 to 1 through June 30, 2000. For an FHLBank to exceed the 20 to 1 leverage ratio limit during this period, the FHLBank's net non-mortgage investments (defined as total investments less mortgage-backed securities, mortgage loan assets, member deposits, member capital investments in the FHLBank, retained earnings, and binding advances commitments) may not exceed 12% of outstanding consolidated obligations for which the FHLBank is the primary obligor. To meet the potential needs of its members, the Bank obtained a waiver from the Finance Board to increase the limit on its net non-mortgage investments to 14% of consolidated obligations and to increase its maximum leverage ratio to 22.5 to 1 through February 29, 2000. As of December 31, 1999, the Bank's leverage ratio was 20.3 times capital and its net non-mortgage investments were 9.9% of its consolidated obligations.

*Off-Balance Sheet Financial Instruments.* In the ordinary course of business, the Bank issues standby letters of credit and enters into various types of transactions that involve interest rate exchange agreements (interest rate swap agreements,

caps, and floors) with off-balance sheet risk. Letters of credit are issued on behalf of members to support their obligations to third parties. The Bank uses interest rate exchange agreements for several purposes. One purpose is to manage its overall interest rate risk profile by adjusting the interest rate sensitivity of its interest-bearing liabilities to be consistent with the interest rate sensitivity of its interest-earning assets. The Bank also provides a variety of products to meet the specific needs of borrowers. Because the financial characteristics of many of these products may not be consistent with the Bank's desired interest rate risk profile, the Bank uses interest rate exchange agreements to modify the financial characteristics of its products to meet the Bank's specific interest rate risk objectives. These instruments are generally negotiated, with terms tailored to meet the specific needs of the Bank and the customer. The Bank may also act as an intermediary between members and third parties for interest rate exchange agreement transactions.

The contractual amounts of letters of credit and notional amounts of interest rate exchange agreements are not recorded as assets or liabilities on the balance sheet. The fees earned by the Bank in connection with letters of credit are recorded as other income. Interest income and expense from interest rate exchange agreements used for risk management purposes are recorded with interest on the instrument being hedged. Interest income and expense from interest rate exchange agreements in which the Bank acts as an intermediary are recorded as other income. In general, gains or losses realized on the termination or redesignation of interest rate exchange agreements, where the related underlying financial instrument remains outstanding, are deferred and amortized over the shorter of the life of the financial instrument that was originally hedged or the period ending on the original maturity date of the interest rate exchange agreement. In general, gains or losses realized on the termination or redesignation of interest rate exchange agreements where the related underlying financial instrument has been terminated are included with the gain or loss on the termination of the underlying financial instrument.

In anticipation of SFAS No. 133 (see "Recently Issued Accounting Standard" on page 19), during 1999 and 1998, the Bank terminated certain interest rate exchange agreements that were hedging existing and anticipated future issuances of discount notes. The Bank realized losses of \$32.3 million and \$13.3 million during 1999 and 1998, respectively, on these terminations. Under SFAS No. 133, the Bank would have been required to mark these agreements to market on January 1, 2001, and periodically thereafter. The amount of the resulting gains and losses would have varied depending on interest rates. The Bank eliminated this accounting uncertainty by terminating the agreements and replacing them, in part, with cer-

tain fixed rate bonds, which will not have accounting volatility under SFAS No. 133. Because the future issuance of discount notes remains probable, the Bank is deferring these losses and amortizing them into interest expense over the remaining terms of the original interest rate swap agreements. The unamortized amount of these losses at December 31, 1999, was \$32.6 million and is included in the carrying amount of discount notes.

As of December 31, 1999, the Bank had interest rate exchange agreements totaling \$124.1 billion (notional amount). Of this amount, \$90.4 billion hedged consolidated obligations, \$31.1 billion hedged advances to members, \$0.8 billion hedged MBS, \$1.4 billion were for intermediated transactions, and \$0.4 billion hedged investments. As of December 31, 1998, the Bank had interest rate exchange agreements totaling \$113.5 billion (notional amount). Of this amount, \$70.2 billion hedged consolidated obligations, \$39.6 billion hedged advances to members, \$1.4 billion hedged MBS, \$2.2 billion were for intermediated transactions, and \$0.1 billion hedged resale agreements.

