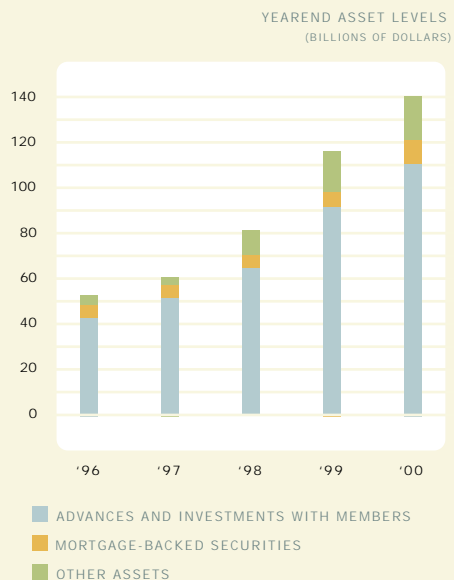


Statements contained in this report, including statements describing the objectives, projections, estimates, or predictions of the future of the Bank, may be "forward-looking statements." These statements may use forward-looking terms, such as "anticipates," "believes," "could," "estimates," "may," "should," "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; a new capital structure; 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 to record levels of \$110.0 billion and \$140.2 billion, respectively, as of December 31, 2000. Advances increased \$19.5 billion, or 22%, and total assets increased \$24.3 billion, or 21%. Contributing to the growth in total assets, the Bank's held-to-maturity securities increased \$5.1 billion, or 50%, as the Bank took advantage of favorable MBS investment opportunities to improve earnings and support its overall growth.

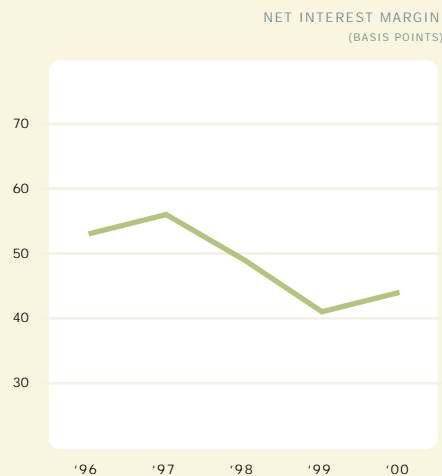


Net interest income increased by \$167.6 million, or 43%, to \$554.6 million, primarily as a result of the significant growth in advances, held-to-maturity securities, and member capital, combined with higher average interest rates and spreads. Net income increased by \$44.0 million to \$376.6 million for the year. This increase was significantly less than the increase in net interest income primarily because the REFCORP assessment is

now classified as an expense. Before 2000, the REFCORP assessment was a charge to capital. In addition, net income for 1999 included one-time gains of \$10.5 million from the reversion of surplus assets from the spin-off/termination involving the Bank's cash balance plan and \$3.6 million from the sale of the Bank's office building in San Francisco. The Bank paid an annual dividend of 7.17% for 2000, compared to 5.36% in 1999.

RESULTS OF OPERATIONS

**Net Interest Income.** Net interest income rose \$167.6 million, or 43%, to \$554.6 million in 2000. Average interest-earning assets increased \$31.7 billion, while the net interest margin increased by 3 basis points, to 44 basis points in 2000 from 41 basis points in 1999. The increase in net interest income was primarily due to the significant growth in advances, investments, and capital, combined with higher interest rates earned on invested capital and higher advance profit spreads. The average yield on interest-earning assets in 2000 was 6.44%, compared to 5.35% in 1999, an increase of 109 basis points. The average cost of interest-bearing liabilities increased 111 basis points, to 6.34% in 2000 from 5.23% in 1999.



**Other Income.** Other income consists primarily of prepayment fees collected from members and fees earned on letters of credit. Also included is the amortization of the deferred gain resulting from the 1999 sale of the Bank's office building in San Francisco, which totaled \$2.1 million and \$1.0 million during 2000 and 1999, respectively. The remaining unamortized amount of the deferred gain on the sale of the building at December 31, 2000, was \$17.4 million. In 1999, other income also included lease income net of related expenses from the Bank's office building of \$1.0 million (before the sale) and recognized one-time gains of \$3.6 million from the building sale and \$10.5 million from the reversion of surplus assets from the spin-off/termination involving the Bank's cash balance plan. Prepayment fees decreased \$1.7 million to \$0.4 million in 2000 from \$2.1 million in 1999. Members prepaid \$0.9 billion of advances in 2000, compared to \$0.5 billion in 1999. These factors led to a \$14.7 million decrease in other income to \$5.3 million in 2000 from \$20.0 million in 1999.

