



# 2002 Annual Report

# Financial Highlights

	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
<b>Statements of Condition</b>					
(in thousands)					
Total Assets	\$42,254,372	\$34,821,290	\$35,536,154	\$37,719,662	\$30,454,769
Investments, interest-bearing deposits, securities purchased under agreements to resell and federal funds sold	12,343,374	9,979,731	10,288,633	13,852,656	11,277,041
Advances	24,008,170	20,756,072	21,157,812	22,949,494	18,673,324
Mortgage loans, net	5,660,662	3,741,776	3,295,422	80,480	5,284
Consolidated obligations	37,331,451	30,761,019	32,102,732	33,881,795	26,495,161
Capital stock	1,858,180	1,539,297	1,744,480	2,229,179	1,498,452
Retained earnings	50,130	42,503	28,975	35,138	27,887
<b>Annual Operating Results</b>					
(in thousands except per share amount)					
Net interest income (before mortgage loan loss provision)	\$117,864	\$121,521	\$192,580	\$167,720	\$136,617
Operating expenses	22,990	22,931	21,169	21,354	15,124
Net income (after adjustment for REFCORP) *	56,917	81,736	124,073	114,419	94,632
Dividends	49,290	68,208	130,236	107,168	84,646
<b>Performance Ratios</b>					
Return on average assets *	0.15%	0.23%	0.36%	0.37%	0.39%
Return on average equity *	3.32	4.82	6.44	6.57	7.23
Net interest margin	0.32	0.35	0.57	0.56	0.57
Operating expenses to average assets	0.06	0.07	0.06	0.07	0.06
Capital-to-asset ratio	4.51	4.54	4.99	6.00	5.01
Dividend rate	3.00	4.45	6.92	6.30	6.63
Dividend spread over average three-month LIBOR **	1.14	0.47	0.29	0.81	0.99

\* For comparative purposes, net income for the years ended December 31, 1999 and 1998 is after proforma adjustments for REFCORP. During these years, REFCORP payments were recorded as reductions of capital in the Statements of Condition. For the years ended December 31, 2002, 2001, and 2000, REFCORP payments were recorded as expenses in the Statements of Income.

\*\* London Inter-Bank Offered Rate



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## **2002 Annual Report**

### **Letter to Stockholders – 70 Years of Success**

In 2002, the Federal Home Loan Bank of Des Moines marked its 70<sup>th</sup> year as a successful funding resource for member financial institutions. The Bank's mission to provide liquidity to our members in Iowa, Minnesota, Missouri, North Dakota and South Dakota remains as strong today as it did when the Federal Home Loan Bank System was established by Congress in 1932. The Bank continues to fulfill its mission to help its member banks, thrifts, credit unions and insurance companies serve their communities by providing funding for housing and economic development.

With an increase in member borrowings, the Bank's outstanding advance balance climbed \$3.2 billion to \$24.0 billion at year-end compared to \$20.8 billion in 2001. This represented the highest year-end balance in the Bank's 70-year history and demonstrated the continual demand from member financial institutions for our credit products.

Outstanding mortgage loans acquired through the Mortgage Partnership Finance® Program (MPF®)\* grew 51 percent to \$5.7 billion at the close of 2002 compared to \$3.7 billion at the end of 2001. The total number of institutions approved to participate in the MPF program increased 74 percent to 33 members compared to 19 participants in 2001. The MPF program offers mortgage lenders a unique partnership and strategic alternative to selling their fixed-rate home loans to a secondary market agency.

The growth in advances and the MPF program were the main contributors to a significant increase in the Bank's assets. Bank assets grew 21 percent to \$42.3 billion at December 31, 2002 from the 2001 year-end balance of \$34.8 billion.

Despite record low interest rates, net interest income declined by only \$3.6 million to \$117.9 million in 2002 from \$121.5 million in 2001 because of solid growth in member programs, such as advances and MPF loans.

The Bank's net income declined by \$24.8 million to \$56.9 million in 2002 from \$81.7 million in 2001, primarily due to a \$24 million charge to earnings to account for derivatives under Statement of Financial Accounting Standards No. 133. This accounting standard requires the Bank to mark all derivatives to market and recognize any unrealized gains or losses in income or other comprehensive income. An \$11 million decline in advance prepayment fees also contributed to the year-over-year reduction in net income.

The Bank's capital was \$1.9 billion at December 31, 2002, an increase of 20 percent from \$1.6 billion at the end of 2001. The increase in capital was a result of higher year-end balances in advances and MPF mortgage loans.

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\* "Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.

In recent years, the Bank has tried to maintain a balance between offering attractively priced products and services and providing a dividend indexed to the average three-month London Inter-Bank Offered Rate (LIBOR), a benchmark for short-term money market interest rates. For 2002, the Bank's Board of Directors established a dividend target of three-month LIBOR plus 30 to 50 basis points. Throughout 2002, because of the historically low level of interest rates, the Bank's Board of Directors approved a 3.00 percent dividend. The 2002 dividend payment of 3.00 percent per annum was 114 basis points higher than the LIBOR index. Comparatively, the Bank's average dividend of 4.45 percent per annum in 2001 was 47 basis points higher than the LIBOR index.

At the close of 2002, the Bank had 1,233 members representing the largest membership of any Federal Home Loan Bank. Of those members, 91 percent had assets of less than \$527 million, the 2002 indexed amount used to define Community Financial Institutions in the Gramm-Leach-Bliley Act. Borrowing members increased from 73 percent in 2001 to 75 percent in 2002 — a clear demonstration of how important our credit products are to the success of our members and their communities.

For more than 12 years, the Bank has set aside 10 percent of its net earnings for Affordable Housing Program (AHP) grants. AHP is another opportunity for our member financial institutions to fund projects that provide housing for low- and moderate-income individuals and families. In 2002, the Des Moines Bank awarded \$10.6 million in AHP funds.

Of that amount, \$8.8 million in AHP grants helped build, revitalize or purchase nearly 1,800 housing units through the twice-a-year competitive grant program. Additionally, the Bank set aside \$1.75 million for two programs: Rural Homeownership Fund and Native American Homeownership Initiative. The Rural Homeownership Fund commitment of \$1.5 million provided 78 communities an added resource for affordable housing in rural areas. Responding to the need for more homeownership opportunities for minorities, the Bank developed the Native American Homeownership Initiative. This new program targets potential Native American homebuyers living in Native American Service Areas. The Bank awarded \$250,000 in grants to 12 member financial institutions who, in turn, will help eligible Native American homeowners with downpayment, closing or rehabilitation costs.

The Bank's Community Investment Advance program successfully supplied \$149 million in discounted advances toward homeownership and rental needs to more than 100 communities. Community Investment Advances of \$111 million also aided another 100 communities with economic development efforts. In 2002, the Des Moines Bank had the largest number of members utilizing Community Investment Advances in the Federal Home Loan Bank System.

In 2002, the Bank introduced the Home Loan Bank Award for Excellence to recognize a project in each of our five states that exemplified a true partnership between a member financial institution and a community development organization. The 2002 theme focused on transitional housing with supportive services. The Bank also sponsored a Leadership Development Training Program. The training involved teams comprised of talented and emerging leaders from member financial institutions and rural community organizations in our district.

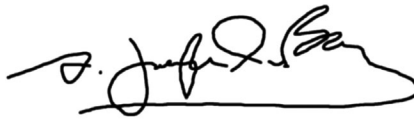
We want to thank our stockholders for the Bank's success in 2002. We also want to express our appreciation to each member of our Affordable Housing Advisory Council and Board of Directors. Their guidance and dedication fuel the advancement and success of the Bank.

We would like to take this opportunity to say thank you to our retiring industry and public interest directors: Thomas J. Larson, president and chief executive officer for Iowa State Bank in Algona, Iowa; James L. Talen, president of Eastwood Bank in Rochester, Minnesota; Marjorie A. Anderson, former chief executive of the Mille Lacs Band of Ojibwe in Onamia, Minnesota; Cecelia A. Grunewaldt, attorney at law, Law Offices of Cecelia A. Grunewaldt in Sioux Falls, South Dakota and William M. Washington, retired director of corporate relations for Sprint in Kansas City, Missouri. We greatly appreciate their diligent guidance and dedicated service to the Bank.

In 2003, we will continue to provide you with the quality products and services you need to achieve your business goals as we have for the past 70 years. It will also be a historical year as the Bank converts from a subscription capital structure to a risk-based capital structure as required by the Gramm-Leach-Bliley Act. We are committed to our partnership with our member financial institutions and their communities and look forward to advancing their success.



Dale J. Torpey  
Chair



F. Joseph Du Bray  
Vice Chair



Patrick J. Conway  
President and CEO

**Federal Home Loan Bank of Des Moines  
2002 Board of Directors**

**Louis K. Ahlemeyer**  
*Chairman  
Community Bank of Pettis  
County  
Sedalia, Missouri*

**Marjorie A. Anderson**  
*Onamia, Minnesota*

**Darlys J. Baum**  
*Executive Director  
South Dakota Housing  
Development Authority  
Pierre, South Dakota*

**Charles R. Brazeale**  
*President/CEO  
The Paris National Bank  
Paris, Missouri*

**Charles L. Cavanagh**  
*Chairman/President  
United Community Bank  
Perham, Minnesota*

**F. Joseph Du Bray (Vice  
Chair)**  
*Senior Vice President/General  
Counsel  
Wellmark, Inc.  
Des Moines, Iowa*

**Neil N. Fruechte**  
*President  
Roundbank  
Waseca, Minnesota*

**Cecelia A. Grunewaldt**  
*Attorney at Law  
Law Offices of Cecelia A.  
Grunewaldt  
Sioux Falls, South Dakota*

**Curtis L. Hage**  
*Chairman and CEO  
Home Federal Bank  
Sioux Falls, South Dakota*

**Thomas J. Larson**  
*President/CEO  
Iowa State Bank  
Algona, Iowa*

**Randy L. Newman**  
*Chairman, CEO, President  
Alerus Financial  
Grand Forks, North Dakota*

**Tony Scallon**  
*Work Experience Coordinator  
Independent School District  
#197  
Minneapolis, Minnesota*

**Wendy Speckerman**  
*Director  
Franklin Management  
Company, Inc.  
Cedar Falls, Iowa*

**James L. Talen**  
*President  
Eastwood Bank  
Rochester, Minnesota*

**Dale J. Torpey (Chair)**  
*President  
Washington Federal Savings  
Bank  
Washington, Iowa*

**William M. Washington**  
*Kansas City, Missouri*

**Thomas E. Woods**  
*President  
T.E. Woods Construction, Inc.  
Heritage Homes Designer &  
Builders, Inc.  
Blue Springs, Missouri*

**John J. Wuest**  
*President  
Heartland Bank  
St. Louis, Missouri*

**Our Mission**

The Federal Home Loan Bank of Des Moines is a customer driven and focused bank, helping communities thrive by providing liquidity, financial services, technical expertise and support to our members.

**Federal Home Loan Bank of Des Moines**  
**2003 Officers**

**Patrick J. Conway**  
*President/CEO*

**Amy E. Angle**  
*Senior Vice President/General  
Counsel/Corporate Secretary*

**F. James Bishop**  
*Senior Vice President/Credit and Sales*

**G. Andy Friedmeyer**  
*Senior Vice President/Chief  
Information Officer*

**Ronald L. Greeson**  
*Senior Vice President/Operations*

**Jianlin Zhai**  
*Senior Vice President/Finance*

**Michael R. Breidenbach**  
*Regional Vice President*

**George L. Crowley**  
*Vice President/Director Credit Sales*

**Phillip M. Everitt**  
*Regional Vice President*

**Anthony L. Fahrenkrog**  
*Regional Vice President*

**Curt D. Heidt**  
*Vice President/Director Community  
Investment*

**Mark R. Heston**  
*Vice President/Director Human  
Resources*

**David K. Horner**  
*Vice President/Director Internal  
Audit*

**Marc S. Johnson**  
*Vice President/Director Credit &  
Collateral*

**Gregory M. Judge**  
*Vice President/Senior Financial  
Strategist*

**Vincent C. Lintz**  
*Vice President/Associate Director  
Housing*

**Xiaohong Ma**  
*Vice President/Director Financial  
Risk Management*

**Lisa A. O'Brien**  
*Vice President/Relationship Manager*

**Robert G. Perez**  
*Regional Vice President*

**Carl G. Plat**  
*Vice President/Director Mortgage  
Asset Management*

**Dara J. Queck**  
*Vice President/Director Member  
Financial Services*

**Nichola K. Schissel**  
*Vice President/Director Public  
Affairs & Communications*

**Steven K. Schuchmann**  
*Vice President/MPF Marketing  
Officer*

**Amy J. Stalzer**  
*Vice President/Controller*

**David A. Threlkeld**  
*Regional Vice President*

**David J. Waldron**  
*Vice President/Money Desk Manager*

**Harold L. Cross**  
*Assistant Vice President/Planning &  
Resource Manager*

**Stephen M. Davis**  
*Assistant Vice President/Marketing  
Manager*

**Carl D. Kinney**  
*Assistant Vice President/Director  
Real Estate Development*

**Eric A. LeSher**  
*Assistant Vice President/Collateral  
Risk Manager*

**Erin E. Lorenzen**  
*Assistant Vice President/Senior  
Quantitative Analyst*

**Joelyn R. Jensen-Marren**  
*Assistant Vice President/Financial  
Risk Manager*

**Russell B. Nay**  
*Assistant Vice President/Systems &  
Programming Director*

**Terri L. Rosonke**  
*Assistant Vice President/Affordable  
Housing Feasibility Specialist*

**Ted L. Rutherford**  
*Assistant Vice President/Accounting  
Manager*

**Chad R. Sellers**  
*Assistant Vice President/Technical  
Support Director*

**Jodie L. Stephens**  
*Assistant Vice President/Credit Risk  
Manager*

**Matthew C. Stone**  
*Regional Assistant Vice President*

**Kevin L. Welsch**  
*Assistant Vice President/Associate  
Director Economic Development*

**David H. White**  
*Assistant Vice President/Administration*

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

### **General**

The Federal Home Loan Bank of Des Moines is one of 12 district banks (FHLBanks) created by Congress under the authority of the Federal Home Loan Bank Act of 1932, as amended (FHLBank Act). The FHLBanks, together with their member institutions and the Office of Finance, operating under the supervision of the Federal Housing Finance Board (Finance Board), comprise the Federal Home Loan Bank System (Bank System). The FHLBanks operate as individual cooperatives where member institutions own capital stock in the cooperative and receive dividends on their investments. The public policy mission of the FHLBanks is to support residential mortgage lending and related community investment through member financial institutions.

We provide wholesale funding (advances and mortgage loans) as well as other products and services to commercial banks, thrifts, credit unions, insurance companies, and eligible housing associates in Iowa, Minnesota, Missouri, North Dakota, and South Dakota. By serving as a readily available source of low-cost funds, we help our members to provide affordable credit in their local markets to support housing, small businesses, and community development.

In September 2002, Moody's Investor Service (Moody's) assigned an Aaa rating to our long-term deposits and a "Prime-1" rating to our short-term deposits. This was the first time Moody's has assigned ratings to the Bank. Also in September 2002, Standard and Poor's (S&P) reaffirmed our AAA counterparty credit rating. Ratings reflect the view of the applicable rating agency at the time the rating is issued, and any explanation of the significance of a rating may be obtained only from the rating agency itself.

This discussion highlights significant factors influencing our financial condition and results of operations. It should be read in conjunction with the financial statements and related notes included in this Annual Report. When used in this document, unless otherwise specified or indicated by the context, the terms "the Bank," "we," "our," and "us" refer to the Federal Home Loan Bank of Des Moines. Average balances are calculated on a daily weighted-average basis. Amounts used to calculate percentage variances are based on numbers in thousands. Accordingly, recalculations may not produce the same results when the amounts are disclosed only in millions.

### **Financial Highlights**

Net income was \$56.9 million in 2002 compared to \$81.7 million in 2001. The \$24.8 million decrease in 2002 net income relative to 2001 resulted primarily from the accounting for derivatives under Statement of Financial Accounting Standards No. 133 (SFAS 133) (see discussion of SFAS 133 in the "Interest-Rate Exchange Agreements" section of this document). SFAS 133 reduced 2002 net income by \$19.5 million after assessments for the Affordable Housing Program (AHP) and the Resolution Funding Corporation (REFCORP), while it increased 2001 net income by \$1.3 million after assessments for AHP and REFCORP. Additionally, prepayment fee income on advances declined significantly in 2002 compared to

2001. Lower net interest income, driven by record-low interest rates and offset somewhat by increased growth in average assets, also contributed to the decline in net income.

Net income in 2001 decreased \$42.3 million to \$81.7 million from \$124.1 million in 2000. The decrease in 2001 net income relative to 2000 was primarily attributable to lower net interest income caused by significant reductions in interest rates, lower average capital balances, and reduced average advance balances. Net interest income was positively impacted by higher average mortgage loan balances through our increased participation in the Mortgage Partnership Finance® (MPF®) program. The decline in 2001 net income was partially offset by increased prepayment fee income received from members who prepaid certain advances during 2001.

Return on average equity decreased to 3.32 percent in 2002 compared to 4.82 percent in 2001 and 6.44 percent in 2000 primarily due to the decline in net income during 2002 and 2001. Average equity remained relatively flat in 2002 and did not significantly impact return on equity for the year. However, a decline in average equity in 2001 due to the redemption of excess capital stock impacted 2001 return on equity by partially offsetting the decline related to net income.

Total assets were \$42.3 billion at December 31, 2002, an increase of \$7.4 billion from year-end 2001 mainly due to increased advance, investment, and mortgage loan balances. Liabilities totaled \$40.3 billion at the end of 2002, an increase of \$7.1 billion since year-end 2001 mainly due to increased consolidated obligations supporting the increased asset balances. Average assets and liabilities, which drive net interest income, also increased in 2002 compared to 2001. While the same factors that caused higher year-end balances also contributed to increased average balances, the numerical increases were not of the same magnitude due to the timing of asset and liability transactions. Average assets were \$37.1 billion during 2002, up \$2.3 billion from 2001 and average liabilities were \$35.4 billion during 2002, up \$2.3 billion from 2001.

During 2002, we paid cash dividends to our stockholders totaling \$49.3 million, compared to \$68.2 million in 2001 and \$130.2 million in 2000. In recent years, we have strived for a balance between offering attractively priced products and providing a dividend indexed to the average three-month London Inter-Bank Offered Rate (LIBOR), the benchmark for short-term money market interest rates. The Board of Directors established a dividend target for 2002 of three-month LIBOR plus 30 to 50 basis points. Based on the historically low level of interest rates during the year, the Board of Directors approved a 3.00 percent dividend throughout 2002, compared to annualized dividend rates of 4.45 percent in 2001 and 6.92 percent in 2000. The 2002 dividend payment represented a spread of 114 basis points over the LIBOR index, compared to spreads of 47 basis points in 2001 and 29 basis points in 2000.

### **Forward-Looking Information**

Statements contained in this report, including statements describing the objectives, projections, estimates, or future predictions in our operations, may be “forward-looking statements.” These statements may be identified by the use of forward-looking terminology, such as “anticipates,” “believes,” “could,” “estimates,” “may,” “should,” “will,” or their negatives or other variations on these terms. We caution 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, including changes in interest rates that affect the housing market;
- our exposure to credit, interest-rate, and counterparty risk and our ability to effectively hedge or manage those risks;
- demand for our advances resulting from changes in our members' deposit flows and credit demands;
- volatility of market prices, rates, and indices that could affect the value of collateral we hold as security for the obligations of our members and counterparties to interest-rate exchange agreements and similar agreements;
- political events, including legislative, regulatory, judicial, or other developments that affect us, our members, counterparties and/or investors in the consolidated obligations of the Bank System;
- competitive forces, including without limitation continued consolidation and merger activity in the financial services industry, other sources of funding available to our members, other entities borrowing funds in the capital markets, and the ability to attract and retain skilled individuals;
- our ability to develop and support technology and information systems sufficient to manage the risks of our business effectively;
- changes in investor demand for consolidated obligations issued by the Bank System;
- timing and volume of market activity;
- our ability to introduce new products and services, and successfully manage the risks associated with those products and services, including new types of collateral securing advances;
- risk of loss arising from litigation filed against one or more the FHLBanks; and
- the effects of inflation or deflation.