### Risk Management

**Liquidity.** The Bank is required to maintain liquidity in accordance with the Finance Board's Financial Management Policy, as well as with policies established by the Board of Directors. The Bank needs liquidity to satisfy member demand for short- and long-term funds and to repay maturing obligations. In their asset/liability management planning, members may look to the Bank to provide standby liquidity. The Bank seeks to be in a position to meet its customers' credit and liquidity needs without maintaining excessive holdings of low-yielding liquid investments, creating a funding shortfall, or being forced to incur unnecessary short-term borrowing costs. The Bank's primary sources of liquidity are consolidated obligation bonds and discount notes and short-term investments. Other short-term borrowings, such as Federal funds purchased, securities sold under agreements to repurchase, and loans from other FHLBanks, also provide liquidity.

**Interest Rate Risk.** Underlying the Bank's financial performance is a multifaceted asset/liability management strategy. The Bank monitors and evaluates the effects of interest rate movements on earnings and the market value of equity. Asset/liability strategies are adjusted to manage interest rate risks within prescribed policy limits. The Bank's financial policies establish guidelines and limits for net interest income sensitivity to interest rate changes, basis relationship changes, periodic and cumulative repricing gaps, the sensitivity of the market value of equity to interest rate changes (duration of equity), and liquidity. The Bank also complies with the duration of equity limits and other limits set forth in the Finance Board's Financial Management Policy.

*Interest Rate Sensitivity*

For the Year Ended December 31, 1999

(In millions)	Interest Rate Sensitivity Period			
	6 Months or Less	6 Months to 1 Year	1 to 5 Years	Over 5 Years
<b>Assets</b>				
Interest bearing deposits in banks	\$ 1,702	\$ —	\$ —	\$ —
Resale agreements	2,559	—	—	—
Federal funds sold	8,636	—	—	—
Investments held to maturity	6,133	800	2,574	875
Advances	67,851	3,984	16,783	1,896
Other assets	2,101	—	—	18
<b>Total Assets</b>	<b>\$ 88,982</b>	<b>\$ 4,784</b>	<b>\$ 19,357</b>	<b>\$ 2,789</b>
<b>Liabilities</b>				
Consolidated obligations	\$100,744	\$ 1,673	\$ 3,943	\$ 1,042
Deposits	327	—	—	—
Other liabilities	2,607	—	—	138
<b>Total Liabilities</b>	<b>\$103,678</b>	<b>\$ 1,673</b>	<b>\$ 3,943</b>	<b>\$ 1,180</b>
Interest Rate Exchange Agreements	17,302	(2,414)	(13,442)	(1,446)
Periodic Gap/Invested Capital	\$ 2,606	\$ 697	\$ 1,972	\$ 163

One measure of interest rate risk is the extent to which the interest rates on the Bank's assets and liabilities reprice at different times. The table above shows the interest rate sensitivity of assets and liabilities by repricing periods. The periodic gaps shown in this table represent the net difference between total asset and liability repricings for a specified time period. For example, the periodic gap for the "6 months or less" time period indicates that as of December 31, 1999, there were \$2.6 billion more assets than liabilities that would reprice during the six-month period beginning on December 31, 1999. As shown in the table above, the Bank's repricing gaps are concentrated in the "six months or less" and the "one to five years" categories.

The following table shows the expected percentage change in the net value of all assets, liabilities, and off-balance sheet items (market value of equity) that would result from a 100-basis-point change in interest rates under different interest rate scenarios. At December 31, 1999, the estimated percentage change in the Bank's market value of equity was 1.29%. If interest rates rose 100 basis points, the Bank's market value of equity would be expected to decline approximately 1.29%, and if interest rates fell 100 basis points, the Bank's market value of equity would be expected to increase approximately 1.29%. If interest rates were 200 basis points higher at December 31, 1999, a 100-basis-point additional shift in interest rates would be expected to either decrease or increase (depending on the direction of the interest rate movement) the Bank's market value of equity by approximately 1.95%. If interest rates were 200 basis points lower at December 31, 1999, a 100-basis-point additional shift in

interest rates would be expected to alter the Bank's market value of equity by approximately 0.17%.

*Market Value of Equity Sensitivity*

As of December 31, 1999

Interest Rate Scenario	Average Percentage Change in the Market Value of Equity per 100-Basis-Point Change in Interest Rates
	Actual rates at December 31, 1999
Rates start 200 basis points higher	1.95%
Rates start 200 basis points lower	0.17%

**Credit Risk.** The Bank closely monitors the creditworthiness of the institutions to which it lends funds. The Bank also places great importance on the quality of both the assets that are pledged as collateral by its customers and the securities purchased under agreements to resell. The Bank emphasizes credit monitoring and collateral asset review and valuation to manage the credit risk associated with its lending activities. It also has procedures to assess the mortgage underwriting and documentation standards of its borrowing members. In addition, the Bank has collateral policies and restricted lending procedures in place to manage its exposure to those customers that experience difficulty in meeting their capital requirements or other standards of creditworthiness. The Bank has not experienced any losses on credit extended to any counterparty since its inception. Based upon the collateral held as security and prior repayment history, no allowance for losses is deemed necessary by management.