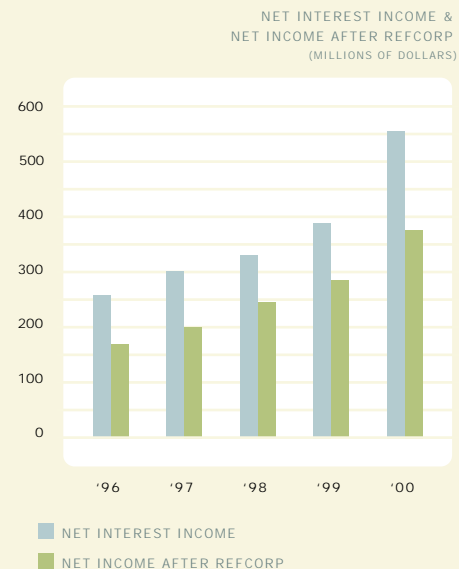
**Other Expense.** Other expense increased to \$48.7 million in 2000 from \$44.1 million in 1999, primarily as a result of a \$4.0 million increase in operating expenses. While operating expenses increased 10% in 2000, average assets increased 34%, leading to a decline in the Bank's ratio of operating expenses to average assets from 4.0 basis points in 1999 to 3.3 basis points in 2000.

**REFCORP and AHP Assessments.** Effective January 1, 2000, the System's annual REFCORP obligation was modified by the Federal Home Loan Bank System Modernization Act of 1999 (Modernization Act) 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). 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 a \$300 million annual annuity with a final maturity date of April 15, 2030. The FHLBanks' payments during 2000 shortened the term of the REFCORP obligation to the first quarter of 2026.

Through 1999, the 12 FHLBanks combined were required to pay \$300 million per year through 2030 to fund part of the interest 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 insufficient 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. The Bank's REFCORP assessment in 2000 totaled \$94.1 million, 20.0% of the Bank's net income after AHP contributions, compared to an assessment of \$47.7 million in 1999, or 14.3% of the Bank's net income. High earnings for the System as a whole in 1999 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 the assessment for 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 2000 or 1999. The Bank set aside a record \$41.9 million for the AHP in 2000, compared to \$31.7 million in 1999, reflecting the higher earnings in 2000.

The Bank's total REFCORP and AHP assessments equaled \$136.0 million in 2000, compared with \$79.4 million in 1999, resulting in an effective "tax" rate on preassessment income of 27%, compared to 22% in the prior year.

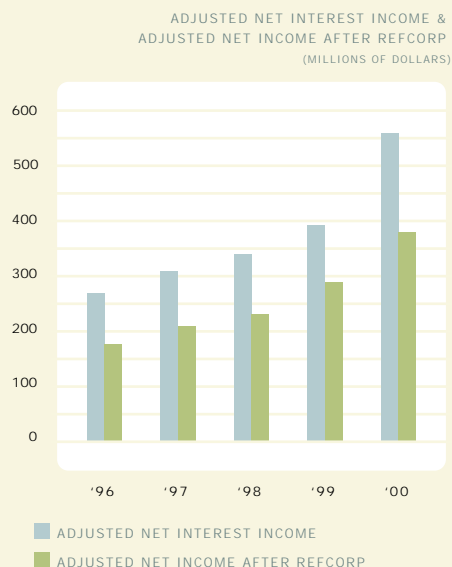


**Net Income.** Net income increased \$44.0 million, or 13%, to \$376.6 million in 2000 from \$332.6 million in 1999. Return on equity (ROE) decreased 50 basis points, to 6.37% in 2000 from 6.87% in 1999, primarily because of the effect of the change in the reporting of the REFCORP assessment, partially offset by an increase in average interest rates. After subtracting the REFCORP assessment for 1999, net income for 1999 was \$284.9 million, resulting in a year-over-year increase of \$91.7 million, or 32%, and the ROE for 1999 was 5.88%.