There can be no assurance that other factors not currently anticipated by us will not materially and adversely affect our results of operations. You are cautioned not to place undue reliance on any forward-looking statements made by us or on our behalf. Forward-looking statements speak only as of the date the statement was made. We undertake no obligation to update or revise any forward-looking statement.

## **Financial Trends**

During 2002, the financial markets continued to exhibit volatility reflecting concern over the pace of the current economic recovery and the state of the equities market, among other factors. The U.S. stock market remained depressed during the year in the context of continuing scandals involving questionable corporate governance and accounting practices, and lower current earnings coupled with only modest growth expectations for 2003 by companies in numerous industries. Two key elements identified by the U.S. Commerce Department that have buoyed the

national economy, the strong housing market and brisk consumer spending, have recently begun to slow, reflecting, in part, consumer concerns about any sustained improvement in the economy and the increased possibility of war with Iraq.

In response to economic conditions, the Federal Reserve Board, through its Federal Open Market Committee, cut the federal funds rate 11 times by a total of 475 basis points during 2001 and again by 50 basis points in November 2002. Other interest rates continued to drop to historic lows throughout 2002. As a result of sustained lower interest rates, which reached 40+ year lows for some maturities during the period, a significant volume of redemptions of callable Bank System consolidated obligations was triggered.

The lower level of interest rates in 2002 and 2001 impacted our profitability primarily due to lower earnings on invested capital. On average, the effective overnight federal funds rate was 1.67 percent during 2002 compared to 3.88 percent in 2001, a decline of 221 basis points. The same rate during 2000 was 6.24 percent, resulting in a decline of 236 basis points during 2001.

For the third quarter ended September 30, 2002, the latest period for which data was available, the Federal Deposit Insurance Corporation (FDIC) reported that total assets, deposits, and loans of all FDIC-insured institutions increased moderately compared to the third quarter ended September 30, 2001. Total assets increased 5.4 percent, while deposits grew 6.0 percent and loans increased 4.7 percent compared to the third quarter of 2001. The growth in deposits reversed a long period of minimal deposit growth, and this growth, if sustained, may reduce future demand for our advance products.

## **Membership**

We have the largest number of members of any FHLBank, with 1,233 members as of December 31, 2002 compared to 1,227 members in 2001. Our membership focus continues to be reflected in the record high level of membership achieved in 2002. At December 31, 2002, our membership consisted of 1,089 commercial banks, 82 thrifts (savings and loan associations and savings banks), 39 credit unions, and 23 insurance companies. Of these members, 91% were community financial institutions (CFIs) under the Gramm-Leach-Bliley Act (GLB Act), which defines CFIs as FDIC-insured depository institutions that had less than \$527 million of assets in 2002.

While banks and thrifts remain an important component of our business strategy, there are limited membership growth opportunities with these types of member institutions because the majority of banks and thrifts in our district are already members. We believe that insurance companies provide the largest potential for membership growth and new business opportunities. Therefore, we plan to focus our strategic planning efforts to assess their needs and to develop products for this developing market.

*Capital Stock.* Because we are a cooperative, members own all of our capital stock. Membership is voluntary. A member must give six months notice of its intent to withdraw. Members that withdraw from membership may not be readmitted to membership for five years. In 2002, only two Bank members withdrew from membership for reasons other than merger or acquisition.

At December 31, 2002, total capital stock was \$1,858 million. Of the total capital stock, \$1,310 million was held by commercial banks, \$316 million by insurance companies, \$154 million by thrifts, \$36 million by credit unions, and \$42 million by former members that merged with non-members.

The following table presents our five largest owners of capital stock on December 31, 2002 (dollars in millions).

Name	City	State	Capital Stock	Percent of Total Capital Stock
Wells Fargo Bank Minnesota, N.A	Minneapolis	MN	\$ 401.3	21.6%
Superior Guaranty Insurance Company	Minneapolis	MN	188.7	10.2%
TCF National Bank	Minneapolis	MN	74.0	4.0%
AmerUs Life Insurance Company	Des Moines	IA	45.4	2.4%
Transamerica Life Insurance Company	Cedar Rapids	IA	45.0	2.4%
			754.4	40.6%
All Others			1,103.8	59.4%
Total Capital Stock			\$ 1,858.2	100.0%

*Advances.* The total number of borrowing members increased from 892 at December 31, 2001 to 929 members at December 31, 2002, while the percentage of total members borrowing increased from 73 percent to 75 percent. Our borrowing members consisted of 836 commercial banks, 61 thrifts, 20 credit unions, and 12 insurance companies on December 31, 2002.

At December 31, 2002, total advances to members at par value were \$23,036 million (par value represents advance balances before considering unamortized commitment fees, premium and discount balances, and hedging adjustments related to the application of SFAS 133). Of the total advances to members, \$17,751 million was held by commercial banks, \$2,103 million by insurance companies, \$2,077 million by thrifts, \$290 million by credit unions, and \$815 million by former members that merged with non-members.

At year-end 2002, we also had \$7.7 million in outstanding advances to three housing associates, down from \$13.8 million at year-end 2001. Housing associates eligible to borrow included five state housing finance agencies, one city housing finance agency, and one tribal housing corporation.

The following table presents our five largest member borrowers on December 31, 2002 (dollars in millions).

Name	City	State	Advances	Percent of Total Advances
Wells Fargo Bank Minnesota, N.A	Minneapolis	MN	\$ 6,757.0	29.3%
TCF National Bank	Minneapolis	MN	1,153.5	5.0%
Transamerica Life Insurance Company	Cedar Rapids	IA	900.0	3.9%
AmerUs Life Insurance Company	Des Moines	IA	888.9	3.9%
Bank Midwest, National Association	Kansas City	MO	645.4	2.8%
			10,344.8	44.9%
All Other Members			12,691.0	55.1%
Housing Associates			7.7	-
Total Advances (at par value)			\$ 23,043.5	100.00%

### **Related Parties**

We operate as a cooperative, which means that our members own our stock. Our advances are made almost exclusively to members. Additionally, the majority of our directors are elected by and from our member stockholders. Therefore, in the normal course of business, we extend credit to members whose officers may serve as our directors. We extend credit to such members on market terms that are no less favorable to us than comparable transactions with other members. At December 31, 2002, we had \$263 million of advances outstanding to members whose officers were serving as directors of the Bank. This amounted to approximately 1 percent of total advances at par value.

### **Statements of Condition**

#### *Advances*

Our traditional “mission asset” is our program of advances to members to provide funds for home mortgage financing, community lending, and liquidity. A primary benefit of Bank membership is the value of uninterrupted access to liquidity at competitive terms. As of December 31, 2002, the carrying value of advances totaled \$24.0 billion, nearly 16% more than at December 31, 2001. Of the total increase, \$2.6 billion was attributed mainly to our members taking advantage of the low interest-rate environment and increasing their borrowings. Approximately \$0.6 billion of the increase resulted from the growth in fair value adjustments related to hedging relationships under SFAS 133 due to current interest rates, the majority of which was offset in derivative assets and liabilities on the statements of condition. We make significant use of interest-rate exchange agreements to restructure interest rates on advances.

The average yield on advances was 2.66 percent for 2002 compared to 4.79 percent for 2001, reflecting the continued low interest-rate environment during 2002.

The composition of our advances at December 31, 2002 and 2001 was as follows (dollars in millions).

	December 31,	
	<u>2002</u>	<u>2001</u>
Fixed-rate:		
Maturity less than one month	\$ 649.9	\$ 1,626.6
Maturity 1 month to 12 months	1,743.5	2,384.0
Maturity greater than one year	7,247.8	3,216.1
Variable-rate:		
Maturity less than one month	177.7	48.1
Maturity 1 month to 12 months	4,168.2	3,614.4
Maturity greater than one year	1,875.4	2,369.1
Callable advances	1,145.2	1,127.2
Convertible (putable) advances	<u>6,035.8</u>	<u>6,032.0</u>
Total par value	23,043.5	20,417.5
Unamortized commitment fees	(0.1)	(0.1)
Discount on AHP advances	(0.3)	(0.4)
Premiums/discounts on advances	0.7	0.4
SFAS 133 hedging adjustments	<u>964.4</u>	<u>338.7</u>
Total advances	<u>\$ 24,008.2</u>	<u>\$ 20,756.1</u>

Approximately 70 percent of the par amount of advances outstanding at December 31, 2002 had a remaining contractual maturity greater than one year compared with 62 percent at December 31, 2001. Floating-rate advances comprised nearly 27 percent of the par amount of advances outstanding at December 31, 2002 compared with 30 percent one year earlier. Convertible advances made up approximately 26 percent of the par amount of advances outstanding at December 31, 2002 compared with 30 percent at December 31, 2001. Advance originations in 2002 were \$29.7 billion, compared to \$50.2 billion in 2001. While advance originations decreased in 2002, outstanding advance balances and composition reflected greater demand by members for long-term advances as a result of the lower interest-rate environment.

### *Investments*

We restrict our investments to high-quality money market and investment securities. We use our short-term portfolio, including commercial paper, interest-bearing deposits, securities purchased under agreements to resell, and federal funds sold, for liquidity and leverage management. We use long-term securities to help provide a stable dividend stream to members and to manage the maturity profile of the balance sheet. These long-term investments include mortgage-backed securities (MBS), U.S. agency obligations, and bonds of state or local housing agencies that provide funds for low-income housing and other similar initiatives. We use interest-rate exchange agreements to alter the cash flows and manage the interest-rate risk on certain investments.

A summary of our investments at December 31, 2002 and 2001 was as follows (dollars in millions).

	December 31,	
	2002	2001
Interest-bearing deposits	\$ 494	\$ 135
Securities purchased under agreements to resell	-	4,000
Federal funds sold	5,751	1,470
Commercial paper	1,324	70
Mortgage-backed securities	4,104	3,840
U.S. agency obligations	635	424
State or local housing agency obligations	28	35
Other	7	6
Total investments	<u>\$ 12,343</u>	<u>\$ 9,980</u>

Investment balances increased approximately 24 percent in 2002 mainly from increased short-term investment opportunities. The level of short-term investments will vary based on changes in other asset classes, levels of capital, and leverage. Additionally, we purchased approximately \$2.0 billion of MBS during the year, offset by \$1.8 billion in principal repayments on existing MBS. Approximately 63 percent of our MBS portfolio represented variable-rate securities at December 31, 2002 and 2001. The MBS portfolio continued to pay down rapidly due to low interest rates that resulted in customer refinances. The annualized pay down rate for MBS during 2002 was approximately 47 percent. The average yield on investments for the year was 2.68 percent compared to 4.65 percent during 2001. The decrease in the average yield was largely attributable to the declining interest-rate environment during 2002.

### *Mortgage Loans*

We purchase single-family mortgage loans from our members through the MPF program. This program provides members an attractive economic alternative to holding mortgage loans in portfolio or selling them in the secondary market. Under the terms of the MPF program, we manage the liquidity, interest-rate, and prepayment risk of the mortgage loans while the members retain all loan and customer servicing activities. The Bank and its members share in the credit risk of the loans.

In 2002, we purchased \$3.6 billion of member mortgage loans, increasing the total balance at December 31, 2002 to \$5.7 billion, up 51 percent from December 31, 2001. We purchased \$2.1 billion of such mortgage loans in 2001. Lower interest rates throughout 2002 resulted in a decline in average yield on mortgage loans to 6.54 percent in 2002 from 7.21 percent in 2001.

We received principal repayments on mortgage loans of approximately \$1.7 billion during 2002 and \$1.6 billion during 2001. The mortgage loan portfolio continued to pay down rapidly due to low interest rates resulting in customer refinances. The annualized pay down rate for mortgage loans during 2002 was approximately 40 percent.

### *Consolidated Obligations*

Consolidated obligations are the joint-and-several obligations of the FHLBanks, backed only by the financial resources of the 12 FHLBanks. Consolidated obligations are not obligations of the United States, and the United States does not guarantee them. Accordingly, should one or more of the FHLBanks be unable to repay their participations in the consolidated obligations, each of the other FHLBanks could be called upon to repay all or part of such obligations.

The Office of Finance issues two types of consolidated obligations on behalf of the FHLBanks: consolidated bonds and consolidated discount notes. Consolidated bonds satisfy term funding requirements. Typically, the maturity of these securities ranges from 1 year to 20 years. Consolidated discount notes provide funds for short-term advances to members and Bank liquidity. These securities have maturities up to 360 days, and they are sold at a discount and mature at par.

These debt instruments are the primary source of funds to support our advances, mortgage loans, and investments. We make significant use of interest-rate exchange agreements to restructure interest rates on consolidated obligations to better match our funding needs and to reduce funding costs. As of December 31, 2002, the Bank's consolidated obligations totaled \$37.3 billion compared with \$30.8 billion at December 31, 2001. Consolidated bonds increased primarily to support the growth in our advances, investments, and mortgage loans during the year. Approximately \$136 million of the increase in consolidated obligations in 2002 related to fair value adjustments of hedging relationships under SFAS 133, the majority of which was offset in derivative assets and liabilities in the statements of condition. The average effective cost of consolidated obligations was 3.01 percent during 2002 compared to 4.99 percent in 2001.

The par amounts of the FHLBanks' outstanding consolidated obligations, including consolidated obligations held by other FHLBanks, were approximately \$680.7 billion and \$637.3 billion at December 31, 2002 and 2001. Regulations require the FHLBanks to maintain, in the aggregate, unpledged Qualifying Assets equal to the consolidated obligations outstanding. Qualifying Assets are defined as cash; secured advances; assets with an assessment or rating at least equivalent to the current assessment or rating of the consolidated obligations; obligations, participations, mortgages, or other securities of or issued by the United States or an agency of the United States; and such securities as fiduciary and trust funds may invest in under the laws of the state in which the FHLBank is located.

## *Capital*

As of December 31, 2002, total capital (including capital stock, retained earnings, and accumulated other comprehensive income) was \$1.9 billion. This balance was up from \$1.6 billion at December 31, 2001. The primary factor contributing to this growth was increased advance and mortgage loan activity by our members, which increased their capital stock requirements.

*Future Capital Structure.* The GLB Act provided a framework for each FHLBank to establish a new capital structure. In 2000, the Finance Board passed regulations requiring each FHLBank to develop and submit a capital plan for approval. We submitted our capital plan to the Finance Board on October 29, 2001 and received approval on July 10, 2002. We expect to convert to the new capital plan on July 1, 2003, although the plan provides for a period until January 10, 2004 for implementation if necessary.

Our new capital plan provides that we will issue a single class of capital stock. A member may request redemption of any portion or all of its excess capital stock by providing the Bank with five-years' written notice. The five-year notice period also applies when a member wishes to withdraw from membership in the Bank. The five-year notice period, which replaces the current six-month notice period, was stipulated in the GLB Act to add more permanence to our capital structure.

The stock will have a par value of \$100 per share and all shares will be purchased, repurchased, redeemed, or transferred only at par value. We will have two subclasses of stock:

- Membership Stock – each member must purchase and hold Membership Stock equal to a percentage of its total assets as of the preceding December 31<sup>st</sup>. We will use Membership Stock to provide capital for our ongoing financial operations, including maintenance of our liquidity and investment portfolios.
- Activity Based Stock – each member will be required to purchase and hold Activity Based Stock equal to a percentage of its outstanding transactions or commitments. Members must comply with the activity-based requirements for as long as the relevant advances, mortgage loans, or other specified transactions remain outstanding. We will use Activity Based Stock to provide the risk-based capital needed to support the activity being engaged in by the member.

When the new capital plan is implemented, we will be subject to risk-based capital rules. Only permanent capital, defined as retained earnings and capital stock, can satisfy the risk-based capital requirement. In addition, the GLB Act specifies a 4 percent minimum capital ratio based on total capital and a 5 percent minimum leverage ratio based on a 1.5 weighting factor applicable to the permanent capital.

### *Interest-Rate Exchange Agreements*

We enter into interest-rate swap, cap, floor, and swaption agreements (collectively, interest-rate exchange agreements) to manage our exposure to changes in interest rates. We use interest-rate exchange agreements in our overall interest-rate risk management to adjust the interest-rate sensitivity of consolidated obligations to approximate more closely the interest-rate sensitivity of assets, and/or to adjust the interest-rate sensitivity of assets to approximate more closely the interest-rate sensitivity of liabilities. In addition, we use interest-rate exchange agreements to manage embedded options in assets and liabilities, to hedge the prepayment risk of prepayable instruments, and to reduce funding costs.

The notional amount of interest-rate exchange agreements reflects our involvement in the various classes of financial instruments. The notional amount does not measure the credit exposure of the Bank. As of December 31, 2002 the notional amount of our interest-rate exchange agreements totaled \$31.9 billion, including \$29.8 billion of interest-rate swaps and \$2.1 billion of interest-rate caps. The corresponding total notional amount as of December 31, 2001 was \$26.6 billion, including \$20.8 billion of interest-rate swaps, \$2.1 billion of interest-rate caps, \$2.5 billion of interest-rate floors, and \$1.2 billion of swaption agreements. The increase in notional from the prior year was due to increased hedging of fixed-rate advances and consolidated obligations.

After netting the fair market values and accrued interest of the derivative instruments by counterparties, positive counterparty balances were classified as derivative assets and negative counterparty balances were classified as derivative liabilities. At December 31, 2002, we recorded derivative assets of \$48 million and derivative liabilities of \$710 million, resulting in a net liability of \$662 million. At December 31, 2001, derivative assets were \$199 million and derivative liabilities were \$118 million, producing a net asset of \$81 million. The decline in our net derivative position was mainly attributable to decreased fair market values of derivatives hedging advances. The decreased fair market values resulted primarily from declining interest rates. Substantially all of the net unrealized losses on our derivative contracts are offset by unrealized gains on the related hedged items.

The following table categorizes the notional amount and the estimated fair value of derivative financial instruments, excluding accrued interest, by product and type of accounting treatment. The category “Fair Value” represents hedges that qualify for fair-value hedge accounting. The category “Economic” represents hedge strategies that do not qualify for hedge accounting. Amounts at December 31, 2002 and 2001 were as follows (dollars in millions).

	December 31,			
	2002		2001	
	Notional	Estimated Fair Value	Notional	Estimated Fair Value
Advances:				
Fair value	\$ 10,586	\$ (967)	\$ 6,829	\$ (338)
Investments:				
Fair value	690	(67)	200	9
Economic	889	(2)	1,978	3
Mortgage Loans:				
Economic	1,265	11	3,972	55
Consolidated Obligations:				
Fair value	17,695	186	10,577	58
Economic	395	1	495	2
Discount Notes:				
Fair value	412	1	1,614	4
Balance Sheet:				
Economic	-	-	900	1
Total Notional and Fair Value	<u>\$ 31,932</u>	<u>\$ (837)</u>	<u>\$ 26,565</u>	<u>\$ (206)</u>
Total Derivatives, excluding				
Accrued Interest		(837)		(206)
Accrued Interest		<u>175</u>		<u>287</u>
Net Derivative Balance		<u>\$ (662)</u>		<u>\$ 81</u>
Net Derivative Assets		48		199
Net Derivative Liabilities		<u>(710)</u>		<u>(118)</u>
Net Derivative Balance		<u>\$ (662)</u>		<u>\$ 81</u>

We adopted SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, on January 1, 2001. SFAS 133 established accounting and reporting standards for derivatives and hedging activities. SFAS 133 requires that all derivative instruments be recorded in the statements of condition at their fair value. Changes in fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated and effective as part of a hedge transaction and, if so, the type of hedge transaction. The gains and losses on derivative instruments that are reported in other comprehensive income will be reclassified as earnings in periods where earnings are affected by the variability of cash flows of the hedged item. The ineffective portion of all hedges will be recognized in current period earnings. Changes in the fair value of non-SFAS 133 qualifying hedges of assets and liabilities (economic hedges) are recorded each period in current earnings.