The Bank has adopted exposure limits for investments that ensure diversification and liquidity. These policies restrict the amounts and terms of the Bank's investment holdings according to the Bank's own capital position as well as the capital

and creditworthiness of the counterparty. In addition, the Bank has invested only in AAA-rated non-agency MBS and MBS that are guaranteed by government-sponsored enterprises (Fannie Mae, Freddie Mac, and Ginnie Mae) and are collateralized by pools of residential mortgages.

The Bank has also adopted policies and exposure limits for off-balance sheet credit exposure. Under these policies, the amount of unsecured credit that may be extended to an individual counterparty is the lower of (i) an amount commensurate with the counterparty's capital and its credit quality, as determined by rating agency credit ratings of the counterparty's debt securities or deposits, or (ii) an absolute credit exposure limit. In addition, the Bank has entered into bilateral security agreements with all active counterparties that provide for delivery of collateral at specified levels to limit credit exposure from off-balance sheet items.

**Concentration Risk.** At December 31, 1999, the Bank had a concentration of advances totaling \$68.9 billion outstanding to two members, representing 76% of total advances outstanding (one member represented 50% and the other represented 26%). At December 31, 1998, the Bank had a concentration of advances totaling \$49.0 billion outstanding to two members, representing 77% of total advances outstanding (one member represented 45% and the other represented 32%). Of the total capital stock outstanding at December 31, 1999, two members held 34.9 million shares, representing 65% of total capital stock outstanding (one member represented 43% and the other represented 22%). At December 31, 1998, two members held 24.9 million shares, representing 56% of total capital stock outstanding (one member represented 33% and the other represented 23%). The Bank manages concentration risk by, among other things, closely monitoring the credit and collateral quality and financial trends of the institutions to which it lends funds, charging market-based prepayment fees on most advances, and monitoring and managing the risks associated with any departure of a large member and the resulting capital redemption.

### Recently Issued Accounting Standard

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS No. 133). In June 1999, the FASB issued SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement No. 133," which amends SFAS No. 133, deferring its effective date. SFAS No. 133 is now effective for all fiscal quarters of all fiscal years beginning after June 15, 2000 (January 1, 2001, for the Bank). SFAS No. 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in

the fair value of derivatives will be recorded each period in current earnings or other comprehensive income (a component of capital), depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. The gains and losses on the derivative instrument that will be reported in other comprehensive income will be reclassified as earnings in the periods in which earnings are affected by the variability of the cash flows of the hedged items. The gain or loss on the ineffective portion of all hedges will be recognized in current-period earnings.

The Bank has not yet determined the full effect that the implementation of SFAS No. 133 will have on its earnings or statement of financial position. However, the new standard may have a negative effect on earnings and other comprehensive income. To provide financial flexibility and in anticipation of the possible effect of implementing SFAS No. 133, retained earnings restricted by the Board of Directors totaled \$27.9 million and \$16.3 million at December 31, 1999 and 1998, respectively.

### Recent Developments

**Legislation.** The Federal Home Loan Bank System Modernization Act of 1999 (the Modernization Act), enacted on November 12, 1999, as Title VI of the Gramm-Leach-Bliley Act, achieves several objectives the Bank has long supported. The major provisions of the Modernization Act are as follows:

#### *Voluntary Membership for All Members*

As of May 12, 2000, membership in the System will become voluntary for federally chartered savings institutions that were members of the System as of November 12, 1999. Membership is already voluntary for all other members and for federal savings institutions chartered after the effective date of the legislation. The lockout period for re-joining the System after withdrawal was reduced from ten years to five years.

#### *Elimination of Qualified Thrift Lender (QTL) Distinctions in Extending Advances to Members*

For advances to members and related stock purchases, there will no longer be a distinction between members that are qualified thrift lenders (defined as members with mortgage-related assets equal to at least 65% of total assets) and members that are not qualified thrift lenders.

#### *Elimination of Collateral Restriction*

Advances secured by certain real estate-related collateral (such as residential second mortgages, home equity lines of credit, commercial first mortgages, participation mortgages, mortgage-related municipal bonds, and home equity loan asset-backed securities) have been limited to 30% of a member's GAAP capital. The Modernization Act eliminated this restriction. The Finance Board will determine the timing and implementation of this change.