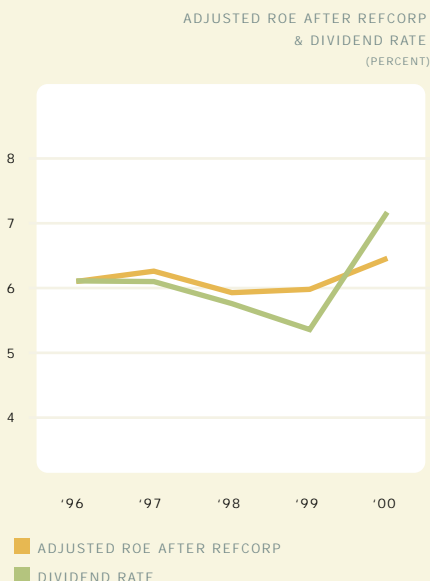
**Adjusted Financial Performance.** The Bank also calculates adjusted financial performance measures to provide a more meaningful comparison of the Bank's financial results over time. These measures reflect earnings before advance prepayment fees, extraordinary gains and losses associated with the early 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 \$560.5 million in 2000 from \$394.0 million in 1999, a 42% increase. Adjusted net income increased 13%, to \$381.4 million in 2000, from \$337.1 million in 1999. Adjusted ROE decreased by 50 basis points, to 6.46% in 2000 from 6.96% in 1999, primarily because of the effect of the change in the reporting of the REFCORP assessment, partially offset by the increase in average interest rates. After subtracting the REFCORP assessment for 1999,

adjusted net income for 1999 was \$289.4 million, resulting in a year-over-year increase of \$92.0 million, or 32%, and the adjusted ROE for 1999 was 5.98%.



**Dividends.** In 2000, the Bank paid \$416.3 million in dividends, an average annual rate of 7.17%. In 1999, dividends totaled \$254.5 million, an average annual rate of 5.36%. All dividends except fractional shares were paid in the form of capital stock.



To provide financial flexibility and in anticipation of the possible effect of implementing SFAS No. 133 (see "Recently Issued Accounting Standard" on page 15), the Board of Directors authorized the transfer of certain amounts from unrestricted retained earnings to restricted retained earnings in 1999. During 1999, the Bank also 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 Bank's Board of Directors totaled \$27.9 million at December 31, 1999. In addition to the retained earnings restricted by the Board of Directors, earnings of \$22.3 million in 1999 were also retained in unrestricted retained earnings.

During the first quarter of 2000, the Bank's Board of Directors authorized the payout of the Bank's unrestricted retained earnings as of December 31, 1999, which equaled \$25.4 million, adding 0.44% to the annual dividend yield. During the second quarter of 2000, in anticipation of SFAS No. 133, the Bank's Board of Directors decided to maintain approximately \$17.1 million in restricted retained earnings to offset the effect on capital of recognizing in other comprehensive income, a component of capital, the remaining unamortized balance of the deferred losses from certain interest rate exchange agreements previously terminated by the Bank. The Bank's Board of Directors then authorized the payout of \$11.5 million from previously restricted retained earnings, adding 0.19% to the annual dividend yield. At the time, the Bank's Board of Directors paid out these retained earnings because it was unclear how existing retained earnings would be treated under future capital regulations. If the Bank had not paid out these retained earnings the Bank's dividend would have been 6.54%, 118 basis points greater than the previous year.

On June 22, 2000, the Finance Board rescinded its dividend policy applicable to the FHLBanks. This rescission effectively eliminated the requirement that the FHLBanks restrict retained earnings for 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. Other gains and losses related to the termination of interest rate exchange agreements and early retirement of consolidated obligations were similarly treated. The Bank's Board of Directors adopted a policy to continue the practice of restricting retained earnings generally consistent with the Finance Board's rescinded dividend policy. 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 these policies totaled \$7.1 million and \$10.7 million at December 31, 2000 and 1999, respectively.