Because all derivatives are recorded at fair value under SFAS 133, we are required to recognize unrealized gains or losses on derivative positions regardless of whether offsetting losses or gains on the related assets or liabilities being hedged are permitted to be recognized in a symmetrical manner. Therefore, SFAS 133 has introduced the potential for a considerable timing difference between income recognition from assets or liabilities and the income effects of hedge instruments entered into to mitigate interest-rate risk and cash flow variability. We generally utilize the most cost-efficient hedging techniques available, viewing the resulting accounting consequences to be an important but secondary consideration. We anticipate that this approach will result in enhanced long-term performance, but increased variability in earnings.

In managing derivative positions with a primary emphasis on economic cost-effectiveness, we utilize retained earnings to absorb some of the variability produced from the accounting results to provide a quarterly dividend indexed to average 3-month LIBOR. We establish and monitor limits on the estimated income variability resulting from the impacts of SFAS 133 based on the level of retained earnings. A significant portion of retained earnings has already been designated for this purpose, and we anticipate increasing total retained earnings to help absorb this variability. The ongoing impact of SFAS 133 on our financial results cannot be predicted, and our retained earnings in the future may not always be sufficient to offset the impact of SFAS 133. Should the balance of retained earnings fall below zero, our ability to pay dividends could be impaired until positive retained earnings are restored.

## **Results of Operations**

Net income decreased in 2002 compared to 2001 primarily from a decline in the fair value of our economic hedges under SFAS 133. Lower net interest income, driven by lower interest rates and offset somewhat by increased growth in average assets, also contributed to the decline. We received lower prepayment fee income during the year and eliminated losses on the early extinguishment of debt that occurred in 2001, but not in 2002. Net income also decreased in 2001 compared to 2000 primarily due to lower net interest income caused by significant reductions in interest rates, lower average capital balances, and reduced average advance balances. The decline in 2001 net income was partially offset by increased prepayment fee income received from members who prepaid certain advances during 2001.

### *Net Interest Income*

Net interest income declined in both 2002 and 2001 as market interest rates declined significantly during both periods. While 2001 spreads decreased because of the change in interest rates, we produced increased spreads in 2002 from improved performance of our mortgage portfolio (MBS and mortgage loans).

A considerable portion of our net interest income was derived from interest earnings on assets supported by capital. As interest rates rose as they did in 2000, the earnings contribution from this portion of the overall asset/funding mix increased. Conversely, when interest rates declined as they did in 2002 and 2001, the earnings contribution decreased.

The following table presents average balances together with the total dollar amounts of interest income and expense and the weighted-average interest rates of major earning asset categories and the sources funding those earning assets (dollars in millions).

	2002			2001			2000		
	Average Balance	Rate	Interest Income / Expense	Average Balance	Rate	Interest Income / Expense	Average Balance	Rate	Interest Income / Expense
Interest-earning assets:									
Advances	\$ 22,304	2.66%	\$ 594.0	\$ 21,146	4.79%	\$ 1,012.1	\$ 22,170	6.44%	\$ 1,427.3
Mortgage-backed securities	4,064	3.84%	155.9	3,681	5.51%	202.8	4,466	6.72%	299.9
Federal funds sold	3,450	1.73%	59.6	2,728	4.28%	116.9	3,208	6.34%	203.5
Securities purchased under agreements to resell	1,244	1.80%	22.4	2,352	3.67%	86.2	389	6.43%	25.0
Other investments	1,632	2.46%	40.3	790	4.89%	38.6	1,503	6.11%	91.8
Mortgage loans	4,022	6.54%	263.1	3,623	7.21%	261.3	2,307	7.79%	179.8
Other interest-earning assets	14	1.65%	0.2	10	3.93%	0.4	5	7.81%	0.4
Total interest-earning assets	36,730	3.09%	1,135.5	34,330	5.01%	1,718.3	34,048	6.54%	2,227.7
Non-interest earning assets	392			452			778		
Total assets	<u>37,122</u>			<u>34,782</u>			<u>34,826</u>		
Interest-bearing liabilities:									
Consolidated obligations:									
Bonds	25,867	3.35%	866.3	25,334	5.14%	1,303.3	24,295	6.32%	1,534.4
Discount notes	6,870	1.75%	120.4	5,169	4.22%	218.3	7,214	6.23%	449.2
Deposits	1,894	1.36%	25.7	2,041	3.54%	72.2	788	6.12%	48.2
Other interest-bearing liabilities	153	3.40%	5.2	59	5.08%	3.0	59	5.59%	3.3
Total interest-bearing liabilities	34,784	2.93%	1,017.6	32,603	4.90%	1,596.8	32,356	6.29%	2,035.1
Non-interest bearing liabilities	624			483			542		
Total liabilities	35,408			33,086			32,898		
Capital	1,714			1,696			1,928		
Total liabilities and capital	<u>\$ 37,122</u>			<u>\$ 34,782</u>			<u>\$ 34,826</u>		
Net interest income and spread		<u>0.16%</u>	<u>\$ 117.9</u>		<u>0.11%</u>	<u>\$ 121.5</u>		<u>0.25%</u>	<u>\$ 192.6</u>
Net interest margin		<u>0.32%</u>			<u>0.35%</u>			<u>0.57%</u>	

Changes in both volume and interest rates influence changes in net interest income and net interest margin. The following table presents the changes in interest income and interest expense between 2002 and 2001 and between 2001 and 2000. Changes that cannot be attributed to either rate or volume have been allocated to the rate and volume variances based on their relative size (dollars in millions).

	Variance – 2002 vs. 2001			Variance – 2001 vs. 2000		
	Total Increase (Decrease) Due to			Total Increase (Decrease) Due to		
	Volume	Rate	Total Increase (Decrease)	Volume	Rate	Total Increase (Decrease)
Interest income:						
Advances	\$ 52.7	\$ (470.8)	\$ (418.1)	\$ (63.3)	\$ (351.9)	\$ (415.2)
Mortgage-backed securities	19.5	(66.4)	(46.9)	(48.1)	(49.0)	(97.1)
Federal funds sold	25.3	(82.6)	(57.3)	(27.4)	(59.2)	(86.6)
Securities purchased under agreements to resell	(30.7)	(33.1)	(63.8)	76.2	(15.0)	61.2
Other investments	27.2	(25.5)	1.7	(37.5)	(15.7)	(53.2)
Mortgage loans	27.3	(25.5)	1.8	95.7	(14.2)	81.5
Other interest-earning assets	<u>0.1</u>	<u>(0.3)</u>	<u>(0.2)</u>	<u>0.2</u>	<u>(0.2)</u>	<u>-</u>
Total interest income	121.4	(704.2)	(582.8)	(4.2)	(505.2)	(509.4)
Interest expense:						
Consolidated obligations:						
Bonds	26.9	(463.9)	(437.0)	63.4	(294.5)	(231.1)
Discount notes	56.7	(154.6)	(97.9)	(108.2)	(122.7)	(230.9)
Deposits	(4.9)	(41.6)	(46.5)	51.1	(27.1)	24.0
Other interest-bearing liabilities	<u>3.4</u>	<u>(1.2)</u>	<u>2.2</u>	<u>-</u>	<u>(0.3)</u>	<u>(0.3)</u>
Total interest expense	<u>82.1</u>	<u>(661.3)</u>	<u>(579.2)</u>	<u>6.3</u>	<u>(444.6)</u>	<u>(438.3)</u>
Net interest income	<u>\$ 39.3</u>	<u>\$ (42.9)</u>	<u>\$ (3.6)</u>	<u>\$ (10.5)</u>	<u>\$ (60.6)</u>	<u>\$ (71.1)</u>

The slight decrease in net interest income in 2002 relative to 2001 was caused primarily by lower interest rates offset by increased average balances and higher net interest spread. Lower interest rates were seen across all interest-earning assets and interest-bearing liabilities as a result of the significant decline in market interest rates. The increase in average balances was driven primarily by higher advance, MBS, and mortgage loan activity during the year. While net interest income decreased in 2002, net interest spread increased 5 basis points to 16 basis points in 2002 compared to 11 basis points in 2001. During 2002, we exercised our option to redeem a significant amount of callable consolidated obligations that funded mortgage loans. These consolidated obligations were replaced by debt with more favorable terms, allowing us to increase spreads in a declining interest-rate environment. The decrease in net interest margin from 2001 to 2002 was largely attributable to the decline in interest rates and the effect of lower interest rates on the earnings from invested capital.

Net interest income decreased by \$71.1 million in 2001 from 2000 primarily due to significantly lower interest rates and secondarily due to lower average capital and advance levels. Approximately \$696 million of capital stock was redeemed during 2001 as a result of lower advance balances and member mergers out of our district. Because of the lower level of available capital, more of our interest-earning assets were supported by interest-bearing liabilities during this period. Average advance balances declined because of lower borrowings by members as well as member mergers out of our district. The decline in average advance balances was offset by an increase in average mortgage loan balances from our expansion of the MPF program. These same factors contributed to the declines in the net interest spread and the net interest

margin between the two years. The impact of the adoption of SFAS 133 lowered the 2001 spread by 3 basis points due to certain adjustments to carrying values of hedged items and other income adjustments.

*Other income*

We reported a loss of \$15.2 million in other income in 2002. We had income of \$14.4 million in 2001 and \$1.5 million in 2000. The primary reason for the 2002 decrease was greater net realized and unrealized losses on derivative and hedging activities under SFAS 133. The secondary reason for the decrease was lower prepayment fees on advances in 2002 compared to 2001. These decreases were offset in part by \$7.7 million of loss on extinguishment of certain consolidated obligations in 2001 that did not occur in 2002.

The following table summarizes the effect of SFAS 133 and the related impact of gains and losses on securities held at fair value on net income before assessments for AHP and REFCORP for the years ended December 31, 2002 and 2001 (dollars in thousands).

	For the Years Ended December 31,	
	<u>2002</u>	<u>2001</u>
Net realized and unrealized gains (losses) on derivatives and hedging activities:		
Economic hedges	\$ (26,324)	\$ (4,565)
Hedge ineffectiveness	1,860	4,232
Net gains (losses) on securities held at fair value	<u>(2,097)</u>	<u>865</u>
Net effect of SFAS 133 before cumulative effect of change in accounting principle	(26,561)	532
Cumulative effect of change in accounting principle	<u>-</u>	<u>1,206</u>
Net effect of SFAS 133	<u><u>\$ (26,561)</u></u>	<u><u>\$ 1,738</u></u>

The derivatives generating these losses were primarily economic hedges used in our mortgage portfolio. These hedges constituted approximately 7 percent of the total notional value of our derivative portfolio. SFAS 133 required us to recognize unrealized gains or losses on our economic hedges in current period earnings, while in many instances, the associated changes in the value of assets being hedged were not afforded similar treatment in the financial statements. As a result, SFAS 133 has materially changed both the timing of income recognition and the financial statement line-item classification of a significant portion of our hedging activities. Because we generally manage derivative positions with a primary emphasis on economic cost-effectiveness as opposed to symmetrical accounting results, SFAS 133 has led to more variability in reported earnings due to changes in market prices and interest rates, and this variability could continue in the future.

In conjunction with the adoption of SFAS 133 in 2001, we recorded a \$1.2 million increase to net income as a cumulative effect of a change in accounting principle. We also reclassified

certain securities to investments held at fair value in 2001 and recorded an unrealized gain of \$0.9 million in other income in 2001 and an unrealized loss of \$2.1 million in 2002.

Prepayment fees decreased to \$5.8 million in 2002, compared to \$16.7 million in 2001 and \$0.1 million in 2000. We charge our members prepayment fees when they prepay certain advances before the original maturity. These fees are intended to make us financially indifferent if the borrower decides to prepay. Because of the low interest-rate environment, many members prepaid their existing advances in 2001. While rates continued to decline in 2002, advance prepayments decreased, resulting in lower prepayment fees. Prepayment fees in 2001 were also higher than 2000 due to member merger activity during the year.

#### *Other expenses*

Other expenses consist primarily of general operating expenses and expense allocations from the Finance Board and Office of Finance. General operating expenses were relatively flat in 2002, but increased approximately \$1.7 million in 2001 mainly due to the addition of approximately 15 full-time equivalent employees during 2001.

#### *Affordable Housing Program and Resolution Funding Corporation Assessments*

We are required by the FHLBank Act to establish and fund an AHP to provide direct grants and below-market interest rate advances to members who use the funds to assist in the purchase, construction, or rehabilitation of housing for qualifying households. In order to fund AHP, the FHLBanks must set aside the greater of \$100 million or 10 percent of current year income before AHP charges, but after the assessment for REFCORP. If the result of the aggregate 10 percent calculation described above is less than \$100 million for all 12 FHLBanks, then the FHLBank Act requires that the shortfall be allocated among the FHLBanks based on the ratio of each FHLBank's income before AHP and REFCORP to the sum of the income before AHP and REFCORP of the 12 FHLBanks. There was no shortfall in 2002, 2001, or 2000. Our AHP expense was \$6.3 million in 2002, \$9.1 million in 2001, and \$13.8 million in 2000.

We also pay 20 percent of net earnings after the AHP obligation to REFCORP to support the payment for part of the interest on the bonds issued by REFCORP. Our REFCORP assessment was \$14.2 million in 2002, \$20.4 million in 2001, and \$31.0 million in 2000. The FHLBanks' obligation to REFCORP is total payments equivalent to a \$300 million annual annuity with a final maturity date of April 15, 2030. The Finance Board in consultation with the Secretary of the Treasury will select the appropriate discounting factors used in this calculation. The Finance Board will shorten or lengthen the period during which the FHLBanks must make payments to REFCORP depending on actual payments relative to the referenced annuity. The cumulative amount we must pay to REFCORP is not immediately determinable due to the interrelationships of all future FHLBanks' earnings. The FHLBanks made REFCORP payments of \$452 million, \$537 million, and \$553 million for the years ended 2002, 2001, and 2000. The FHLBanks' payments for 2002 defease all future benchmark payments after the fourth quarter of 2021 and \$71 million of the \$75 million benchmark payment for the fourth quarter of 2021.

The AHP and REFCORP assessments fluctuate directly with net income, resulting in lower assessments in 2002 and 2001.

## **Segments**

We have two reportable operating segments: Traditional Member Finance and Mortgage Finance. Traditional Member Finance includes products such as advances and investments with their related funding and hedging. Mortgage Finance includes mortgage loans acquired through the MPF program and MBS and their related funding and hedging.

The Traditional Member Finance segment had net interest income of \$75.6 million in 2002 compared to \$92.2 million in 2001. The 2002 decrease relative to 2001 was mainly due to lower interest rates which were seen across all interest-earnings assets and interest-bearing liabilities as a result of the significant decline in market interest rates. Lower interest rates significantly affected this segment because of the importance of interest-earning assets supported by capital to net interest income. The decrease attributable to lower interest rates was partially offset by a \$1.5 billion increase in average segment asset balances in 2002 compared to 2001, primarily attributable to higher average advances and short-term investments.

The Mortgage Finance segment produced net interest income before provision for credit losses on mortgage loans of \$42.3 million in 2002 compared to \$29.3 million in 2001. The 2002 increase relative to 2001 was primarily attributable to increased volume of both mortgage loans and MBS as we experienced continued growth in this portion of our business despite the rapid pay downs that have occurred in these portfolios in the current low interest-rate environment. Average assets in the Mortgage Finance segment increased approximately \$797 million in 2002 compared to 2001. Improved spreads were realized from the redemption of callable consolidated obligations, which were replaced by debt with more favorable terms.

In 2000, net interest income from the Traditional Member Finance segment was \$148.2 million and net interest income before provision for credit losses on mortgage loans from the Mortgage Finance segment was \$44.4 million. The decrease in both segments in 2001 compared to 2000 was driven mainly by lower earnings on invested capital due to significantly lower interest rates as well as lower average capital balances. Average assets in the Traditional Member Finance segment decreased approximately \$585 million in 2001 compared to 2000 due to a decrease in average advance balances from reduced borrowings by our members and mergers of members out of our district. Average assets in the Mortgage Finance segment increased approximately \$542 million in 2001 relative to 2000 due to increased average mortgage loan balances from expansion of the MPF program. This growth occurred despite substantial mortgage loans prepayments received during the period.

## **Affordable Housing Program and Community Investment Advance Program**

We help members meet their Community Reinvestment Act responsibilities by providing access to subsidized and other low-cost funding to create affordable rental and homeownership opportunities. Funding is also used for commercial and economic development activities that

benefit low- and moderate-income neighborhoods, thus contributing to the revitalization of these communities.

The FHLBanks have two major community investment programs – the AHP and the Community Investment Advance (CIA) program – which are designed to meet the needs of specific populations. AHP is a grant program that benefits projects targeting families at or below 80 percent of the area median income. The CIA program is a below-market advance program created to assist in the funding of both community development and affordable housing projects. During 2002, we awarded approximately \$10.6 million in AHP funds and provided nearly \$260 million in discounted advances through the CIA program.

We awarded more than \$8.8 million in AHP grants to help build, revitalize or purchase 51 projects comprising nearly 1,800 housing units. In addition to the above projects, we developed the Native American Homeownership Initiative (NAHI) during 2002, a program specifically targeting potential Native American homebuyers living on Native American Reservations and Settlements. We awarded \$250,000 to twelve member financial institutions through this program. We also awarded \$1.5 million to 78 communities through the Rural Homeownership Fund (RHF). Both the NAHI and the RHF help qualified homebuyers with closing costs, down payment assistance, or rehabilitation costs. Since inception of the AHP in 1990, we have funded or committed to fund more than \$88 million of AHP awards to support more than 700 projects with approximately 25,000 units of affordable housing.

Through the CIA program, more than 100 communities received nearly \$149 million in discounted advances in 2002 to provide for the homeownership or rental needs of individuals and families. Also through the CIA program, more than 100 communities borrowed approximately \$111 million in 2002 to finance their economic development efforts. Since inception of the CIA program in 1990, we have originated more than \$2.6 billion in discounted advances to members for their affordable housing and economic development needs.

## **Liquidity and Capital Resources**

Our principal source of liquidity is the FHLBanks' ability to raise funds in the capital markets by issuing consolidated obligations (discount notes and bonds). Because of the FHLBanks' credit quality, efficiency, and standing in the capital markets, the FHLBanks have ready access to funding. During 2002, we received proceeds from the issuance of consolidated discount notes of approximately \$427 billion and proceeds from the issuance of consolidated bonds of approximately \$33 billion.

To provide further access to funding, the FHLBank Act authorizes the Secretary of the Treasury, at his or her discretion, to purchase consolidated obligations up to an aggregate principal amount of \$4 billion. No borrowings under this authority have been outstanding since 1977.

Other sources of liquidity include short-term investments, repurchase agreements, payments collected on advances and mortgage loans, member deposits, and the issuance of capital stock. We had cash, cash equivalents, and short-term investments with a carrying value of \$7.7 billion

at December 31, 2002, compared with \$5.7 billion at December 31, 2001. We maintain minimum liquidity to meet our net funding requirements assuming we are unable to access the consolidated obligation debt market each day for five consecutive business days. In addition, we maintain overnight investments of at least \$250 million to fund new lending.

Primary uses of cash include issuance of advances, purchases of mortgage loans and investments, repayment of consolidated obligations and member deposits, and redemption of capital stock.

We issue letters of credit on behalf of our members to facilitate business transactions with third parties. Members may use letters of credit to facilitate residential housing finance or other housing activity, facilitate community lending, assist with asset/liability management, and provide liquidity or other funding. Members must fully collateralize letters of credit. As of December 31, 2002 and 2001, we had \$910 million and \$727 million in letters of credit outstanding.

At December 31, 2002, we had approximately \$22.1 million in outstanding commitments to purchase mortgage loans compared to \$1.6 million at December 31, 2001. While we had no outstanding commitments for additional advances at December 31, 2002, we had approximately \$8.6 million of such commitments at December 31, 2001.

We had approximately 18.6 million shares of stock outstanding at December 31, 2002, compared to 15.4 million shares outstanding at December 31, 2001. We issued 3.6 million shares to members and redeemed 0.4 million shares from members in 2002. We issued 4.9 million shares to members and redeemed 7.0 million shares from members in 2001. Our capital stock fluctuates based on members' total assets and activity with the Bank. Our minimum requirements are designed so that we remain adequately capitalized as member activity changes.