### *Expanded Access for Community Financial Institutions*

The Modernization Act provides enhanced access to the System for community financial institutions (CFIs). CFIs are defined as FDIC-insured depository institutions with average total assets over the preceding three-year period of less than \$500 million (to be adjusted each year by the annual percentage increase in the Consumer Price Index). The Modernization Act provides enhanced access for CFIs in the following areas:

- *Membership:* CFIs are exempt from the membership eligibility requirement that an institution must have at least 10% of its total assets in residential mortgage loans.
- *Long-term Advances:* CFIs may use long-term advances to finance small business, small farm, and small agribusiness loans in addition to residential housing finance.
- *Expanded Collateral:* CFIs may pledge secured small business or agriculture loans or securities representing whole interests in such loans as collateral for advances.

### *Revised REFCORP Assessment*

Effective January 1, 2000, the System's annual REFCORP obligation was modified from a fixed annual assessment of \$300 million for the System as a whole to 20% of each FHLBank's net earnings (after AHP assessments and operating expenses).

In 1999, the Bank's REFCORP payments represented approximately 14.3% of net income. The Bank's payments for this annual REFCORP obligation ranged as high as 56.5% of net income in the early 1990s. In recent years, high earnings throughout the System reduced the percentage of earnings necessary for the Bank to meet its share of the obligation.

With the new assessment, the amount of the Bank's REFCORP payments will rise and fall with its earnings. To the extent that the System's annual REFCORP payments are higher or lower than \$300 million, the term of the REFCORP obligation will be shortened or lengthened so that the value of all payments made by the System is equivalent to the value of an annuity sufficient to pay the System's original REFCORP obligation.

The benefit of the new assessment formula is that, in years of lower earnings, the Bank's payment may be less than it would have been under the previous assessment formula. If the System maintains relatively strong earnings, as it has in recent years, the total number of years over which the REFCORP payments will be made may be reduced significantly.

### *New Capital Structure*

The Modernization Act establishes a framework for implementation of a new capital structure for the FHLBanks. Once the Finance Board adopts implementing regulations, each FHLBank will develop its own capital plan, based on its business strategy and financial goals and its members' interests.

Each FHLBank's capital plan must be approved by the Finance Board. The new capital structure provisions include the following:

- *Classes of Stock:* The Modernization Act defines two classes of capital stock: Class A, redeemable by members with six months' notice, and Class B, redeemable by members with five years' notice. Each FHLBank's capital plan will establish the terms, rights, and preferences of each class of stock issued by the Bank.
- *Capital Requirements:* The Modernization Act includes a leverage capital requirement and a risk-based capital requirement. Under the leverage requirement, each FHLBank must maintain a total capital-to-assets ratio of at least 5%, using a multiplier of 1.5 for permanent capital, and a total capital-to-assets ratio of at least 4%, without using a multiplier for permanent capital. Permanent capital is defined as Class B stock and retained earnings. The risk-based capital standard requires that each FHLBank hold enough permanent capital to meet credit risk and market risk (based on a rigorous stress test), with due consideration for the risk-based capital tests established for other government-sponsored enterprises under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. Each FHLBank's capital plan must specify how it intends to comply with these capital requirements.
- *Transition Period:* The Finance Board must establish new capital regulations within one year after the Modernization Act and the FHLBanks must submit their individual capital plans to the Finance Board for approval within 270 days after the final regulations are published. Capital plans may be implemented over a transition period not to exceed three years. In the meantime, the requirements for purchase and retention of FHLBank capital stock in place prior to November 12, 1999, remain in effect.

### *Corporate Governance*

Many corporate governance functions that previously required Finance Board approval no longer require that approval. These functions include the declaration of dividends and approval of budgets and bylaws. The term of all elected and appointed directors is now three years, rather than two years for elected directors and four years for appointed directors. Terms will be staggered under rules to be established by the Finance Board. The Finance Board will also give the FHLBanks guidelines for determining whether to uphold the results of the 1999 election of directors or to set aside those results for the purpose of selecting directors to fill terms beginning on January 1, 2001. The Board of Directors now elects its own chair and vice chair for two-year terms from among the Bank's directors.

*Regulation* With the enactment of the Modernization Act, the Finance Board has published proposed, interim, and final rules implementing or relating to the statutory changes, including:

- A proposed rule defining the powers and responsibilities of the boards of directors and senior management of the FHLBanks.
- A proposed rule to implement changes in the calculation of the FHLBanks' annual REFCORP payments.
- An interim final rule amending the membership and advances regulations to conform certain provisions to the Modernization Act.
- A final rule devolving certain corporate governance responsibilities to the FHLBanks and removing regulations that required Finance Board approval for some corporate governance matters.