**FINANCIAL CONDITION**

Total assets grew 21% during the year, to \$140.2 billion at December 31, 2000, from \$115.9 billion at December 31, 1999, and average total assets rose 34% in 2000, to \$128.4 billion from \$95.9 billion in 1999.

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

## Average Balance Sheets

(Dollars in millions)	2000			1999		
	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	\$ 2,007.0	\$ 131.1	6.53%	\$ 1,306.2	\$ 68.5	5.24%
Resale agreements	1,523.9	93.9	6.16	2,091.2	110.9	5.31
Federal funds sold	8,564.7	549.1	6.41	6,813.9	354.5	5.20
Held-to-maturity securities*	13,710.6	898.0	6.55	9,128.3	524.8	5.75
Advances*	99,959.9	6,431.3	6.43	74,689.3	3,970.1	5.32
Loans to other FHLBanks	10.1	0.7	6.91	8.2	0.4	4.87
Total interest-earning assets	125,776.2	8,104.1	6.44	94,037.1	5,029.2	5.35
Other assets	2,582.9	—		1,878.3	—	
Total Assets	\$128,359.1	\$8,104.1	6.31%	\$95,915.4	\$5,029.2	5.24%
<b>LIABILITIES AND CAPITAL</b>						
Interest-bearing liabilities:						
Consolidated obligations:						
Bonds*	\$ 86,908.7	\$5,527.1	6.36%	\$76,170.9	\$3,962.1	5.20%
Discount notes*	31,739.5	1,996.8	6.29	12,253.8	666.1	5.44
Deposits	221.5	13.5	6.10	237.2	11.5	4.87
Borrowings	202.7	12.1	5.92	48.0	2.5	5.14
Total interest-bearing liabilities	119,072.4	7,549.5	6.34	88,709.9	4,642.2	5.23
Other liabilities	3,379.1	—		2,364.4	—	
Total Liabilities	122,451.5	7,549.5	6.17	91,074.3	4,642.2	5.10
Total Capital	5,907.6	—		4,841.1	—	
Total Liabilities and Capital	\$128,359.1	\$7,549.5	5.88%	\$95,915.4	\$4,642.2	4.84%
Net Interest Income		\$ 554.6			\$ 387.0	
Net Interest Margin**			0.44%			0.41%
Total Average Assets/Capital Ratio	21.7x			19.8x		

\* Interest income/expense and average rates include the effect of associated interest rate exchange agreements.

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

**Advances.** Advances outstanding increased 22% in 2000, from \$90.5 billion at December 31 1999, to \$110.0 billion at December 31, 2000, a new record high for the Bank. This growth, which continued a trend that began in 1996, caused average advances to increase 34% compared to the prior year, to \$100.0 billion in 2000 from \$74.7 billion in 1999. 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 and fixed rate advances. The Bank's largest members accounted for most of the increase during the year; in all, 103 members increased their advance borrowings from yearend 1999 to yearend 2000.

**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, negotiable certificates of deposits, 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), and to a small degree, other housing related investments, 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. Many 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. The Bank also 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

certain 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 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 Bank's MBS portfolio increased 53% in 2000, to \$10.8 billion, or approximately 161% of capital, at December 31, 2000, from \$7.0 billion, or approximately 130% of capital, at December 31, 1999. 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.

Relative to yearend 1999, the Bank's total non-MBS investment portfolio remained unchanged at \$16.2 billion as of December 31, 2000. Interest-bearing deposits in banks increased \$1.0 billion, commercial paper increased \$1.2 billion, housing finance agency bonds increased \$0.2 billion, while securities purchased under agreements to resell decreased \$2.1 billion and Federal funds sold decreased \$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% of average total assets in 2000 and 1999. 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 21% in 2000, to \$129.5 billion at December 31, 2000, from \$107.4 billion at December 31, 1999. Average consolidated obligations in 2000 were \$118.6 billion, 34% above the \$88.4 billion average in 1999.

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 conventional adjustable rate instruments tied to an index, such as LIBOR. During 2000 and 1999, 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 non-callable debt.