At December 31, 2002, approximately 98 percent of our capital was capital stock. We had an aggregate capital-to-asset ratio of 4.51 percent at December 31, 2002, compared to a ratio of 4.54 percent at December 31, 2001.

Finance Board regulations generally limit an FHLBank's leverage ratio, which is calculated monthly based on a ratio of average assets to average capital, to no more than 21 times its average capital. However, an FHLBank whose average non-mortgage assets, after deducting average deposits and average capital, do not exceed 11 percent of its average assets may have a leverage ratio as high as 25 times its average capital. Our year-to-date average leverage ratio was 21.6 to 1 during 2002 compared to 20.5 to 1 during 2001. Our year-to-date average non-mortgage assets, after deducting average deposits and average capital, as a percentage of total average assets during 2002 and 2001, were 6.13 percent and 5.53 percent.

During 2002 and 2000, dividends represented 12 months of earnings. We modified our dividend payment cycle during 2001 to facilitate a change in the timing of dividend declaration and payment. This change resulted in 11 months of Bank income being paid in dividends in 2001.

In recent years, we have tried to maintain a balance between offering attractively priced products and providing a dividend indexed to average three-month LIBOR. During 2002, the Board of Directors established a dividend target of LIBOR plus 30 to 50 basis points. Throughout 2002, the Board of Directors approved a 3.00 percent dividend, resulting in cash dividend payments to our stockholders totaling \$49.3 million. The dividend rate approved by the Board of Directors resulted from the historically low level of interest rates during the year. The 2002 dividend payment of 3.00 percent was 114 basis points higher than the LIBOR index, compared to the 2001 dividend payment of 4.45 percent, which was 47 basis points higher than the LIBOR index.

Because of the earnings variability that may result from SFAS 133, we have designated a significant portion of retained earnings to absorb this variability. Management has established and monitors limits on the estimated income variability resulting from the impacts of SFAS 133 based on the level of our retained earnings.

As previously discussed, the Finance Board approved our new capital plan on July 10, 2002. The new capital plan was required by the GLB Act. Our capital plan provides that we will issue a single class of capital stock with a par value of \$100 per share. We will have two subclasses of stock: Membership Stock, which will provide capital for our ongoing financial operations, and Activity Based Stock, which will be used to provide the risk-based capital needed to support the activity being engaged in by the member. We expect to convert to the new capital plan on July 1, 2003, although the plan provides for a period until January 10, 2004 for implementation if necessary. Once the plan has been implemented, a member may request redemption of any portion or all of its excess capital stock by providing the Bank with five-years' written notice.

We do not have any variable interest entities or any other type of off-balance sheet conduits.

See additional discussion of liquidity risk management in "Risk Management."

### **Recently Issued Accounting Standards**

FASB issued Interpretation No. 45, "*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FASB Interpretation No. 34*" (FIN 45) on November 25, 2002. FIN 45 expands existing disclosure requirements at December 31, 2002 for guarantees and provides initial recognition and measurement provisions to be applied on a prospective basis for guarantees issued or modified after December 31, 2002. Management has evaluated the effect of adopting FIN 45 and has determined that the effect of adoption is not material.

We adopted SFAS No. 145, "*Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections as of April 2002*" on June 30, 2002. SFAS 145 eliminated the requirement that gains and losses from the extinguishment of debt (except for those considered unusual or infrequent in nature) be aggregated and, if material, classified as an extraordinary item, net of the related income tax effect. In accordance with the transition provisions of SFAS 145, previously reported gains and losses on early retirement of debt have

been reclassified into other income under Other, net. The amounts reclassified included a loss of \$7,659,000 for the year ended December 31, 2001 and a gain of \$350,000 for the year ended December 31, 2000.

### **Critical Accounting Policies**

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, income, and expenses during the periods presented as well as the disclosure of contingent assets and liabilities. The following are considered our critical accounting policies due to their subjective nature, high degree of judgment and complexity, and significance to the financial statements.

#### *Derivatives and Hedging*

SFAS 133 established accounting and reporting standards for derivatives and hedging activities. We designate derivatives as fair-value hedges under SFAS 133 or as economic hedges, which are hedges that do not satisfy SFAS 133's hedge criteria or hedges for which accounting under SFAS 133 has not been elected. All derivatives are recorded as assets or liabilities on the balance sheet at their respective fair values with unrealized gains and losses recorded in the results of operations. For all hedge relationships, ineffectiveness resulting from differences between the changes in fair value of the hedged item and changes in fair value of the derivative are recorded in other income.

We base the estimated fair values of interest-rate exchange agreements with similar terms on available market prices including accrued interest receivable and payable. However, active markets do not exist for many types of financial instruments. Consequently, fair values for these instruments must be estimated using techniques such as discounted cash flow analysis and comparisons to similar instruments. Estimates developed using these methods are highly subjective and require judgments regarding significant matters such as the amount and timing of future cash flows and the selection of discount rates that appropriately reflect market and credit risks. Changes in these judgments often have a material effect on the fair value estimates. Since these estimates are made as of a specific point in time, they are susceptible to material near term changes.

We assess at the inception of the hedge and on an ongoing basis whether the derivative used in the hedging transaction has been effective in offsetting changes in the fair value of the hedged item, and whether the derivative is expected to remain effective in future periods. We typically use regression analyses or other statistical analyses to assess the effectiveness of our hedges. The assumptions used in these analyses are highly subjective and the use of different assumptions could produce materially different results. Management regularly evaluates these analyses and the related assumptions for reasonableness compared to expected results.

Economic hedges, which are entered into for risk management purposes, represented approximately 8 percent of the outstanding notional value of our derivatives as of December 31, 2002. We generally utilize the most cost-efficient hedging techniques available, viewing the resulting accounting consequences to be an important but secondary consideration. For example,

we enter into interest-rate caps, floors, swaptions and callable swaps primarily to hedge the prepayment risk embedded in our mortgage portfolios. SFAS 133 requires us to recognize the change in fair value on these derivative positions in current-period earnings with no fair value adjustment to an asset or liability. Because of this, SFAS 133 provides potential for considerable timing differences between income recognition from assets or liabilities and the income effects of hedge instruments entered into to mitigate interest-rate risk and cash flow variability.

#### *Allowance for Loan Losses*

We maintain an allowance for loan losses on our mortgage loans at levels management believes to be adequate to absorb estimated losses inherent in the total mortgage portfolio at the balance sheet date. The allowance for loan losses on mortgage loans totaled \$3.3 million at December 31, 2002. The allowance is increased through periodic provisions charged to expense and decreased by charge-offs, net of recoveries. Setting the level of reserves requires significant judgment and regular evaluation by management. Many factors, including past performance, loan portfolio characteristics, collateral valuations, industry data, and current economic conditions are important assumptions in estimating mortgage losses. The use of different estimates or assumptions as well as changes in external factors could produce materially different allowance levels.

### **RISK MANAGEMENT**

We have risk management policies that control our exposure to market, liquidity, credit, operational, and business risk. These policies are established by our Board of Directors to conform to Finance Board regulations and policies. Our first risk management objective is to manage assets, liabilities, and derivative exposures in ways that protect capital stock from risks, mainly fluctuations in market interest rates, spreads, and interest-rate volatilities. The second objective is to pay an appropriate rate of return to shareholders.

Our risk management policy provides the framework where an effective internal control system covering all risk areas is established and maintained. This system, which is an essential part of our risk management process, addresses, among other things, the production of reliable, complete, transparent, and timely financial and management information for Bank management, the Board of Directors, and the Finance Board. It also addresses compliance with applicable laws, regulations, policies, and directives of our Board of Directors and senior management. We perform, at least annually, a written risk assessment designed to reasonably identify and evaluate material risks, including both quantitative and qualitative aspects that could adversely affect the achievement of our performance objectives and compliance requirements.

Oversight of our overall risk management is provided by the Board of Directors through periodic review of our policies, exposures, and performance and compliance reports as well as regular reports by our internal and external auditors. The Board of Directors is responsible for setting our risk philosophies and working with senior management to align our objectives and strategies to these philosophies. Senior management develops, directs, and executes appropriate steps to carry out Bank strategies and policies established by the Board of Directors. Senior

management also oversees compliance and performance reporting, including the oversight of various risk management committees that address exposure to our defined risks.

We have a Code of Conduct that requires all employees, including senior management, to maintain the highest standards of honesty, integrity, impartiality, and ethical conduct at all times. It provides policies on topics such as compliance with applicable governmental laws, rules, and regulations; treatment of confidential and proprietary information; acceptance of gifts; financial relationships and interests; and fraud. The Code provides for the prompt reporting of violations of the Code to the General Counsel of the Bank. The General Counsel of the Bank provides interpretations of the Code and makes final rulings regarding violations. The Code provides for remedial or disciplinary action, or dismissal for Code violations.

## **Market Risk**

Market risk, also called interest-rate risk, is defined as the risk that net interest income or net market value of our capital stock will change as a result of changes in market conditions, such as interest rates, spreads, or interest-rate volatilities. Our Financial Risk Management Policy is designed to provide an asset and liability management framework to respond to changes in market conditions without creating undue balance sheet stress. The Board of Directors routinely reviews both the policy limits and the actual exposures to verify that the level of interest-rate risk in our balance sheet remains at prudent and reasonable levels.

Management's Asset/Liability Committee (ALCO) oversees the supervision and measurement of market risk. During its monthly meetings, ALCO reviews and approves financial strategies related to our asset/liability management objectives, reviews actual financial performance to business plan, reviews financial reports to analyze market risks, and monitors compliance with all financial risk measurements and limits.

The net market value of our assets, liabilities, and derivatives is primarily affected by changes in the level of interest rates. Duration measures an instrument's exposure to interest rate changes. Duration is the weighted-average maturity (typically measured in years) of an instrument's cash flows, weighted by the present value of those cash flows. As duration lengthens, risk increases. Duration is also a measure of price volatility. For example, the value of an instrument with a duration of 5 years will change by approximately 5 percent with a 1 percentage point change in interest rates. Higher duration numbers, whether positive or negative, indicate greater price volatility. A positive duration generally indicates a degree of interest-rate risk exposure in a rising rate environment, and a negative duration generally indicates a degree of interest-rate risk exposure in a declining rate environment.

Duration of equity, an extension of this conceptual framework, is a measure designed to capture the potential for the market value of a firm's capital to change with movements in interest rates. Duration of equity is the market value-weighted duration of assets minus the market value-weighted duration of liabilities divided by the market value of equity. We maintain duration of equity within ranges specified by the Board of Directors and by the Finance Board through management of the durations of our assets, liabilities, and interest-rate exchange agreements. The Board of Directors and the Finance Board require that our duration of equity,

assuming current interest rates, be maintained within a range of + / -5 years. We must also maintain our duration of equity, under an assumed instantaneous + / -200 basis points parallel shift in interest rates, within a range of + / -7 years.

We use an internal modeling system for measuring duration of equity. Base case and various interest-rate shock scenarios are used to model interest-rate sensitivity. The table summarizes our duration of equity in years at December 31, 2002 and 2001.

	<u>- 200 Basis Points</u>	<u>Base</u>	<u>+ 200 Basis Points</u>
December 31, 2002	(4.2)	(2.6)	2.0
December 31, 2001	2.5	(0.1)	(1.6)

We report the results of our duration of equity calculations to the Finance Board each quarter. Following implementation of our new capital plan, we ultimately will replace duration of equity-based limits on interest-rate risk with value-at-risk limits.

Growth of mortgage assets with their embedded optionality, partially offset by the related funding and hedging instruments, has the effect of widening the duration of equity range. In addition to measuring duration of equity, we also measure duration gap, the difference between the durations of assets and liabilities. Our duration gap at December 31, 2002 was (1.4) months compared to 0.6 months at December 31, 2001.

We also use a variety of other measurement and monitoring tools including interest-rate gap analysis and basis risk analysis, as well as simulations of income and market value variability. The Bank's financial management guidelines specify ranges for each of these variables.

The optionality embedded in certain financial instruments can create additional interest-rate risk. When a member prepays an advance, we could suffer lower future income if the principal portion of the prepaid advance were reinvested in lower-yielding assets that continue to be funded by higher-cost debt. To protect against this risk, we charge a prepayment fee that makes us financially indifferent to a borrower's decision to prepay an advance. When we offer advances (other than short-term advances) that a member may prepay without a prepayment fee, we usually finance such advances with callable debt or otherwise hedge the embedded option.

*Derivatives.* We enter into interest-rate exchange agreements to manage our exposure to changes in interest rates. We use derivatives to adjust the effective maturity, repricing frequency, or option characteristics of financial instruments to achieve risk management objectives. We do not use derivatives for speculative purposes.

Our current hedging strategies relate to hedges of existing assets/liabilities that qualify for fair-value hedge accounting treatment under SFAS 133, and economic hedges that are used to reduce market risk at the balance sheet or portfolio level. Economic hedges do not qualify for SFAS 133 accounting treatment and, as a result, only the derivative instrument is marked-to-market.

Prior to the execution of transactions under a new strategy, the hedging strategy must be approved by ALCO and all documentation for the strategy, including the basis for its treatment under SFAS 133, must be complete.

We manage the risk arising from changing market prices and volatility of a consolidated obligation by matching the cash inflow on the interest-rate exchange agreement with the cash outflow on the consolidated obligation. In addition, we require collateral agreements on all interest-rate exchange agreements which establish collateral delivery thresholds. While consolidated obligations are the joint-and-several obligations of the FHLBanks, each FHLBank serves as counterparty to interest-rate exchange agreements associated with specific debt issues for which it is the primary obligor.

In a typical transaction, fixed-rate consolidated obligations are issued for us by the Office of Finance, and we simultaneously enter into a matching interest-rate exchange agreement in which the counterparty pays us fixed cash flows designed to mirror in timing and amount the cash outflows paid by us on the consolidated obligation. In this typical transaction, we pay a variable cash flow that closely matches the interest payments we receive on short-term or variable-rate assets. This intermediation between the capital and derivative markets permits us to raise funds at lower costs than would otherwise be available through the issuance of floating-rate consolidated obligations in the capital markets.

With issuance of a fixed-rate convertible advance, we have effectively purchased from the member a put option that enables us to terminate the advance after the lock-out period and before final maturity. If we exercise our option, the member then has the choice of converting the advance to any available advance product at the then-current rate. We may hedge a convertible advance by entering into a cancelable interest-rate exchange agreement where we pay interest at a fixed rate and receive interest at a variable rate. The swap counterparty has the option to cancel the interest-rate exchange agreement on any put date, which would normally occur in a rising rate environment. If the counterparty exercises its option to terminate the swap, we then exercise our option to terminate the related advance.

We hold mortgage-related investments, including mortgage loans and MBS. The prepayment options embedded in mortgages can result in extensions or contractions in the expected maturities of these investments, depending on changes in interest rates. The Finance Board limits this source of interest-rate risk by restricting the types of MBS we may own to those with limited average life changes under certain interest-rate shock scenarios. We may hedge against contraction risk by funding some mortgage-related investments with consolidated obligations that have call features. Additionally, we may use interest-rate caps, floors, and other interest-rate exchange agreements to manage the extension and contraction variability of mortgage-related investments. We may also use interest-rate exchange agreements to transform the characteristics of investment securities other than MBS.

We manage the interest-rate and prepayment risk associated with mortgages through a combination of debt issuance and derivatives. We issue both callable and non-callable debt to achieve cash-flow patterns and liability durations similar to those expected on the mortgage loans. We also use derivatives to match the expected prepayment characteristics of the

mortgages. We analyze the risk of the mortgage portfolio on a regular basis by considering the interest-rate environment under various rate scenarios and performing analyses of the duration and convexity of the portfolio.

The following table categorizes the earnings impact of our net realized and unrealized gains and losses on derivatives and hedging activities by product for the years ended December 31, 2002 and 2001 (dollars in thousands).

	<u>Investments</u>	<u>Advances</u>	<u>Mortgage Loans</u>	<u>Consolidated Obligations</u>	<u>Balance Sheet</u>	<u>Total</u>
2002	\$ (2,366)	\$ (2,669)	\$ (23,331)	\$ 4,127	\$ (225)	\$ (24,464)
2001	\$ (6,933)	\$ 2,318	\$ 4,930	\$ 2,640	\$ (3,288)	\$ (333)

See additional discussion of our net realized and unrealized gains and losses on derivatives and hedging activities in the “Interest-Rate Exchange Agreements” and the “Other Income” sections of this document.

### **Liquidity Risk**

Liquidity risk is the risk that we will be unable to meet our obligations as they come due or meet the credit needs of our members and housing associates in a timely and cost-efficient manner. Day-to-day and contingency liquidity objectives are designed to protect our financial strength and to allow us to withstand market disruption. To achieve this objective, we establish liquidity management requirements and maintain liquidity in accordance with Finance Board regulations and our own liquidity policy.

ALCO provides oversight of liquidity risk management by reviewing and approving liquidity management strategies. Our liquidity risk management process is based on on-going calculations of net funding requirements, which are determined by analyzing future cash flows based on assumptions of the expected behavior of members and our assets, liabilities, capital stock, and derivatives. We maintain minimum liquidity to meet our net funding requirements assuming we are unable to access the consolidated obligation debt market each day for five consecutive business days. In addition, we maintain overnight investments of at least \$250 million to fund new lending.

### **Credit Risk**

We define credit risk as the potential that our borrowers or counterparties will fail to meet their obligations in accordance with agreed upon terms. The Bank’s primary credit risks arise from our ongoing lending, investing, and hedging activities through contractual agreements. Our overall objective in managing credit risk is to operate a sound credit-granting process and to maintain appropriate credit administration, measurement, and monitoring practices.

The Board of Directors establishes our credit risk philosophy by regularly reviewing our credit policies, positions, and compliance reports. Senior management has ultimate day-to-day responsibility for credit risk management and has established a Credit Committee to oversee and approve credit risk management strategies. In addition to approving strategy, the Credit Committee reviews credit risks to verify that they are appropriately identified, measured, and managed.

*Advances.* We engage in secured lending activities with eligible institutions. Credit risk arises from the possibility that, in the event a borrower defaults on its obligation to the Bank, the collateral pledged to us is insufficient to cover its obligation.

We manage credit risk to borrowers by: (1) utilizing agreements that require borrowers to maintain sufficient collateral acceptable to us to secure indebtedness to the Bank, (2) reviewing members' borrowing capacity by monitoring borrowers' creditworthiness through internal and external analysis, and (3) performing collateral review and valuation procedures to verify the sufficiency of pledged collateral. We have never experienced a credit loss on an advance since our inception. Based upon the collateral held as security and prior repayment history, management does not believe an allowance for credit losses on advances is necessary at this time.

As of December 31, 2002 and 2001, two borrowers had outstanding advances greater than \$1 billion. These advance holdings represented approximately 34 percent and 36 percent of the total par value of advances outstanding at each year end.

We are required by law to make advances solely on a secured basis. Each type of collateral accepted meets regulatory guidelines and is assigned a discounted value based on its relative risk. As of December 31, 2002 and 2001, members reported nearly \$46 billion and \$42 billion of collateral (net of applicable discount or margin factors) to support approximately \$24 billion and \$21 billion of advances and other activities with the Bank in each period. Residential, first-lien whole-loan collateral comprised approximately 76 percent and 78 percent of the total collateral reported by members for 2002 and 2001. The remainder of reported collateral consisted of securities collateral, other real estate related collateral, and eligible CFI collateral (secured small-business, small-farm, and small-agribusiness loans). Advances to CFIs secured by eligible CFI collateral represented approximately \$43 million of total advances outstanding at December 31, 2002, compared to \$28 million at December 31, 2001.

*Investments.* We maintain an investment portfolio to promote asset diversification and liquidity. Short-term unsecured investments such as commercial paper and federal funds are used primarily for liquidity management purposes. The credit risk associated with these investments relates to the ability of the counterparty to repay us in accordance with contractual terms. Finance Board regulations and Bank policies adopted by the Board of Directors limit the amount and term of unsecured credit exposures to counterparties other than to the U.S. Government. Unsecured credit limits are based on the credit quality of the counterparty and by the capital level of the counterparty or the Bank.