In 1999, the Finance Board also published a final rule establishing a framework for the orderly allocation of joint and several liability for consolidated obligations among the FHLBanks to provide for the continued timely payment of principal and interest on consolidation obligations in the unlikely event of the projected or actual inability of an FHLBank to meet its debt service payment obligations.

In 2000, the Finance Board published a proposed rule to reorganize the FHLBanks' Office of Finance and broaden its responsibilities in two key respects: the FHLBanks, rather than the Finance Board, would issue consolidated obligations through the Office of Finance, with the Office of Finance preparing the combined financial reports for the System. The Office of Finance would also serve as a vehicle to carry out joint activities for the FHLBanks. In connection with this proposed rule, the Finance Board also proposed changes to the Financial Management Policy of the FHLBank System, deleting the "Funding Guidelines," eliminating the Systemwide liability-based leverage limit, and replacing the current FHLBank liability-based leverage limit with a minimum total capital requirement that would, in effect, recast the leverage limit as a percentage of assets.

## Year 2000

The Bank adopted a comprehensive Year 2000 Plan in 1997 to identify its mission-critical systems, assess the state of Year 2000 compliance of those systems, and repair or replace non-compliant systems. In 1999, the Bank completed the remediation and implementation of all systems identified as non-compliant and completed the testing of all mission-critical systems, including integrated testing and selected testing with key business partners. The Bank also completed its Year 2000 business resumption plan and its liquidity man-

agement plan on schedule in 1999. As a result of these efforts, the Bank maintained ample liquidity throughout the period and was able to provide a full range of products and services before and after the century date change.

The Bank incurred operating costs of \$3.1 million in 1999 and \$3.4 million in 1998 to address the Year 2000 compliance of the Bank's systems, to conduct individual and integrated systems testing, to develop contingency plans, and to monitor and address the Year 2000 compliance preparations of the Bank's key business partners. These costs include the use of consultants to supplement Bank staff, but exclude the cost of Bank staff and management assigned to the project. The costs incurred in 1999 and 1998 did not have material effect on the Bank's net income.

## Comparison of 1998 to 1997

Net income was \$294.1 million in 1998, compared to \$249.1 million in 1997. The increase in net interest income to \$331.3 million in 1998 from \$301.2 million in 1997 was due to a 25% increase in average interest-earning assets outstanding during the year, partially offset by a 7-basis-point decrease in the net interest margin. The decrease in the net interest margin was primarily due to credit pricing policies established by the Bank to compete with other providers of wholesale funds, which decreased advance profit spreads, coupled with lower earnings on invested capital as a result of a lower interest rate environment during 1998.

Non-interest income was \$30.4 million in 1998 and \$2.7 million in 1997. The Bank collected \$24.7 million in prepayment fees in 1998, compared to \$17.9 million in 1997, as more advances were prepaid. The Bank also recognized \$19.8 million in losses in 1997 from the termination of interest rate swaps that were no longer required to hedge short-term borrowings.

Net non-interest expense increased to \$67.7 million in 1998 from \$54.8 million in 1997. The increase was primarily due to an increase of \$6.9 million in the Bank's operating expenses and an increase of \$5.1 million in the statutory contribution to the AHP, which was assessed on higher earnings in 1998. Operating expenses as a percentage of average assets were 5.1 basis points in 1998 compared to 5.2 basis points in 1997.

The Bank's total REFCORP and AHP assessments equaled \$75.9 million in 1998 and \$71.3 million in 1997. These amounts reflected effective "tax" rates on income of 24% and 26%, respectively. The Bank's REFCORP assessment totaled \$48.5 million in 1998 and \$49.1 million in 1997. Higher earnings realized by the 12 FHLBanks combined in both 1998 and 1997 enabled the FHLBanks to meet the \$300 million annual assessment without a shortfall allocation.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

The Bank set aside \$27.4 million for the AHP in 1998, compared to \$22.2 million in 1997. The increase reflected higher earnings in 1998.

Adjusted net interest income increased 10%, to \$339.9 million in 1998 from \$308.9 million in 1997. This increase was the primary reason adjusted net income rose 8%, to \$279.9 million in 1998 from \$258.6 million in 1997.

In 1998, the Bank paid a total of \$220.9 million in dividends, primarily stock dividends, an average annual rate of 5.76%. This rate was 34 basis points lower than in 1997, when dividends totaled \$201.3 million and the average annual rate was 6.10%. All dividends except fractional shares were paid in the form of capital stock.