**Capital and Capital Ratios.** Each member is required to purchase Bank stock based on the amount of its residential mortgage loans or its outstanding Bank advances. Average capital during 2000 was \$5.9 billion, a 22% increase from \$4.8 billion in 1999. This increase was due to capital stock purchases by new members and additional capital stock purchases by existing members to support additional borrowings during the year. This increase was net of redemptions of capital stock totaling \$0.5 billion, which primarily resulted from the Bank's mandatory surplus capital stock redemption policy, which 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 \$372.2 million and \$413.4 million in surplus capital stock during 2000 and 1999, respectively.

The Finance Board's regulations effective through June 30, 2000, prohibited the issuance of consolidated obligations and other unsecured senior liabilities above 20 times the Bank System's total capital. The Finance Board's Financial Management Policy also applied this limit on an FHLBank-by-FHLBank basis. This leverage limitation was temporarily increased to 25 times an FHLBank's total capital through June 30, 2000, provided certain conditions were met, in order to facilitate Year 2000-related lending. On June 2, 2000, the Finance Board adopted a final rule amending the FHLBanks' leverage limit requirements. Effective July 1, 2000, each FHLBank's leverage limit is based on a ratio of assets to capital, rather than a ratio of liabilities to capital. The final rule deletes the Bank System-wide leverage limit from the regulations but limits each FHLBank's assets generally to no more than 21 times capital. Nevertheless, an FHLBank whose non-mortgage assets, after deducting deposits and capital, do not exceed 11 percent of its assets may have total assets in an amount no greater than 25 times its capital. As of December 31, 2000, the Bank's total assets to capital and non-mortgage assets to assets ratios were 22.3x and 8.93%, respectively.

**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, cap, and floor agreements) 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.

As of December 31, 2000, the Bank had interest rate exchange agreements, primarily interest rate swaps, totaling \$156.9 billion (notional amount). Of this amount, \$109.2 billion hedged consolidated obligations, \$45.9 billion hedged advances, \$0.7 billion hedged MBS, and \$1.1 billion were for intermediated transactions. As of December 31, 1999, the Bank had interest rate exchange agreements, primarily interest rate swaps, totaling \$124.1 billion (notional amount). Of this amount, \$90.4 billion hedged consolidated obligations, \$31.1 billion hedged advances, \$0.8 billion hedged MBS, \$1.4 billion were for intermediated transactions, and \$0.4 billion hedged held-to-maturity securities.

#### 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 amended 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. Gains and losses on derivative instruments 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. In June 2000, the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," which addressed a limited number of implementation issues arising from SFAS No. 133.

In anticipation of SFAS No. 133, 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 to be recorded in other comprehensive income would have varied depending on interest rates. The Bank eliminated this accounting uncertainty by terminating the agreements and replacing them, in part, with certain 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, 2000, was \$17.1 million and is included in the carrying amount of discount notes.

Effective January 1, 2001, as a result of SFAS No. 133, the Bank recognized in other comprehensive income the remaining unamortized balance of these deferred losses, \$17.1 million, as part of the cumulative effect of adopting SFAS No. 133. Previously, the Bank's Board of Directors had retained \$17.1 million in restricted retained earnings to offset the effect of these deferred losses on capital. In addition, a loss of \$2.5 million was charged to January 2001 earnings as part of the cumulative effect of adopting SFAS No. 133, due to unrealized gains of \$7.1 million related to the transfer of held-to-maturity securities to securities held at fair value and unrealized net losses of \$9.6 million from the remaining cumulative effect of adjustments related to fair value hedges and transactions not meeting the requirements for fair value or cashflow hedges under SFAS No. 133. The ongoing impact of SFAS No. 133 on the Bank cannot be predicted, and the Bank's retained earnings in the future may not be sufficient to offset the full impact of SFAS No. 133. As a result, the effect of SFAS No. 133 may lead to increased volatility in future earnings and dividends.

## RISK MANAGEMENT

**Liquidity.** The Bank is required to maintain liquidity in accordance with certain regulations, with the Finance Board's Financial Management Policy, and 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 or being forced to incur unnecessarily high borrowing costs. The Bank's primary sources of liquidity are short-term investments and issuance of new consolidated obligation bonds and discount notes. 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 potential 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 and guidelines. The Bank's financial policies and guidelines establish 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.