The following table summarizes our non-derivative unsecured credit exposure to counterparties other than the U.S. Government or U.S. Government agencies (including accrued interest receivable) as of December 31, 2002 (dollars in millions):

<u>Credit Ratings (1)</u>	<u>Certificates of Deposit</u>	<u>Commercial Paper</u>	<u>Overnight Federal Funds</u>	<u>Term Federal Funds</u>	<u>Total</u>
AAA	\$ -	\$ 310	\$ -	\$ -	\$ 310
AA	-	744	2,230	350	3,324
A	231	270	1,640	1,407	3,548
BBB	-	-	104	25	129
Total	<u>\$ 231</u>	<u>\$ 1,324</u>	<u>\$ 3,974</u>	<u>\$ 1,782</u>	<u>\$ 7,311</u>

(1) Credit Rating is the lower of S&P, Moody's, and Fitch ratings stated in terms of the S&P equivalent.

This compares to total exposure of \$1,675 million at December 31, 2001. The significant increase in our unsecured credit exposure results primarily from the termination of \$4 billion of repurchase agreements during 2002. Proceeds received from the terminations were shifted to commercial paper and overnight and term federal funds.

At December 31, 2002, 64 percent of this exposure had an overnight maturity, 18 percent had a maturity from 2 to 30 days, 17 percent had a maturity from 31 to 90 days, and the remaining one percent had a maturity less than 271 days. We had aggregate unsecured credit exposure of more than \$250 million, but less than \$285 million to each of 8 counterparties at December 31, 2002. The aggregate unsecured credit exposure to these counterparties represented approximately 29 percent of our unsecured credit exposure to non-government counterparties.

We also had unsecured exposure on U.S. agency bonds of \$603 million at December 31, 2002 and \$410 million at December 31, 2001. These exposures had a maturity greater than 270 days.

Additionally, we invest in MBS that are issued or guaranteed by government-sponsored housing enterprises as well as non-agency MBS rated AAA by one of the Nationally Recognized Statistical Ratings Organizations (NRSRO). We are exposed to credit risk to the extent that the guarantors or third parties providing credit enhancements fail to perform. We perform ongoing analysis to evaluate the investments and creditworthiness of the issuers and servicers for potential credit issues. As of December 31, 2002, we owned approximately \$3.3 billion of MBS that were issued or guaranteed by government-sponsored housing enterprises and approximately \$0.8 billion of non-agency MBS rated AAA by an NRSRO.

*Mortgage loans.* In managing our credit risk exposure in acquired MPF loans, we assume a limited first loss obligation, calculated as a predetermined percentage of the unpaid principal balance. Members assume credit losses up to the amount of the credit enhancement obligation as specified in their master agreements. This member credit enhancement obligation is collateralized under various agreements entered into with the Bank. In certain circumstances, we also use mortgage insurance to reduce credit risk. Losses remaining after the member credit enhancement and any mortgage insurance are the responsibility of the Bank.

Our MPF portfolio totaled \$5.7 billion par value at December 31, 2002 and was made up of loans from all 50 states, the District of Columbia, and Puerto Rico. Mortgage loans from an individual state make up no more than 16 percent of the total portfolio while the top five states make up less than 40 percent. The portfolio was composed of 64 percent conventional loans and 36 percent government-insured loans with an average original loan amount of approximately \$131 thousand at December 31, 2002. The average original loan-to-value (LTV) ratio of the conventional loan portfolio was approximately 72 percent while the LTV ratio of the government-insured portfolio was approximately 96 percent at December 31, 2002. Generally, the lower the LTV ratio, the lower the incidence and severity of default.

We have a loan loss provision that is consistent with the reserve rates used by other government-sponsored enterprises that invest in residential mortgage loans. This reserve totaled \$3.3 million at year-end 2002. Periodically, the Credit Committee reviews the adequacy of the loan loss provision taking into consideration both quantitative and qualitative factors, including historical net charge off levels for similar assets and adjustments for changes based on current market conditions. Management periodically reports the status of the loan loss provision to the Board of Directors. Management believes we have the policies and practices in place to appropriately manage this credit risk.

We place any conventional mortgage loan that is 90 days or more past due on nonaccrual status, where interest income on the loan is not accrued and any cash payments received are applied to interest until all interest is recovered before being applied to principal. A government-insured loan that is 90 days or more past due is not placed on nonaccrual status because members are obligated to repurchase any such loan.

We monitor the delinquency levels of our mortgage loan portfolio on a monthly basis. A summary of our delinquencies at December 31, 2002 follows (dollars in millions).

	<u>Unpaid Principal Balance</u>		
	<u>Conventional</u>	<u>Government- Insured</u>	<u>Total</u>
30 days	\$ 40.7	\$ 93.7	\$ 134.4
60 days	2.5	23.8	26.3
90 days	1.0	6.6	7.6
Greater than 90 days	0.5	2.7	3.2
Foreclosures and Bankruptcies	3.8	23.1	26.9
Total Delinquencies	<u>\$ 48.5</u>	<u>\$ 149.9</u>	<u>\$ 198.4</u>
Total Mortgage Loans Outstanding	<u>\$ 3,569.5</u>	<u>\$ 2,033.7</u>	<u>\$ 5,603.2</u>
Delinquencies as a % of Total Mortgage Loans	<u>1.36%</u>	<u>7.37%</u>	<u>3.54%</u>
Delinquencies 90 Days and greater as a % of Total Mortgage Loans	<u>0.15%</u>	<u>1.59%</u>	<u>0.67%</u>

At December 31, 2001, delinquencies as a percentage of total mortgage loans were 2.23% for conventional, 6.72% for government-insured, and 6.01% in total. Delinquencies 90 days and

greater as a percentage of total mortgage loans at December 31, 2001 were 0.50% for conventional, 0.36% for government-insured, and 0.38% in total.

*Derivatives.* Most of our hedging strategies use over-the-counter (OTC) derivatives instruments that expose us to counterparty credit risk because the transactions are executed and settled between two parties. When the OTC derivative has a market value above zero, the counterparty owes that value to the Bank over the remaining life of the derivative instrument. Credit risk arises from the possibility that the counterparty will not be able to fulfill its commitment to pay the amount owed to us.

We manage counterparty credit risk by: (1) establishing Board-approved credit standards for authorizing only highly-rated derivative counterparties, (2) utilizing master netting and bilateral collateral agreements, (3) continuously monitoring counterparty creditworthiness through internal and external analysis, and (4) managing credit exposures through collateral delivery. We calculate market values for all derivative contracts at least monthly and review them for reasonableness against independent sources. As a result of these risk mitigation initiatives, management does not anticipate any credit losses on our derivative agreements, and accordingly, has not set aside specific reserves for derivative counterparty exposures.

We had 24 active derivative counterparties as of December 31, 2002, most of which are large highly-rated banks and major broker-dealers. At December 31, 2002, six counterparties represented approximately 58 percent of the total notional amount of outstanding derivative transactions, and each had a credit rating of A+ or better. One counterparty with a AAA credit rating, Lehman Brothers Financial Products, represented approximately 72 percent of our net exposure after collateral.

The following table summarizes our derivative counterparty credit exposure, after applying netting agreements and collateral, at December 31, 2002 (dollars in millions).

<u>Credit Ratings (1)</u>	<u>Number of Counterparties</u>	<u>Notional Amount (2)</u>	<u>Total Exposure at Fair Value (3)</u>	<u>Exposure, Net of Collateral (4)</u>
AAA	3	\$ 3,569	\$ 42	\$ 42
AA	3	1,192	2	2
AA-	10	15,436	1	1
A+	6	9,066	2	2
A	2	2,669	1	1
<b>Total</b>	<b>24</b>	<b>\$ 31,932</b>	<b>\$ 48</b>	<b>\$ 48</b>

- (1) Credit Rating is the lower of S&P and Moody's ratings stated in terms of the S&P equivalent.
- (2) Notional amounts serve as a factor in determining periodic amounts to be received and paid and generally do not represent actual amounts to be exchanged or directly reflect our exposure to institutional credit risk.
- (3) For each counterparty, this amount includes derivatives with a net positive market value including the related accrued interest receivable/payable (net).
- (4) "Total Exposure at Fair Value" less fair value of collateral held as determined at the counterparty level.

At December 31, 2001, we had \$26.6 billion in notional amount outstanding with 25 counterparties. Of these counterparties, 3 were rated AAA, 4 were rated AA, 12 were rated AA-, 4 were rated A+, and 2 were rated A. The total net exposure at fair value was \$199 million. After offsetting collateral of \$74 million, exposure net of collateral amounted to \$125 million.

## **Operational Risk**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, systems, or external events. Operational risk is inherent in all of our business activities and processes. Management has established extensive policies and procedures to reduce the likelihood of operational risk and designed our annual risk assessment process to provide ongoing identification, measurement, and monitoring of operational risk. The Operations Risk Committee, established by senior management, reviews the risk assessment results and business unit recommendations regarding operational risk.

Management reduces the risk of process and system failures by implementing controls designed to provide assurance that transactions are recorded in accordance with source documentation and maintaining certain back-up facilities. In addition, management has developed and tested a comprehensive disaster recovery plan to restore mission critical processes and systems in a timely manner.

We use various financial models and model output to quantify financial risks and analyze potential strategies. Management mitigates the risk of incorrect model output leading to inappropriate business decisions by benchmarking model results to independent sources and having third-parties periodically validate critical model output.

We mitigate the operational risk related to human factors by following comprehensive human resource policies and practices.

Despite the above policies and oversight, some operational risks are beyond our control, and the failure of other parties to adequately address their operational risk could adversely affect us.

## **LEGISLATION AND REGULATORY DEVELOPMENTS**

*Capital Plans.* On January 30, 2001, the Finance Board published a final rule implementing the GLB Act and requiring a new capital structure for all of the FHLBanks. The rule established risk-based and leverage capital requirements, addressed different classes of stock that we may issue and the rights and preferences that may be associated with each class of stock, and required us to submit a capital plan to the Finance Board for approval by October 29, 2001. The Finance Board approved our capital structure plan on July 10, 2002. The capital rule provided a transition period that allows us up to three years from the effective date of our capital plan to implement our new capital structure. However, as previously discussed, we expect to implement our plan on July 1, 2003. Until we fully implement our new capital plan, the current requirements for Bank capital stock remain in effect.

*Multiple Membership Petitions.* The Finance Board published a solicitation of comments on the implications for the FHLBanks raised by structural changes occurring in its membership. The solicitation was prompted by the submission of several petitions requesting that the Finance Board permit a single depository institution to become a member of two FHLBanks concurrently. On January 22, 2002, the Finance Board announced that it intended to defer action on multi-district membership petitions until it decided on a course of action to address broader membership issues. In December of 2002, the Finance Board announced that an independent legal analysis reaffirmed the Finance Board's authority to regulate the terms of membership in the FHLBanks as part of its mandate, and that the Finance Board would consider a proposed regulation during 2003. In advance of that rulemaking, the Finance Board solicited comments from the FHLBanks regarding the ongoing changes in the financial services industry.

*Discussions of Enhanced Financial Disclosures.* The staff of the Finance Board has initiated discussions with the staff of the Division of Corporation Finance of the Securities and Exchange Commission (SEC) and the Department of Treasury about expansion of the financial disclosures of the FHLBanks in accordance with SEC regulations. The Office of Finance prepares the combined financial reports of the FHLBanks based on current Finance Board regulations, which are generally consistent with SEC Regulations S-K and S-X, subject to certain exceptions contained in the Finance Board regulations due to the unique nature of the FHLBanks (the FHLBanks, as part of a cooperative system, are not publicly traded corporations, and the member financial institutions hold all FHLBank stock). It is not yet known whether enhanced financial disclosures of the FHLBanks will fall under SEC guidelines or Finance Board regulations.

*MPF Shared Funding Program.* In December 2002, the Finance Board approved the Shared Funding program, a new business activity submitted by the FHLBank of Chicago on behalf of all FHLBanks participating in the MPF program. The Shared Funding program allows mortgage loans eligible for purchase through the MPF program to be pooled into securities and allows the securities to be sold to the FHLBanks and FHLBank members. The securities offered under the Shared Funding program will not be guaranteed by the FHLBanks. As a participant in the MPF program, we plan to allow our members to sell qualifying mortgage loans into the Shared Funding program. Additionally, we plan to purchase mortgage pass-through securities under this program that are rated at least AA by an NRSRO.



## **Audit Committee Report**

The Audit Committee of the Board of Directors of the Federal Home Loan Bank of Des Moines for 2002 was composed of ten Directors, four of whom were appointed to the Board by the Federal Housing Finance Board and six of whom were elected to the Board by the members of the Bank. The Audit Committee members are independent, as defined by the Federal Housing Finance Board.

The Audit Committee oversees the Bank's financial reporting process; reviews compliance with laws, regulations, policies and procedures; and evaluates the adequacy of administrative, operating, and internal accounting controls. The Audit Committee is governed by a written charter and satisfied its responsibilities during 2002 in compliance with the charter. In fulfilling its responsibilities, the Audit Committee has reviewed and discussed the audited financial statements with management. The Committee has discussed with the independent auditors the matters required to be discussed by SAS No. 61, Communication with Audit Committee, as may be modified or supplemented. The Committee has also received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1, and has discussed with the auditors the auditor's independence.

Based on the review and discussions referred to above, the Audit Committee recommends to the Board of Directors that the 2002 financial statements be included in the Annual Report.

Thomas J. Larson, Chair  
Cecelia A. Grunewaldt, Vice Chair  
Charles R. Brazeale  
F. Joseph Du Bray  
Curtis L. Hage

Randy L. Newman  
Wendy Speckerman  
Thomas E. Woods  
John J. Wuest  
Dale J. Torpey, Ex Officio

**February 24, 2003**

**To the Board of Directors of the  
Federal Home Loan Bank of Des Moines**

In our opinion, the accompanying statements of condition and the related statements of income, capital and of cash flows present fairly, in all material respects, the financial position of the Federal Home Loan Bank of Des Moines (the "FHLBank") at December 31, 2002 and 2001, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the FHLBank's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Also, in accordance with those standards and as part of our audit of the FHLBank's financial statements, we issued a separate report on compliance and on internal control over financial reporting. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2, the FHLBank adopted Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by Statement of Financial Accounting Standards No. 138, on January 1, 2001.

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

PricewaterhouseCoopers LLP  
Chicago, Illinois

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENTS OF CONDITION**  
(In thousands, except per share amounts)

	December 31,	
	2002	2001
<b>ASSETS</b>		
Cash and due from banks (Note 3)	\$ 102,741	\$ 63,820
Interest-bearing deposits	494,000	135,296
Securities purchased under agreements to resell (Note 4)	-	4,000,000
Federal funds sold	5,751,000	1,470,000
Investments:		
Held-to-maturity securities (Note 5)	5,253,996	4,013,036
Available-for-sale securities, includes \$323,252 pledged in 2002 (Note 6)	778,628	213,753
Securities held at fair value (Note 7)	65,750	147,646
Advances (Note 8)	24,008,170	20,756,072
Mortgage loans held for portfolio, net of allowance for credit losses on mortgage loans of \$3,255 in 2002 and \$3,102 in 2001 (Note 10)	5,660,662	3,741,776
Accrued interest receivable	65,680	56,262
Premises and equipment, net	6,507	7,120
Derivative assets	47,907	198,717
Other assets	19,331	17,792
<b>Total assets</b>	<b>\$ 42,254,372</b>	<b>\$ 34,821,290</b>
<b>LIABILITIES AND CAPITAL</b>		
<b>LIABILITIES:</b>		
Deposits: (Note 11)		
Demand and overnight	\$ 1,610,110	\$ 1,817,020
Term	24,090	160,870
<b>Total deposits</b>	<b>1,634,200</b>	<b>1,977,890</b>
Borrowings: (Note 12)		
Loans from other FHLBanks	50,000	50,000
Securities sold under agreements to repurchase	300,000	-
<b>Total borrowings</b>	<b>350,000</b>	<b>50,000</b>
Consolidated obligations, net: (Note 13)		
Discount notes	7,758,105	7,316,676
Bonds	29,573,346	23,444,343
<b>Total consolidated obligations</b>	<b>37,331,451</b>	<b>30,761,019</b>
Accrued interest payable	292,112	293,766
Affordable Housing Program (Note 9)	19,663	26,689
Payable to REFCORP (Note 1)	4,094	6,541
Derivative liabilities	710,280	118,111
Other liabilities	7,632	5,132
<b>Total liabilities</b>	<b>40,349,432</b>	<b>33,239,148</b>
Commitments and contingencies (Notes 1, 8, 9, 13, 15, 17, and 19)		
<b>CAPITAL: (Note 14)</b>		
Capital stock (\$100 par value) issued and outstanding:		
18,581,797 shares in 2002 and 15,392,968 shares in 2001	1,858,180	1,539,297
Retained earnings	50,130	42,503
Accumulated other comprehensive income:		
Net unrealized gain (loss) on available-for-sale securities (Note 6)	(3,370)	342
<b>Total capital</b>	<b>1,904,940</b>	<b>1,582,142</b>
<b>Total liabilities and capital</b>	<b>\$ 42,254,372</b>	<b>\$ 34,821,290</b>

The accompanying notes are an integral part of these financial statements.

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENTS OF INCOME**  
(In thousands)

	For the Years Ended December 31,		
	2002	2001	2000
<b>INTEREST INCOME:</b>			
Advances	\$ 594,039	\$ 1,012,104	\$ 1,427,272
Interest-bearing deposits	4,841	5,707	8,720
Securities purchased under agreements to resell	22,421	86,196	24,995
Federal funds sold	59,635	116,880	203,471
Investments:			
Held-to-maturity securities	179,184	225,788	382,968
Available-for-sale securities	9,946	1,577	-
Securities held at fair value	2,124	8,408	-
Mortgage loans held for portfolio	263,061	261,273	179,823
Loans to other FHLBanks	233	368	431
Total interest income	<u>1,135,484</u>	<u>1,718,301</u>	<u>2,227,680</u>
<b>INTEREST EXPENSE:</b>			
Consolidated obligations	986,732	1,521,586	1,983,567
Deposits	25,699	72,169	48,231
Borrowings from other FHLBanks	3,016	2,905	2,989
Securities sold under agreements to repurchase	1,933	-	-
Other borrowings	240	120	313
Total interest expense	<u>1,017,620</u>	<u>1,596,780</u>	<u>2,035,100</u>
<b>NET INTEREST INCOME BEFORE MORTGAGE</b>			
<b>LOAN LOSS PROVISION</b>	117,864	121,521	192,580
Provision for credit losses on mortgage loans (Note 10)	<u>(154)</u>	<u>(1,091)</u>	<u>(2,021)</u>
<b>NET INTEREST INCOME AFTER MORTGAGE</b>			
<b>LOAN LOSS PROVISION</b>	<u>117,710</u>	<u>120,430</u>	<u>190,559</u>
<b>OTHER INCOME:</b>			
Prepayment fees, net (Note 8)	5,826	16,714	101
Service fees	3,049	3,633	3,987
Net gain (loss) on securities held at fair value	(2,097)	865	-
Net realized and unrealized loss on derivatives and hedging activities (Note 2)	(24,464)	(333)	-
Other, net	2,521	(6,497)	(2,617)
Total other income	<u>(15,165)</u>	<u>14,382</u>	<u>1,471</u>
<b>OTHER EXPENSES:</b>			
Operating	22,990	22,931	21,169
Finance Board	1,188	1,234	1,272
Office of Finance	897	603	664
Total other expenses	<u>25,075</u>	<u>24,768</u>	<u>23,105</u>
<b>INCOME BEFORE ASSESSMENTS</b>			
	<u>77,470</u>	<u>110,044</u>	<u>168,925</u>
Affordable Housing Program	6,324	9,080	13,834
REFCORP (Note 1)	14,229	20,434	31,018
Total assessments	<u>20,553</u>	<u>29,514</u>	<u>44,852</u>
<b>INCOME BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE</b>			
	56,917	80,530	124,073
Cumulative effect of a change in accounting principle (Note 2)	<u>-</u>	<u>1,206</u>	<u>-</u>
<b>NET INCOME</b>	<u>\$ 56,917</u>	<u>\$ 81,736</u>	<u>\$ 124,073</u>

The accompanying notes are an integral part of these financial statements.