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 following table 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, including the impact of interest rate exchange agreements, for a specified time period. For example, the periodic gap for the "6 months or less" time period indicates that as of December 31, 2000, there were \$2.8 billion more assets than liabilities that would reprice during the six-month period beginning on December 31, 2000. As shown in this table, the Bank's repricing gaps, by design, are concentrated in the "six months or less" and the "one to five years" categories.

## Interest Rate Sensitivity

For the Year Ended December 31, 2000

(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>				
Investments	\$ 21,836	\$ 1,296	\$ 2,856	\$ 1,011
Advances	78,224	5,214	24,203	2,391
Other assets	3,141	—	—	18
<b>Total Assets</b>	<b>\$103,201</b>	<b>\$ 6,510</b>	<b>\$ 27,059</b>	<b>\$ 3,420</b>
<b>LIABILITIES</b>				
Consolidated obligations	\$ 62,794	\$ 15,630	\$ 49,559	\$ 1,481
Deposits	376	—	—	—
Other liabilities	3,888	—	—	170
<b>Total Liabilities</b>	<b>\$ 67,058</b>	<b>\$ 15,630</b>	<b>\$ 49,559</b>	<b>\$ 1,651</b>
Interest Rate Exchange Agreements	(33,295)	9,537	25,314	(1,556)
<b>Periodic Gap/Invested Capital</b>	<b>\$ 2,848</b>	<b>\$ 417</b>	<b>\$ 2,814</b>	<b>\$ 213</b>

The following table shows the estimated 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, 2000, the estimated percentage change in the Bank's market value of equity was 1.4%. If interest rates rose 100 basis points, the Bank's market value of equity would be expected to decline approximately 1.4%, and if interest rates fell 100 basis points, the Bank's market value of equity would be expected to increase approximately 1.4%. If interest rates were 200 basis points higher at December 31, 2000, 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 2.0%. If interest rates were 200 basis points lower at December 31, 2000, a 100-basis-point additional shift in interest rates would be expected to alter the Bank's market value of equity by approximately 0.7%.

#### Market Value of Equity Sensitivity

As of December 31, 2000		Average Percentage Change In the Market Value of Equity
Interest Rate Scenario	Per 100-Basis-Point Change in Interest Rates	
Actual rates at December 31, 2000		1.4%
Rates start 200 basis points higher		2.0%
Rates start 200 basis points lower		0.7%

**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 member 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 in AAA-rated non-agency MBS and MBS that are guaranteed by government-sponsored enterprises (Fannie Mae,

Freddie Mac, and Ginnie Mae) and housing finance agency bonds, generally AAA-rated mortgage revenue bonds (federally taxable), all of which 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 non-member derivative counterparties that provide for delivery of collateral at specified levels to limit credit exposure from off-balance sheet items.

**Concentration Risk.** At December 31, 2000, the Bank had a concentration of advances totaling \$89.2 billion outstanding to three members, representing 81% of total advances outstanding (44%, 24%, and 13%, respectively). At December 31, 1999, the Bank had a concentration of advances totaling \$74.5 billion outstanding to three members, representing 82% of total advances outstanding (50%, 26%, and 6%, respectively). Of the total capital stock outstanding at December 31, 2000, three members held 48.3 million shares, representing 77% of total capital stock outstanding (42%, 22%, and 13%, respectively). At December 31, 1999, three members held 38.2 million shares, representing 71% of total capital stock outstanding (43%, 22%, and 6%, respectively). 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 potential departure of a large member and the resulting capital redemption.

#### RECENT DEVELOPMENTS

**Regulation.** In 2000, the Finance Board issued several final rules implementing or relating to the Federal Home Loan Bank System Modernization Act of 1999, including:

**Capital Requirements for Federal Home Loan Banks:** In December 2000, the Finance Board approved a final rule, effective March 1, 2001, to implement a new capital structure for the FHLBanks. The rule establishes risk-based and leverage capital requirements for the FHLBanks; addresses the different classes of stock that an FHLBank may issue and the rights and preferences that may be associated with each class of stock; and requires each FHLBank to submit a capital plan to the Finance Board for approval by October 29, 2001. In the meantime, the requirements for purchase and retention of FHLBank capital stock in place prior to November 12, 1999, remain in effect.