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENTS OF CAPITAL**  
**YEARS ENDED DECEMBER 31, 2002, 2001, AND 2000**  
(In thousands)

	Capital Stock		Retained Earnings	Accumulated Other Comprehensive Income	Total Capital
	Shares	Par Value			
BALANCE, DECEMBER 31, 1999	22,292	\$ 2,229,179	\$ 35,138	\$ -	\$ 2,264,317
Proceeds from sale of capital stock	3,288	328,835	-	-	328,835
Redemption of capital stock	(8,135)	(813,534)	-	-	(813,534)
Net income	-	-	124,073	-	124,073
Cash dividends on capital stock	-	-	(130,236)	-	(130,236)
BALANCE, DECEMBER 31, 2000	17,445	1,744,480	28,975	-	1,773,455
Proceeds from sale of capital stock	4,905	490,469	-	-	490,469
Redemption of capital stock	(6,957)	(695,652)	-	-	(695,652)
Comprehensive income:					
Net income	-	-	81,736	-	81,736
Other comprehensive income:					
Net unrealized gain on available-for-sale securities	-	-	-	342	342
Comprehensive income	-	-	81,736	342	82,078
Cash dividends on capital stock	-	-	(68,208)	-	(68,208)
BALANCE, DECEMBER 31, 2001	15,393	1,539,297	42,503	342	1,582,142
Proceeds from sale of capital stock	3,601	360,061	-	-	360,061
Redemption of capital stock	(412)	(41,178)	-	-	(41,178)
Comprehensive income:					
Net income	-	-	56,917	-	56,917
Other comprehensive income:					
Net unrealized loss on available-for-sale securities	-	-	-	(3,712)	(3,712)
Comprehensive income	-	-	56,917	(3,712)	53,205
Cash dividends on capital stock	-	-	(49,290)	-	(49,290)
BALANCE, DECEMBER 31, 2002	18,582	\$ 1,858,180	\$ 50,130	\$ (3,370)	\$ 1,904,940

The accompanying notes are an integral part of these financial statements.

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENTS OF CASH FLOWS**  
(In thousands)

	For the Years Ended December 31.		
	2002	2001	2000
<b>OPERATING ACTIVITIES:</b>			
Net income	\$ 56,917	\$ 81,736	\$ 124,073
Cumulative effect of change in accounting principle	-	(1,206)	-
Income before cumulative effect of change in accounting principle	<u>56,917</u>	<u>80,530</u>	<u>124,073</u>
Adjustments to reconcile income before cumulative effect of change in accounting principle to net cash provided by operating activities:			
Depreciation and amortization:			
Net premiums and discounts on consolidated obligations, investments, mortgage loans, and deferred fees received on interest-rate exchange agreements	(177,674)	(179,961)	170,566
Concessions on consolidated obligation bonds	21,660	14,005	3,836
Deferred loss on interest-rate exchange agreements, net	729	690	711
Premises and equipment	928	998	936
Other	(75)	353	-
Provision for credit losses on mortgage loans held for portfolio	154	1,091	2,021
Loss due to change in net mark-to-market adjustments for interest-rate exchange agreements	-	-	5,764
Decrease in securities held at fair value, net of transfers and transition adjustments	81,896	56,231	-
Net change in fair value adjustment on derivative and hedging activities	84,256	(47,779)	-
Net realized loss on disposal of premises and equipment	-	6	6
Decrease (increase) in accrued interest receivable	(9,418)	628,574	(55,796)
Decrease (increase) in derivative asset accrued interest	202,515	(257,948)	-
Decrease in derivative liability accrued interest	(90,693)	(28,815)	-
Increase in other assets	(23,199)	(471)	(20,564)
Net increase (decrease) in Affordable Housing Program (AHP) liability and discount on AHP advances	(7,079)	(1,380)	2,987
Decrease in accrued interest payable	(1,654)	(134,682)	(31,764)
Increase (decrease) in payable to REFCORP	(2,447)	(1,327)	2,801
Decrease in payable for securities settlement	-	-	(103,297)
Increase (decrease) in other liabilities	<u>2,500</u>	<u>(8,172)</u>	<u>(5,513)</u>
Total adjustments	<u>82,399</u>	<u>41,413</u>	<u>(27,306)</u>
Net cash provided by operating activities	<u>139,316</u>	<u>121,943</u>	<u>96,767</u>

The accompanying notes are an integral part of these financial statements.

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENTS OF CASH FLOWS**  
(In thousands)

	For the Years Ended December 31,		
	2002	2001	2000
<b>INVESTING ACTIVITIES:</b>			
Net decrease (increase) in interest-bearing deposits	(358,704)	134,704	(20,000)
Net decrease (increase) in securities purchased under agreements to resell	4,000,000	(3,200,000)	(800,000)
Net decrease (increase) in Federal funds sold	(4,281,000)	2,485,000	2,720,000
Net decrease (increase) in short-term held-to-maturity securities	(1,240,836)	(60,703)	831,942
Proceeds from sales of long-term held-to-maturity securities	33,134	-	-
Proceeds from maturities of long-term held-to-maturity securities	1,716,529	2,175,757	833,225
Purchases of long-term held-to-maturity securities	(1,734,340)	(1,054,434)	(1,144)
Purchases of available-for-sale securities	(493,339)	(222,555)	-
Principal collected on advances	27,064,650	50,903,470	86,248,050
Advances made	(29,690,989)	(50,162,868)	(84,456,349)
Principal collected on mortgage loans held for portfolio	1,681,047	1,619,041	96,130
Mortgage loans held for portfolio originated or purchased	(3,605,130)	(2,073,951)	(3,313,911)
Net increase in premises and equipment	(313)	(1,590)	(857)
Net cash provided by (used in) investing activities	<u>(6,909,291)</u>	<u>541,871</u>	<u>2,137,086</u>
<b>FINANCING ACTIVITIES:</b>			
Net increase (decrease) in deposits	(343,690)	842,417	221,203
Net increase in securities sold under agreements to repurchase	300,000	-	-
Net proceeds from issuance of consolidated obligations:			
Discount notes	426,477,584	152,059,247	73,507,846
Bonds	33,420,889	21,535,199	9,875,096
Payments for maturing and retiring consolidated obligations:			
Discount notes	(426,024,602)	(152,720,924)	(74,958,130)
Bonds	(27,290,878)	(22,114,131)	(10,374,274)
Proceeds from issuance of capital stock	360,061	490,469	328,835
Payments for redemption of capital stock	(41,178)	(695,652)	(813,534)
Cash dividends paid	(49,290)	(68,208)	(130,236)
Net cash provided by (used in) financing activities	<u>6,808,896</u>	<u>(671,583)</u>	<u>(2,343,194)</u>
Net increase (decrease) in cash and cash equivalents	38,921	(7,769)	(109,341)
Cash and cash equivalents at beginning of the year	<u>63,820</u>	<u>71,589</u>	<u>180,930</u>
Cash and cash equivalents at end of the year	<u>\$ 102,741</u>	<u>\$ 63,820</u>	<u>\$ 71,589</u>
<b>Supplemental Disclosures:</b>			
Cash paid for interest	\$ 1,136,452	\$ 1,973,404	\$ 1,908,886

The accompanying notes are an integral part of these financial statements.

# FEDERAL HOME LOAN BANK OF DES MOINES

## NOTES TO FINANCIAL STATEMENTS

### Background Information

The Federal Home Loan Bank of Des Moines (the Bank), a federally chartered corporation that is exempt from all federal, state, and local taxation except real property taxes, is one of 12 district Federal Home Loan Banks (FHLBanks). The FHLBanks serve the public by enhancing the availability of funds (advances and mortgage loans) for residential mortgages and targeted community development. The Bank provides a readily available, low-cost source of funds to its member institutions in Iowa, Minnesota, Missouri, North Dakota, and South Dakota. The Bank is a cooperative whose member institutions own the capital stock of the Bank and receive dividends on their investment. Regulated financial depositories and insurance companies engaged in residential housing finance can apply for membership. All members must purchase stock in the Bank.

The Federal Housing Finance Board (Finance Board), an independent agency in the executive branch of the United States Government, supervises and regulates the FHLBanks and the Office of Finance. The Finance Board ensures that the FHLBanks operate in a safe and sound manner, carry out their housing finance mission, remain adequately capitalized, and can raise funds in the capital markets. Also, the Finance Board establishes policies and regulations covering the operations of the FHLBanks. Each FHLBank operates as a separate entity with its own management, employees, and board of directors. The Bank does not have any variable interest entities or any other type of off-balance sheet conduits.

The FHLBanks' debt instruments (consolidated obligations) are the joint and several obligations of all the FHLBanks and are the primary source of funds for the FHLBanks. Deposits, other borrowings, and capital stock issued to members provide other funds. Some FHLBanks also provide member institutions with correspondent services, such as item processing, collection, and settlement.

In accordance with Finance Board regulations, the Bank has established formal directors' compensation and travel reimbursement policies. The directors' compensation policy includes fees for attending board meetings. During 2002, the Bank compensated its directors a total of \$300,000, which includes \$95,000 that was deferred under a deferred compensation plan. In addition, the Bank paid \$91,000 for travel and related expenses in connection with the performance of director duties.

### Note 1—Summary of Significant Accounting Policies

*Use of Estimates.* The preparation of financial statements requires management to make assumptions and estimates. These assumptions and estimates may affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of income and expenses. Actual results could differ from these estimates.

*Investments.* The Bank carries at cost investments for which it has both the ability and intent to hold to maturity, adjusted for the amortization of premiums and accretion of discounts using a method that approximates the level-yield method. In addition, the Bank adjusted the carrying value of these investments for the unamortized costs of, and deferred gains and losses from, associated interest-rate exchange agreements for periods prior to the implementation of Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of Effective Date of FASB Statement No. 133*, and as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* (SFAS 133).

The Bank classifies certain investments that it may sell before maturity as available-for-sale and carries them at fair value. The change in fair value of the available-for-sale securities is recorded in other comprehensive income as a net unrealized gain or loss on available-for-sale securities.

The Bank classifies certain investments as securities held at fair value and carries them at fair value. The Bank records changes in the fair value of these investments in other income.

The Bank computes gains and losses on sales of investment securities using the specific identification method and includes these gains and losses in other income. The Bank treats securities purchased under agreements to resell as collateralized financings.

*Advances.* The Bank presents advances net of unearned commitment fees and discounts on advances for the Affordable Housing Program (AHP). The Bank amortizes the premiums and discounts on advances to interest income using a method that approximates the level-yield method. In addition, prior to implementing SFAS 133 in 2001, the Bank adjusted the carrying value of advances for the unamortized cost of, and deferred gains and losses from, associated interest-rate exchange agreements. The Bank credits interest on advances to income as earned. Following the requirements of the Federal Home Loan Bank Act of 1932 (the Act), as amended, the Bank obtains sufficient collateral on advances to protect it from losses. The Act limits eligible collateral to certain government or government-agency securities, residential mortgage loans, cash or deposits with the Bank, and other eligible real estate-related assets. Community financial institutions (FDIC-insured institutions with assets less than \$527 million during 2002, which may be adjusted by the Finance Board based on changes in the Consumer Price Index) are subject to additional statutory collateral rules that permit the use of secured small business and agricultural loans. The Bank has not incurred any credit losses on advances since its inception. Because of the collateral held as security on the advances and repayment history, management of the Bank believes that an allowance for credit losses on advances is unnecessary.

*Mortgage Loans Held for Portfolio.* The Bank is participating in the Mortgage Partnership Finance® (MPF®) (“Mortgage Partnership Finance” and “MPF” are registered trademarks of the FHLBank of Chicago) program under which the Bank invests in mortgage loans which are funded by the Bank through, or purchased from, its participating members. The Bank manages the liquidity, interest rate, and prepayment risk of the loans, while the members retain the marketing and servicing activities. The Bank and the members share in the credit risk of the loans. The Bank assumes a limited first loss obligation, and the members assume credit losses up to the amount of the credit enhancement obligation as specified in the master agreement.

The Bank classifies mortgage loans as held for investment and reports them at their principal amount outstanding, net of deferred loan fees and premiums and discounts.

The Bank defers and amortizes mortgage loan origination fees and premiums/discounts as interest income over the average life of the related mortgage loan. Actual prepayment experience and estimates of future principal prepayments are used in calculating the average lives of the mortgage loans. The Bank aggregates the mortgage loans by similar characteristics (type, coupon, maturity, and acquisition date) in determining prepayment estimates.

The Bank records non-origination fees, such as credit enhancement fees and pair-off fees, in interest income and other income, accordingly.

The Bank places a conventional mortgage loan on nonaccrual status when the collection of the contractual principal or interest is 90 days or more past due. When a mortgage loan is placed on nonaccrual status, current year accrued but uncollected interest is reversed against interest income. The Bank records cash payments received on nonaccrual loans first as interest income until it recovers all interest and then as principal. A government-guaranteed loan is not placed on nonaccrual status when the collection of the contractual principal or interest is 90 days or more past due because the member is obligated to repurchase the loan.

The Bank bases the allowance for credit losses on management’s estimate of credit losses inherent in the Bank’s mortgage loan portfolio as of the balance sheet date. Actual losses greater than defined levels are offset by the members’ credit enhancement up to their respective limits. The Bank performs periodic reviews of its portfolio to identify the losses inherent within the portfolio and to determine the likelihood of collection of the portfolio. The overall allowance is determined by an analysis that includes consideration of various data observations such as past performance, current performance, loan portfolio characteristics, collateral valuations, industry data, and prevailing economic conditions.

The first loss liability is the responsibility of the Bank and is a predetermined percentage of the unpaid principal balance, net of related charge-offs. The Bank’s members bear credit risk on their respective mortgages through a credit enhancement. This member credit risk may be collateralized under various agreements entered into with the Bank. In certain circumstances, the Bank uses mortgage insurance to reduce credit risk. Losses remaining after the member credit enhancement and any mortgage insurance are the responsibility of the Bank.

*Affordable Housing Program.* The Act requires each FHLBank to establish and fund an AHP (see Note 9). The Bank charges the required funding for AHP at the time of the commitment to earnings and establishes a liability. The AHP funds provide direct subsidies to members to assist in the purchase, construction, or rehabilitation of housing for very low-, low-, and moderate-income households. The Bank grants AHP advances at interest rates below the customary interest rate for non-subsidized advances. When the Bank makes an AHP advance, the present value of the variation in the cash flow caused by the difference in the interest rate between the AHP advance rate and the FHLBanks' related cost of funds for comparable maturity funding is charged against the AHP liability and recorded as a discount on the AHP advance.

*Prepayment Fees.* The Bank charges its members a prepayment fee when members prepay certain advances before the original maturity. The Bank credits prepayment fees to other income. The Bank nets gains and losses on the termination of interest-rate exchange agreements associated with prepaid advances with prepayment fees in other income.

*Commitment Fees.* The Bank defers commitment fees for advances and accretes them to interest income using the straight-line method over the life of the resulting advance. Refundable fees are deferred until the commitment expires or until the advance is made. The Bank records commitment fees for letters of credit as a deferred credit when it receives the fees and accretes them to other income using the straight-line method over the term of the letter of credit.

*Derivatives.* All derivatives are recognized in the statements of condition at their fair value and are designated as (1) a hedge of the fair value of (a) a recognized asset or liability or (b) an unrecognized firm commitment (a "fair-value" hedge); (2) a hedge of (a) a forecasted transaction or (b) the variability of cash flows that are to be received or paid in connection with a recognized asset or liability (a "cash-flow" hedge); (3) a hedge of the foreign currency component of a hedged item in a fair-value or cash-flow hedge; (4) a non-SFAS 133 hedge of an asset or liability (economic hedge) for asset-liability management purposes. Changes in the fair value of a derivative that is effective as — and that is designated and qualifies as — a fair-value hedge, along with changes in the fair value of the hedged asset or liability that are attributable to the hedged risk (including changes that reflect gains or losses on firm commitments), are recorded in current-period earnings. Changes in the fair value of a derivative that is effective as — and that is designated and qualifies as — a cash-flow hedge, to the extent that the hedge is effective, are recorded in other comprehensive income, until earnings are affected by the variability of cash flows of the hedged transaction (e.g., until periodic settlements of a variable-rate asset or liability are recorded in earnings). Changes in the fair value of a derivative that is effective as — and that is designated and qualifies as — a foreign-currency hedge are recorded in either current-period earnings or other comprehensive income, depending on whether the hedging relationship satisfies the criteria for a fair-value or cash-flow hedge. Any hedge ineffectiveness (which represents the amount by which the changes in the fair value of the derivative differ from the changes in fair value of the hedged item or the variability in the cash flows of the forecasted

transaction) is recorded in current-period earnings. Changes in the fair value of a stand-alone derivative designated as an economic hedge are recorded in current-period earnings with no fair value adjustment to an asset or liability. Hedge ineffectiveness and changes in the fair value of stand-alone derivatives are recorded in other income as “Net realized and unrealized loss on derivatives and hedging activities.” The Bank has not currently designated any derivatives as cash-flow hedges or hedges of foreign-currency transactions.

The Bank occasionally purchases financial instruments in which a derivative instrument is “embedded” and that are not remeasured at fair value with changes in fair value reported in earnings as they occur. Upon purchasing the financial instrument, the Bank assesses whether the economic characteristics of the embedded derivative are clearly and closely related to the economic characteristics of the remaining component of the financial instrument (i.e., the host contract) and whether a separate, non-embedded instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. When it is determined that (1) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract and (2) a separate, stand-alone instrument with the same terms would qualify as a derivative instrument, the embedded derivative is separated from the host contract, carried at fair value, and designated as either (a) a hedging instrument in a fair-value, cash-flow, or foreign-currency hedge or (b) a stand-alone derivative instrument pursuant to an economic hedge.

The Bank formally documents all relationships between derivative hedging instruments and hedged items, as well as its risk-management objectives and strategies for undertaking various hedge transactions and its method of assessing ineffectiveness. This process includes linking all derivatives that are designated as fair-value hedges to assets and liabilities in the statements of condition or firm commitments. The Bank also formally assesses (both at the hedge’s inception and at least quarterly on an ongoing basis) whether the derivatives that are used in hedging transactions have been effective in offsetting changes in the fair value of hedged items and whether those derivatives may be expected to remain effective in future periods. The Bank typically uses regression analyses or other statistical analyses to assess the effectiveness of its hedges. When it is determined that a derivative has not been or is not expected to be effective as a hedge, the Bank discontinues hedge accounting prospectively, as discussed below.

The Bank discontinues hedge accounting prospectively when (1) it determines that the derivative is no longer effective in offsetting changes in the fair value or cash flows of a hedged item; (2) the derivative and/or the hedged item expires or is sold, terminated, or exercised; (3) a hedged firm commitment no longer meets the definition of a firm commitment; or (4) management determines that designating the derivative as a hedging instrument is no longer appropriate.

When hedge accounting is discontinued due to the Bank's determination that the derivative no longer qualifies as an effective fair-value hedge, the Bank will continue to carry the derivative in the statements of condition at its fair value, cease to adjust the hedged asset or liability for changes in fair value, and begin to amortize the cumulative basis adjustment on the hedged item into earnings over the remaining life of the hedged item using a method that approximates the level-yield method. When hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, the Bank will continue to carry the derivative in the statements of condition at its fair value, removing from the statements of condition any asset or liability that was recorded to recognize the firm commitment and recording it as a gain or loss in current-period earnings. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, the Bank will carry the derivative at its fair value in the statements of condition, recognizing changes in the fair value of the derivative in current-period earnings.

The Bank is not a derivatives dealer and thus does not trade derivatives for short-term profit.

The Bank is subject to credit risk due to the risk of nonperformance by counterparties to the derivative agreements. The degree of counterparty risk on derivative agreements depends on the extent to which master netting arrangements are included in such contracts to mitigate the risk. The Bank manages counterparty credit risk through credit analysis and collateral requirements and by following the requirements set forth in the Finance Board's Financial Management Policy. Based on credit analyses and collateral requirements, the management of the Bank does not anticipate any credit losses on its agreements.