**Advances, Eligible Collateral, New Business Activities and Related Matters:** This rule allows the FHLBanks to accept small business loans, small farm loans, and small agri-business loans as collateral from community financial institutions (CFIs) and permits CFIs to use long-term advances to finance small businesses, small farms, and small agri-businesses. The rule also removes the 30%-of-GAAP-capital limit on the amount of a member's advances that may be secured by other real estate-related collateral.

**Acquired Member Assets, Core Mission Activities, Investments and Advances:** This rule authorizes FHLBanks to hold acquired member assets and enumerates the types of core mission assets that must be addressed in an FHLBank's strategic business plan. The rule also addresses the FHLBanks' investment, advances, and debt issuance authorities.

**Office of Finance; Authority of FHLBanks to Issue Consolidated Obligations:** This rule reorganizes the Office of Finance; permits the FHLBanks to issue consolidated obligations on which the FHLBanks are jointly and severally liable; expands the Office of Finance's functions to include preparation of the FHLBanks' combined financial reports; and replaces the existing FHLBank liability-based leverage limit with a leverage limit based on a ratio of assets to capital.

**Powers and Responsibilities:** This rule sets forth the responsibilities of the boards of directors and senior management of the FHLBanks to ensure that they fulfill their duties to operate the FHLBanks in a safe and sound manner and further the FHLBanks' housing finance and community lending missions. The rule also requires that each FHLBank maintain a strategic business plan (describing how the FHLBank's business activities will achieve the FHLBank's mission), an internal control system, and an audit committee.

**New Business Activity.** In 2000, the Bank made a strategic decision to participate in the Federal Home Loan Bank System's Mortgage Partnership Finance® Program. In February 2001, the Finance Board authorized the Bank's participation. The Bank intends to begin offering the MPF® Program later this year. ("Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.)

### COMPARISON OF 1999 TO 1998

Net income was \$332.6 million in 1999, compared to \$294.1 million in 1998. Net interest income increased to \$387.0 million in 1999 from \$331.3 million in 1998 as a result of a 40% increase in average interest-earning assets outstanding during the year, partially offset by an 8-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, and lower earnings on invested capital as a result of a lower interest rate environment in 1999 than in 1998.

Other income was \$20.0 million in 1999 and \$30.4 million in 1998. The Bank collected \$2.1 million in prepayment fees in 1999, compared to \$24.7 million in 1998, as fewer advances were prepaid. During 1999, the Bank recognized one-time gains of \$10.5 million from the spin-off/termination involving the Bank's cash balance plan and \$3.6 million from the sale of the Bank's building.

Other expense increased to \$75.8 million in 1999 from \$67.7 million in 1998. The increase was primarily due to an increase of \$3.6 million in the Bank's operating expenses and an increase of \$4.3 million in the statutory contribution to the AHP, which was assessed on higher earnings in 1999. Operating expenses as a percentage of average assets were 4.0 basis points in 1999 compared to 5.1 basis points in 1998.

The Bank's total REFCORP and AHP assessments equaled \$79.4 million in 1999 and \$75.9 million in 1998. These amounts reflected effective "tax" rates on income of 22% and 24%, respectively. The Bank's REFCORP assessment totaled \$47.7 million in 1999 and \$48.5 million in 1998. Higher earnings realized by the 12 FHLBanks combined in both 1999 and 1998 enabled the FHLBanks to meet the \$300 million annual assessment without a shortfall allocation.

The Bank set aside \$31.7 million for the AHP in 1999, compared to \$27.4 million in 1998. The increase reflected higher earnings in 1999.

Adjusted net interest income increased 16%, to \$394.0 million in 1999 from \$339.9 million in 1998. This increase was the primary reason adjusted net income rose 20%, to \$337.1 million in 1999 from \$279.9 million in 1998.

In 1999, the Bank paid a total of \$254.5 million in dividends, primarily stock dividends, an average annual rate of 5.36%. This rate was 40 basis points lower than in 1998, when dividends totaled \$220.9 million and the average annual rate was 5.76%. All dividends except fractional shares were paid in the form of capital stock.