#### *Hedging Activities.*

General - The Bank enters into interest-rate swaps, swaptions, interest-rate cap and floor agreements, calls, puts, and futures and forward contracts (collectively, interest-rate exchange agreements) to manage its exposure to changes in interest rates. The Bank may adjust the effective maturity, repricing frequency, or option characteristics of financial instruments to achieve risk-management objectives. The Bank uses interest-rate exchange agreements in two ways: either by designating them as a fair-value hedge of an underlying financial instrument or in asset-liability management (i.e., a non-SFAS 133 economic hedge). For example, the Bank uses interest-rate exchange agreements in its overall interest-rate risk management to adjust the interest-rate sensitivity of consolidated obligations to approximate more closely the interest-rate sensitivity of assets (both advances and investments), and/or to adjust the interest-rate sensitivity of advances, investments or mortgage loans to approximate more closely the interest-rate sensitivity of liabilities. In addition to using interest-rate exchange agreements to manage mismatches of interest rates between assets and liabilities, the Bank also uses interest-rate exchange agreements to manage embedded options in assets and liabilities, to hedge the market value of existing assets and liabilities and anticipated transactions, to hedge the duration risk of prepayable instruments, and to reduce funding costs.

A non-SFAS 133 economic hedge (economic hedge) is defined as an interest-rate exchange agreement hedging specific or non-specific underlying assets, liabilities or firm commitments that do not qualify for hedge accounting under the rules of SFAS 133, but are acceptable hedging strategies under the Bank's risk management program. These strategies also comply with Finance Board regulatory requirements. An economic hedge by definition introduces the potential for earnings variability due to the change in fair value recorded on the interest-rate exchange agreement(s) that are not offset by corresponding changes in the value of the economically hedged assets, liabilities, or firm commitments.

The Bank, consistent with Finance Board regulation, enters into interest-rate exchange agreements only to reduce the market risk exposures inherent in otherwise unhedged assets and funding positions. Bank management utilizes interest-rate exchange agreements in cost efficient strategies and may enter into interest-rate exchange agreements that do not necessarily qualify for hedge accounting under SFAS 133 accounting rules. As a result, the Bank recognizes only the change in fair value of these interest-rate exchange agreements in other income as "Net realized and unrealized loss on derivatives and hedging activities" with no offsetting fair value adjustments for the asset, liability, or firm commitment.

Consolidated Obligations – The Bank manages the risk arising from changing market prices and volatility of a consolidated obligation by matching the cash inflow on the interest-rate exchange agreement with the cash outflow on the consolidated obligation. While consolidated obligations are the joint-and-several obligations of the FHLBanks, one or more FHLBanks may individually serve as counterparties to interest-rate exchange agreements associated with specific debt issues.

For instance, in a typical transaction, fixed-rate consolidated obligations are issued for one or more FHLBanks, and each of those FHLBanks simultaneously enters into a matching interest-rate exchange agreement in which the counterparty pays fixed cash flows to the FHLBank designed to mirror in timing and amount the cash outflows the FHLBank pays on the consolidated obligation. Such transactions are treated as fair-value hedges under SFAS 133. In this typical transaction, the Bank pays a variable cash flow that closely matches the interest payments it receives on short-term or variable-rate advances. This intermediation between the capital and swap markets permits the Bank to raise funds at lower costs than would otherwise be available through the issuance of floating-rate consolidated obligations in the capital markets.

Advances - With issuances of fixed-rate convertible advances, the Bank may purchase from the member a put option that enables the Bank to terminate the advance. Members then have the option of converting the advance to any available advance product at the then-current rate. The Bank may hedge a convertible advance by entering into a cancelable interest-rate exchange agreement where the Bank pays fixed and receives variable. This type of hedge is treated as a fair-value hedge under SFAS 133. The swap counterparty can cancel the interest-rate exchange agreement on any put date, which would normally occur in a rising rate environment.

The optionality embedded in certain financial instruments held by the Bank can create interest-rate risk. When a member prepays an advance, the Bank could suffer lower future income if the principal portion of the prepaid advance were invested in lower-yielding assets that continue to be funded by higher-cost debt. To protect against this risk, the Bank generally charges a prepayment fee that makes it financially indifferent to a borrower's decision to prepay an advance. When the Bank offers advances (other than short-term advances) that a member may prepay without a prepayment fee, it usually finances such advances with callable debt or otherwise hedges this option.

Mortgage Loans – The Bank invests in mortgage assets. The prepayment options embedded in mortgage assets can result in extensions or contractions in the expected maturities of these investments, depending on changes in estimated prepayment speeds. The Finance Board's Financial Management Policy limits this source of interest-rate risk by restricting the types of mortgage assets the Bank may own to those with limited average life changes under certain interest-rate shock scenarios and establishing limitations on duration of equity.

The Bank manages the interest-rate and prepayment risk associated with mortgages through a combination of debt issuance and derivatives. The Bank issues both callable and non-callable debt to achieve cash-flow patterns and liability durations similar to those expected on the mortgage loans. The Bank also purchases interest-rate caps and floors, swaptions, and callable swaps to minimize the prepayment risk embedded in the mortgage loans. Although these derivatives are valid economic hedges against the prepayment risk of the loans, they are not specifically linked to individual loans and, therefore, do not receive either fair-value or cash-flow hedge accounting. The derivatives are marked-to-market through earnings.

The Bank analyzes the duration, convexity and earnings risk of the mortgage portfolio on a regular basis under various rate scenarios.

Investments – The Bank invests in U.S. agency securities, mortgage-backed securities and the taxable portion of state or local housing finance agency securities. The interest-rate and prepayment risk associated with these investment securities is managed through a combination of debt issuance and derivatives. The Bank may manage against prepayment and duration risk by funding investment securities with consolidated obligations that have call features, by hedging the prepayment risk with caps or floors or by adjusting the duration of the securities by using interest-rate exchange agreements to modify the cash flows of the securities. These securities may be classified as held-to-maturity, available-for-sale or held at fair value as determined at the time the investment is made.

Prior to the implementation of SFAS 133, the Bank adjusted the carrying value of these investments for the fair value of interest-rate exchange agreements that are associated with them. Beginning in 2001, for available-for-sale securities that have been hedged and qualify as a fair value hedge, the Bank records the portion of the change in value related to the risk being hedged in other income as “Net realized and unrealized loss on derivatives and hedging activities” together with the related change in the fair value of the interest-rate exchange agreement, and the remainder of the change in other comprehensive income as “Net unrealized gain or loss on available-for-sale securities.”

The Bank may also manage the risk arising from changing market prices and volatility of investment securities classified as held at fair value by entering into interest-rate exchange agreements (economic hedges) that offset the changes in fair value of the securities. The market value changes of both the securities held at fair value and the associated interest-rate exchange agreements are included in other income in the statements of income.

*Premises and Equipment.* The Bank records premises and equipment at cost less accumulated depreciation and amortization, which amounted to approximately \$9,202,000 and \$8,433,000 at December 31, 2002 and 2001. The Bank computes depreciation on the straight-line method over the estimated useful lives of assets ranging from two to twenty-five years. The Bank includes gains and losses on disposal of premises and equipment in other income.

*Concessions on Consolidated Obligations.* The Bank defers and amortizes, using a method that approximates the level-yield method, the amounts paid to dealers in connection with the sale of consolidated obligation bonds over the term or estimated life of the bonds. The Office of Finance prorates the amount of the concession to the Bank based upon the percentage of the debt issued that is assumed by the Bank. Concessions applicable to the sale of consolidated obligation discount notes are deferred and amortized using the straight-line method over the term of the discount notes. Unamortized concessions are included in “Other assets.”

*Discounts and Premiums on Consolidated Obligations.* The Bank amortizes the discounts on consolidated obligation discount notes to expense using the straight-line method over the term of the related notes due to their short-term nature. It amortizes the discounts and premiums on consolidated bonds to expense using a method that approximates the level-yield method over the term to maturity or estimated life of the consolidated obligation bonds.

*Resolution Funding Corporation Assessments.* Although the Bank is exempt from ordinary federal, state, and local taxation except for local real estate tax, it is required to make payments to the Resolution Funding Corporation (REFCORP). Each FHLBank is required to pay 20 percent of net earnings after AHP to REFCORP. The FHLBanks will expense these amounts until the aggregate amounts actually paid by all 12 FHLBanks are equivalent to a \$300 million annual annuity whose final maturity date is April 15, 2030, at which point the required payment of each FHLBank to REFCORP will be fully satisfied. The Finance Board in consultation with

the Secretary of the Treasury will select the appropriate discounting factors to be used in this calculation. The Finance Board will shorten or lengthen the period during which the FHLBanks must make payments to REFCORP depending on actual payments relative to the referenced annuity. The cumulative amount to be paid to REFCORP by the Bank is not determinable at this time due to the interrelationships of all future FHLBanks' earnings. The FHLBanks' payments for 2002 defease all future benchmark payments after the fourth quarter of 2021 and \$71 million of the \$75 million benchmark payment for the fourth quarter of 2021.

*Finance Board and Office of Finance Expenses.* The Bank is assessed for its proportionate share of the costs of operating the Finance Board's operating office and the Office of Finance, which manages the sale of consolidated obligations.

*Estimated Fair Values.* Some of the Bank's financial instruments lack an available trading market characterized by transactions between a willing buyer and a willing seller engaging in an exchange transaction. Therefore, the Bank uses significant estimates and present-value calculations when disclosing estimated fair values. The Bank assumes that book value approximates fair value for financial instruments with three months or less to repricing or maturity. Note 18 details the estimated fair values of the Bank's financial instruments.

*Cash Flows.* In the statements of cash flows, the Bank considers cash and due from banks as cash and cash equivalents.

*Reclassifications.* Certain amounts in the 2001 and 2000 financial statements have been reclassified to conform with the 2002 presentation.

## **Note 2 — Change in Accounting Principle and Recently Issued Accounting Standards & Interpretations**

*Adoption of SFAS 145.* The Bank adopted Statement of Financial Accounting Standards No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" (SFAS 145) on June 30, 2002. SFAS 145 rescinds both SFAS 4, "Reporting Gains and Losses from the Extinguishment of Debt" and the amendment to SFAS 4, SFAS 64, "Extinguishment of Debt made to Satisfy Sinking-Fund Requirements," and eliminates the requirement that gains and losses from the extinguishment of debt (except for those considered unusual or infrequent in nature) be aggregated and, if material, classified as an extraordinary item, net of the related income tax effect. In accordance with the transition provisions of SFAS 145, previously reported gains and losses on early retirement of debt have been reclassified into other income under "Other, net." The amounts reclassified included a loss of \$7,659,000 for the year ended December 31, 2001 and a gain of \$350,000 for the year ended December 31, 2000.

*Adoption of FIN 45.* FASB issued Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34” (FIN 45) on November 25, 2002. FIN 45 expands existing disclosure requirements at December 31, 2002 for guarantees and provides initial recognition and measurement provisions to be applied on a prospective basis for guarantees issued or modified after December 31, 2002. Management of the Bank has evaluated the effect of adopting FIN 45 and has determined that the effect of adoption is not material.

*Adoption of SFAS 133.* The Bank adopted SFAS 133 on January 1, 2001. SFAS 133 requires that all derivative instruments be recorded in the statements of condition at their fair value. Changes in fair value of derivatives are recorded each period in current earnings or other comprehensive income, 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 derivative instruments that are reported in other comprehensive income will be reclassified to earnings in the periods in which earnings are affected by the variability of the cash flows of the hedged item. The ineffective portion of all hedges will be recognized in current period earnings. Changes in the fair value of non-SFAS 133 hedges of assets or liabilities (economic hedges) for asset-liability management are recorded each period in current earnings.

For a derivative designated as a fair-value hedge, the transition adjustment for the derivative was reported as a cumulative effect adjustment of net income. Concurrently, any fair value gain or loss on the hedged item was recognized as an adjustment of the hedged item’s carrying amount, but only to the extent of the offsetting transition adjustment of the derivative, and was also reported as a cumulative effect adjustment of net income. The transition provisions of SFAS 133 also provide that at the date of initial implementation an entity may transfer any security classified as held-to-maturity to available-for-sale or trading (herein referred to as securities held at fair value), and any security classified as available-for-sale to securities held at fair value.

In accordance with the transition provisions of SFAS 133, the Bank recorded the following cumulative effect adjustments to earnings as of January 1, 2001 (in thousands):

Net adjustments related to fair-value hedges and derivative transactions not designated as hedges under SFAS 133	\$ (2,423)
Unrealized net gains on investments transferred from held-to-maturity to securities held at fair value	<u>3,629</u>
Total cumulative effect of accounting change on earnings	<u>\$ 1,206</u>

On January 1, 2001, the Bank transferred held-to-maturity securities with an amortized cost of \$200,248,000 and an estimated fair value of \$203,877,000 into the securities held at fair value category. The unrealized gain related to the transfer of certain held-to-maturity securities into the securities held at fair value category was \$3,629,000 and has been shown as an increase to the Bank’s results of operations in 2001 as a cumulative effect of a change in accounting principle.

The remaining cumulative effect of adjustments related to fair-value hedges and derivative transactions not designated as hedges under SFAS 133 has been shown as a charge to the Bank's results of operations in 2001 as part of the cumulative effect of a change in accounting principle, decreasing net income by \$2,423,000. These factors combined resulted in a net SFAS 133 transaction gain on January 1, 2001, totaling \$1,206,000.

As a result of SFAS 133, the Bank recorded derivative assets of \$47,907,000 and \$198,717,000 and derivative liabilities of \$710,280,000 and \$118,111,000 at December 31, 2002 and 2001. The Bank recorded the following net realized and unrealized losses on derivatives and hedging activities in other income for the years ended December 31, 2002 and 2001 (in thousands):

	<u>2002</u>	<u>2001</u>
Net gains related to hedge fair-value ineffectiveness	\$ 1,860	\$ 4,232
Net losses on economic hedges	<u>(26,324)</u>	<u>(4,565)</u>
Net realized and unrealized losses on derivatives and hedging activities	<u>\$ (24,464)</u>	<u>\$ (333)</u>

Comparative information for 2000 may not be relevant and is not disclosed in accordance with the provisions of SFAS 133.

### **Note 3—Cash and Due from Banks**

*Compensating Balances.* The Bank maintains collected cash balances with commercial banks in return for certain services. These agreements contain no legal restrictions about the withdrawal of funds. The average compensating balances for the years ended December 31, 2002 and 2001, were approximately \$9,476,000 and \$5,792,000.

In addition, the Bank maintained average required clearing balances with various Federal Reserve Banks and branches of approximately \$69,885,000 and \$42,000,000 for the years ended December 31, 2002 and 2001. These are required clearing balances and may not be withdrawn; however, the Bank may use earnings credits on these balances to pay for services received from the Federal Reserve Banks.

*Pass-through Deposit Reserves.* The Bank acts as a pass-through correspondent for member institutions required to deposit reserves with the Federal Reserve Banks. The amount shown as cash and due from banks includes pass-through reserves deposited with Federal Reserve Banks of approximately \$660,000 and \$114,000 as of December 31, 2002 and 2001. The Bank includes member reserve balances in other liabilities in the statements of condition.

#### Note 4—Securities Purchased Under Agreements to Resell

The Bank purchases securities under agreements to resell. These amounts represent short-term loans and are assets in the statements of condition. One of the Federal Reserve Banks or a third-party custodian holds the securities purchased under agreements to resell in safekeeping in the name of the Bank. Should the market value of the underlying securities decrease below the market value required as collateral, the counterparty must place an equivalent amount of additional securities in safekeeping in the name of the Bank or the dollar value of the resale agreement will be decreased accordingly.

#### Note 5—Held-to-Maturity Securities

*Major Security Types.* Held-to-maturity securities as of December 31, 2002, were as follows (in thousands):

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
Commercial paper	\$ 1,324,114	\$ 9	\$ 39	\$ 1,324,084
U.S. agency obligations	169,832	4,666	-	174,498
State or local housing agency obligations	28,445	87	142	28,390
Other	<u>6,577</u>	<u>752</u>	<u>-</u>	<u>7,329</u>
	1,528,968	5,514	181	1,534,301
Mortgage-backed securities	<u>3,725,028</u>	<u>60,202</u>	<u>2,319</u>	<u>3,782,911</u>
Total	<u>\$ 5,253,996</u>	<u>\$ 65,716</u>	<u>\$ 2,500</u>	<u>\$ 5,317,212</u>

Held-to-maturity securities as of December 31, 2001, were as follows (in thousands):

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
Commercial paper	\$ 69,997	\$ -	\$ 4	\$ 69,993
U.S. agency obligations	210,125	3,278	-	213,403
State or local housing agency obligations	34,494	926	1	35,419
Other	<u>6,454</u>	<u>220</u>	<u>-</u>	<u>6,674</u>
	321,070	4,424	5	325,489
Mortgage-backed securities	<u>3,691,966</u>	<u>25,824</u>	<u>17,044</u>	<u>3,700,746</u>
Total	<u>\$ 4,013,036</u>	<u>\$ 30,248</u>	<u>\$ 17,049</u>	<u>\$ 4,026,235</u>

*Redemption Terms.* The amortized cost and estimated fair value of held-to-maturity securities, excluding associated interest-rate exchange agreements, as of December 2002 and 2001, by contractual maturity, are shown below (in thousands). Expected maturities of some securities and mortgage-backed securities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment fees.

<u>Year of Maturity</u>	<u>2002</u>		<u>2001</u>	
	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
Due in one year or less	\$ 1,324,629	\$ 1,324,613	\$ 110,319	\$ 111,131
Due after one year through five years	-	-	1,000	1,045
Due after five years through ten years	174,450	179,854	174,419	177,056
Due after ten years	29,889	29,834	35,332	36,257
	<u>1,528,968</u>	<u>1,534,301</u>	<u>321,070</u>	<u>325,489</u>
Mortgage-backed securities	<u>3,725,028</u>	<u>3,782,911</u>	<u>3,691,966</u>	<u>3,700,746</u>
Total	<u>\$ 5,253,996</u>	<u>\$ 5,317,212</u>	<u>\$ 4,013,036</u>	<u>\$ 4,026,235</u>

The amortized cost of the Bank's mortgage-backed securities classified as held-to-maturity includes net discounts of \$2,357,000 and \$6,561,000 at December 31, 2002 and 2001.

*Interest Rate Payment Terms.* The following table details interest rate payment terms for investment securities classified as held-to-maturity at December 31, 2002 and 2001 (in thousands):

	<u>2002</u>	<u>2001</u>
Amortized cost of fixed-rate held-to-maturity securities other than mortgage-backed securities	\$ 1,528,968	\$ 321,070
Amortized cost of held-to-maturity mortgage-backed securities:		
Pass-through securities:		
Fixed-rate	886,808	630,307
Variable-rate	267,314	108,612
Collateralized mortgage obligations:		
Fixed-rate	296,280	746,252
Variable-rate	<u>2,274,626</u>	<u>2,206,795</u>
	<u>3,725,028</u>	<u>3,691,966</u>
Total	<u>\$ 5,253,996</u>	<u>\$ 4,013,036</u>

## Note 6—Available-for-Sale Securities

*Major Security Types.* Available-for-sale securities as of December 31, 2002, were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. agency obligations	\$ 421,195	\$ 44,037	\$ -	\$ 465,232
Mortgage-backed securities	<u>293,680</u>	<u>19,716</u>	<u>-</u>	<u>313,396</u>
Total	<u>\$ 714,875</u>	<u>\$ 63,753</u>	<u>\$ -</u>	<u>\$ 778,628</u>

At December 31, 2001, the Bank had U.S. agency obligations classified as available-for-sale securities with an amortized cost of \$222,353,000, estimated fair value of \$213,753,000 and gross unrealized losses of \$8,600,000.

At December 31, 2002 and 2001, U.S. agency obligations paid interest at fixed rates. At December 31, 2002, mortgage-backed securities were made up of fixed-rate collateralized mortgage obligations.

The Bank has recorded \$(76,065,000) and \$8,942,000 of unrealized gains (losses) associated with hedging activities for the years ended December 31, 2002 and 2001.

*Redemption Terms.* The amortized cost and estimated fair value of available-for-sale securities, excluding associated interest-rate exchange agreements, as of December 31, 2002 and 2001, by contractual maturity, are shown below (in thousands). Expected maturities of some securities and mortgaged-backed securities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment fees.

Year of Maturity	2002		2001	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due after five years through ten years	\$ 199,654	\$ 222,114	\$ -	\$ -
Due after ten years	<u>221,541</u>	<u>243,118</u>	<u>222,353</u>	<u>213,753</u>
	421,195	465,232	222,353	213,753
Mortgage-backed securities	<u>293,680</u>	<u>313,396</u>	<u>-</u>	<u>-</u>
Total	<u>\$ 714,875</u>	<u>\$ 778,628</u>	<u>\$ 222,353</u>	<u>\$ 213,753</u>

The amortized cost of the Bank's mortgage-backed securities classified as available-for-sale includes net premiums of \$3,655,000 at December 31, 2002.

## Note 7—Securities Held at Fair Value

The Bank had mortgage-backed securities held at fair value of \$65,750,000 and \$147,646,000 as of December 31, 2002 and 2001, respectively.

Net gain (loss) on securities held at fair value during the years ended December 31, 2002 and 2001, included a change in net unrealized holding gain (loss) of \$(2,097,000) and \$865,000.

## Note 8—Advances

*Redemption Terms.* At December 31, 2002 and 2001, the Bank had advances outstanding, including AHP advances (see Note 9), at interest rates ranging from 1.28 percent to 8.25 percent and 1.76 percent to 8.49 percent, as summarized below (in thousands). Certain advances with interest rates ranging from 3.15 percent to 6.00 percent are AHP subsidized advances.

Year of Maturity	2002		2001	
	Amount	Weighted Average Interest Rate %	Amount	Weighted Average Interest Rate %
2002	-	-	7,691,153	3.33
2003	7,007,894	2.17	2,251,507	3.76
2004	1,748,407	3.65	892,278	5.03
2005	1,992,616	4.16	644,126	5.74
2006	967,436	4.44	684,954	5.18
2007	1,211,681	4.15	103,519	5.73
Thereafter	<u>10,115,478</u>	4.78	<u>8,149,947</u>	4.84
Total par value	23,043,512	3.80	20,417,484	4.20
Unamortized commitment fees	(71)		(81)	
Discount on AHP advances	(372)		(425)	
Premium on advances	1,027		804	
Discount on advances	(352)		(430)	
SFAS 133 hedging adjustments	<u>964,426</u>		<u>338,720</u>	
Total	<u>\$24,008,170</u>		<u>\$20,756,072</u>	

The Bank offers advances to members that may be prepaid on pertinent dates (Call Dates) without incurring prepayment or termination fees (Callable Advances). Other advances may only be prepaid by paying a fee to the Bank (Prepayment Fee) that makes the Bank financially indifferent to the prepayment of the advance. At December 31, 2002 and 2001, the Bank had Callable Advances of \$1,145,198,000 and \$1,127,163,000.

The following table summarizes advances at December 31, 2002 and 2001, by year of maturity or next Call Date for Callable Advances (in thousands):

<u>Year of Maturity or Next Call Date</u>	<u>2002</u>	<u>2001</u>
2002	\$ -	\$ 7,818,347
2003	7,640,551	2,824,175
2004	1,907,698	1,060,854
2005	2,011,890	664,303
2006	1,092,568	816,003
2007	1,318,426	104,018
Thereafter	<u>9,072,379</u>	<u>7,129,784</u>
Total par value	<u>\$ 23,043,512</u>	<u>\$ 20,417,484</u>

The Bank also offers fixed-rate convertible advances. With a convertible advance, the Bank effectively purchases a put option from the member that allows the Bank to terminate the fixed-rate advance on pertinent dates (Put Dates), which normally occurs when interest rates increase. Customers have the option of converting the advance to any available advance product at the then-current rate. At December 31, 2002 and 2001, the Bank had convertible advances outstanding totaling \$6,035,750,000 and \$6,032,000,000.

The following table summarizes advances at December 31, 2002 and 2001, by year of maturity or next put date (in thousands):

<u>Year of Maturity or Next Put Date</u>	<u>2002</u>	<u>2001</u>
2002	\$ -	\$ 11,991,703
2003	12,376,644	3,308,957
2004	2,150,207	1,284,078
2005	1,955,116	502,626
2006	901,136	618,654
2007	1,235,181	103,519
Thereafter	<u>4,425,228</u>	<u>2,607,947</u>
Total par value	<u>\$ 23,043,512</u>	<u>\$ 20,417,484</u>

*Security Terms.* The Bank lends to financial institutions involved in housing finance within its district according to the Act. The Act requires the Bank to obtain sufficient collateral on advances to protect against losses and to accept only certain U.S. government or government-agency securities, residential mortgage loans, cash or deposits with the Bank, and other eligible real estate-related assets as collateral on such advances. However, as more fully described in Note 1, community financial institutions (CFIs) are subject to expanded statutory collateral provisions that permit the use of secured small business and agriculture loans. Borrowing members pledge their capital stock of the Bank as additional collateral for advances.

The Act requires that total advances from the Bank to a member not exceed 20 times the member's capital stock in the Bank. At December 31, 2002 and 2001, the Bank had rights to

collateral with an estimated value greater than outstanding advances. Based upon the financial condition of the member, the Bank:

(1) Allows a member to retain possession of the collateral assigned to the Bank, if the member executes a written security agreement and agrees to hold such collateral for the benefit of the Bank; or

(2) Requires the member specifically to assign or place physical possession of such collateral with the Bank or a third-party custodian approved by the Bank.

Beyond these provisions, Section 10(e) of the Act affords any security interest granted by a member to the Bank priority over the claims or rights of any other party. The two exceptions are claims that would be entitled to priority under otherwise applicable law or perfected security interests.

*Credit Risk.* While the Bank has never experienced a credit loss on an advance to a member, the expanded eligible collateral for CFIs provides the potential for additional credit risk. Bank management has policies and practices in place to appropriately manage this credit risk. Accordingly, the Bank has not provided any allowances for losses on advances.

The Bank's potential credit risk from advances is concentrated in commercial banks and insurance companies. As of December 31, 2002, the Bank had advances of \$6,757,000,000 outstanding to one member institution, and this represented 28 percent of total advances outstanding. The interest income from advances to this member institution amounted to \$168,637,000 during 2002. The Bank held sufficient collateral to cover the advances to this institution, and the Bank does not expect to incur any credit losses on these advances.

*Interest Rate Payment Terms.* The following table details additional interest rate payment terms for advances at December 31, 2002 and 2001 (in thousands):

	<u>2002</u>	<u>2001</u>
Par amount of advances:		
Fixed-rate	\$16,720,187	\$14,278,865
Variable-rate	<u>6,323,325</u>	<u>6,138,619</u>
Total	<u>\$23,043,512</u>	<u>\$20,417,484</u>

*Prepayment Fees.* During 2002, 2001, and 2000, the Bank charged members prepayment fees when they prepaid the principal on certain advances before original maturity. Some of these advances had associated interest-rate exchange agreements. Upon termination of these advances, the Bank terminated the associated interest-rate exchange agreements and netted the resulting gains or losses with the prepayment fees in the statements of income. The Bank received prepayment fees, net of gains or losses on associated interest-rate exchange agreements, of \$5,826,000, \$16,714,000, and \$101,000 during the years ended December 31, 2002, 2001, and 2000. The corresponding principal amount prepaid during these same years was \$219,760,000, \$1,035,338,000, and \$98,175,000.

## Note 9—Affordable Housing Program

Section 10(j) of the Act requires each FHLBank to establish and fund an AHP. Each FHLBank provides subsidies in the form of direct grants and below market interest rate advances to members who use the funds to assist in the purchase, construction, or rehabilitation of housing for very low-, low-, and moderate-income households. Annually, the FHLBanks must set aside for the AHP the greater of \$100 million or 10 percent of the current year's income before charges for AHP, but after the assessment for REFCORP (see Note 1). The Bank charges the amount set aside for AHP to expense and recognizes it as a liability. The Bank relieves the AHP liability as members use subsidies. If the result of the aggregate 10 percent calculation described above is less than \$100 million for all 12 FHLBanks, then the Act requires the shortfall to be allocated among the FHLBanks based on the ratio of each FHLBank's income before AHP and REFCORP to the sum of the income before AHP and REFCORP of the 12 FHLBanks. There was no shortfall in 2002, 2001, or 2000. The Bank had outstanding principal in AHP-related advances of \$3,770,000 and \$4,056,000 at December 31, 2002 and 2001.

## Note 10—Mortgage Loans Held for Portfolio

The MPF program involves investment by the Bank in mortgage loans which are either funded by the Bank through, or purchased from, its participating members. The total loans represent held-for-investment loans under the MPF program whereby the Bank's members originate, service, and credit enhance home mortgage loans which are owned by the Bank. Mortgage loans with a contractual maturity of 15 years or less are classified as medium term, and all other mortgage loans are classified as long term. The following table presents information as of December 31, 2002 and 2001 on mortgage loans held for portfolio (in thousands):

	<u>2002</u>	<u>2001</u>
Real Estate:		
Fixed medium-term single-family mortgages	\$ 617,422	\$ 41,253
Fixed long-term single-family mortgages	<u>4,985,796</u>	<u>3,699,930</u>
Total par value	5,603,218	3,741,183
Unamortized premiums and discounts	60,699	3,695
Allowance for credit losses	<u>(3,255)</u>	<u>(3,102)</u>
Total mortgage loans held for portfolio	<u>\$ 5,660,662</u>	<u>\$ 3,741,776</u>

The par value of mortgage loans held for portfolio outstanding at December 31, 2002 and 2001, was comprised of government-guaranteed loans totaling \$2,033,702,000 and \$3,143,673,000 and conventional loans totaling \$3,569,516,000 and \$597,510,000, respectively.

The allowance for credit losses was as follows (in thousands):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Balance, beginning of year	\$ 3,102	\$ 2,036	\$ 15
Charge-offs	(20)	(25)	-
Recoveries	<u>19</u>	<u>-</u>	<u>-</u>
Net charge-offs	<u>(1)</u>	<u>(25)</u>	<u>-</u>
Provision for credit losses	<u>154</u>	<u>1,091</u>	<u>2,021</u>
Balance, end of year	<u>\$ 3,255</u>	<u>\$ 3,102</u>	<u>\$ 2,036</u>

Mortgage loans, other than those included in large groups of smaller-balance homogeneous loans, are considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all principal and interest amounts due according to the contractual terms of the mortgage loan agreement. At December 31, 2002 and 2001, the Bank had no recorded investments in impaired mortgage loans.

#### **Note 11—Deposits**

The Bank offers demand and overnight deposits for members and qualifying non-members. In addition, the Bank offers short-term deposit programs to members.

Certain financial institutions have agreed to maintain compensating balances in consideration of correspondent and other non-credit services. These balances are classified as deposits on the accompanying financial statements. The compensating balances held by the Bank averaged \$562,293,000 and \$274,662,000 during 2002 and 2001. The Bank has imputed interest expense associated with compensating balances held and has included \$6,869,000, \$8,051,000, and \$8,404,000 in service fee income for the years ended December 31, 2002, 2001, and 2000.

## **Note 12—Borrowings**

*Securities Sold Under Agreements to Repurchase.* The Bank has sold securities under repurchase agreements. The amounts received under these agreements represent long-term borrowings and are liabilities in the statements of condition. The Bank has delivered securities sold under agreements to repurchase to the primary dealer. Should the market value of the underlying securities fall below the market value required as collateral, the Bank must deliver additional securities to the dealer.

*Borrowings from other FHLBanks.* The Bank had \$50,000,000 in borrowings from other FHLBanks at December 31, 2002 and 2001. The borrowings mature in 2003 and have a weighted average interest rate of 5.47 percent.

## **Note 13—Consolidated Obligations**

Consolidated obligations are the joint and several obligations of the FHLBanks and consist of consolidated bonds and discount notes. Through December 31, 2000, the Finance Board issued consolidated obligations through the Office of Finance. Effective January 1, 2001, and in accordance with final rules adopted by the Finance Board, the Finance Board discontinued issuing consolidated obligations, and the FHLBanks began issuing consolidated obligations through the Office of Finance as their agent. Consolidated bonds are issued primarily to raise intermediate and long-term funds for the FHLBanks and are not subject to any statutory or regulatory limits on maturity. Consolidated discount notes are issued primarily to raise short-term funds of less than one year. These notes sell at less than their face amount and are redeemed at par value when they mature.

The par amounts of the FHLBanks' outstanding consolidated obligations, including consolidated obligations held by other FHLBanks, were approximately \$680.7 billion and \$637.3 billion at December 31, 2002 and 2001. Regulations require the FHLBanks to maintain, in the aggregate, unpledged Qualifying Assets equal to the consolidated obligations outstanding. Qualifying Assets are defined as cash; secured advances; assets with an assessment or rating at least equivalent to the current assessment or rating of the consolidated obligations; obligations, participations, mortgages, or other securities of or issued by the United States or an agency of the United States; and such securities as fiduciary and trust funds may invest in under the laws of the state in which the FHLBank is located.

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 has been based on a ratio of assets to capital, rather than a ratio of liabilities to capital. The Finance Board's former regulations prohibited the issuance of consolidated obligations if such issuance would bring the FHLBanks' outstanding consolidated obligations and other unsecured senior liabilities above 20 times the FHLBanks' total capital. The Finance Board's Financial Management Policy also applied this limit on an FHLBank-by-FHLBank basis. The final rule deletes the FHLBanks' overall leverage limit from the regulations, but limits each FHLBank's assets generally to no more than 21 times its capital. However, a 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 not greater than 25 times its capital.

To provide the holders of consolidated obligations issued before January 29, 1993 (prior bondholders), the protection equivalent to that provided under the FHLBanks' previous leverage limit of 12 times the FHLBanks' capital stock, prior bondholders have a claim on a certain amount of the Qualifying Assets [Special Asset Account (SAA)] if capital stock is less than 8.33 percent of consolidated obligations. At December 31, 2002 and 2001, the FHLBanks' capital stock was 5.2 percent of the par value of consolidated obligations outstanding, and the minimum SAA balance was approximately \$24.0 million and \$28.3 million. Further, the regulations require each FHLBank to transfer Qualifying Assets in the amount of its allocated share of the FHLBanks' SAA to a trust for the benefit of the prior bondholders if its capital-to-assets ratio falls below two percent.

*General Terms.* Consolidated obligations are issued with either fixed-rate coupon payment terms or variable-rate coupon payment terms that use a variety of indices for interest rate resets including the London Interbank Offered Rate (LIBOR), Constant Maturity Treasury (CMT), 11th District Cost of Funds Index (COFI), Prime, and others. In addition, to meet the expected specific needs of certain investors in consolidated obligations, both fixed-rate bonds and variable-rate bonds may also contain certain features, which may result in complex coupon payment terms and options. When such consolidated obligations are issued, the Bank enters into interest-rate exchange agreements containing offsetting features that effectively convert the terms of the bond to those of a simple variable-rate bond or a fixed-rate bond.

These consolidated obligations, beyond having fixed-rate or simple variable-rate coupon payment terms, may also have the following broad terms regarding either principal repayment or coupon payment terms:

*Indexed Principal Redemption Bonds* (Index Amortizing Notes) repay principal according to predetermined amortization schedules that are linked to the level of a certain index. As of December 31, 2002 and 2001, most of the index amortizing notes had fixed-rate coupon payment terms. Usually, as market interest rates rise (fall), the maturity of the Index Amortizing Notes extends (contracts); and

*Optional Principal Redemption Bonds* (Callable Bonds) are redeemable in whole or in part at the Bank's discretion on predetermined call dates according to the terms of the bond offerings.

With respect to interest payments, consolidated bonds may also have the following terms:

*Step-up Bonds* generally pay interest at increasing fixed rates for specified intervals over the life of the bond. These bonds generally contain provisions enabling the Bank to call bonds at its option on the step-up dates;

*Range Bonds* pay interest at fixed or variable rates provided a specified index is within a specified range. The computation of the variable interest rate differs for each bond issue, but the bond generally pays zero interest or a minimal rate of interest if the specified index is outside the specified range;

*Comparative Index Bonds* have coupon rates determined by the difference between two or more market indices, typically Prime, CMT, and LIBOR; and

*Zero-Coupon Bonds* are long-term discounted instruments that earn a fixed yield to maturity or the optional principal redemption date if exercised prior to maturity. All principal and interest are paid at maturity or on the optional principal redemption date.

*Redemption Terms.* The following is a summary of the Bank's participation in consolidated bonds outstanding at December 31, 2002 and 2001, by year of contractual maturity (in thousands):

<u>Year of Maturity</u>	<u>2002</u>		<u>2001</u>	
	<u>Amount</u>	<u>Weighted Average Interest Rate %</u>	<u>Amount</u>	<u>Weighted Average Interest Rate %</u>
2002	\$ -	-	\$ 5,473,785	4.14
2003	8,449,670	3.69	5,854,700	4.73
2004	4,306,400	3.38	2,435,700	5.12
2005	4,131,500	3.96	1,940,800	5.55
2006	2,321,850	4.53	1,617,810	5.44
2007	1,635,070	5.70	683,600	7.18
Thereafter	9,304,725	6.17	7,965,400	6.97
Index amortizing notes	<u>3,090</u>	4.53	<u>215,677</u>	5.91
Total par value	30,152,305	4.62	26,187,472	5.50
Bond premiums	51,557		30,294	
Bond discounts	(837,902)		(2,840,696)	
SFAS 133 hedging adjustments	207,895		68,511	
Deferred net losses on terminated interest-rate exchange agreements	<u>(509)</u>		<u>(1,238)</u>	
Total	<u>\$29,573,346</u>		<u>\$23,444,343</u>	

Consolidated bonds outstanding at December 31, 2002 and 2001, include Callable Bonds totaling \$15,409,245,000 and \$13,147,287,000. The Bank uses fixed-rate Callable Bonds to finance Callable Advances (see Note 8), mortgage-backed securities, and mortgage loans. The Bank may also enter into an interest rate swap (in which the Bank pays variable and receives fixed) with a call feature that mirrors the option embedded in the debt (a sold callable swap). The combined sold callable swap and Callable Bond allows the Bank to provide members attractively priced variable-rate advances, while converting its own payment to a variable rate.

The Bank's consolidated bonds outstanding includes (in thousands):

	<u>2002</u>	<u>2001</u>
Par amount of consolidated bonds:		
Non-callable or non-putable	\$14,743,060	\$13,040,185
Callable	<u>15,409,245</u>	<u>13,147,287</u>
Total par value	<u>\$30,152,305</u>	<u>\$26,187,472</u>

The following table summarizes consolidated bonds outstanding at December 31, 2002 and 2001, by year of maturity or next call date (in thousands):

<u>Year of Maturity or Next Call Date</u>	<u>2002</u>	<u>2001</u>
2002	\$ -	\$13,777,395
2003	21,070,915	7,337,700
2004	2,839,400	1,534,700
2005	2,229,500	928,800
2006	833,600	531,700
2007	598,800	323,600
Thereafter	2,577,000	1,537,900
Index amortizing notes	<u>3,090</u>	<u>215,677</u>
Total par value	<u>\$30,152,305</u>	<u>\$26,187,472</u>

*Interest Rate Payment Terms.* The following table details interest rate payment terms for consolidated bonds at December 31, 2002 and 2001 (in thousands). Range Bonds are classified as Comparative Index Bonds.

	<u>2002</u>	<u>2001</u>
Par amount of consolidated bonds:		
Fixed-rate	\$26,327,060	\$20,299,362
Simple variable-rate	1,100,500	1,890,000
Step-up	81,560	91,110
Comparative index	1,493,185	157,000
Zero-coupon	<u>1,150,000</u>	<u>3,750,000</u>
Total par value	<u>\$30,152,305</u>	<u>\$26,187,472</u>

*Discount Notes.* The Bank's participation in consolidated discount notes, all of which are due within one year, was as follows (in thousands):

	<u>2002</u>		<u>2001</u>	
	<u>Amount</u>	<u>Weighted Average Interest Rate %</u>	<u>Amount</u>	<u>Weighted Average Interest Rate %</u>
Par value	\$ 7,767,725	1.24	\$ 7,338,572	2.04
Bond discounts	(10,207)		(25,499)	
SFAS 133 hedging adjustments	<u>587</u>		<u>3,603</u>	
Total	<u>\$ 7,758,105</u>		<u>\$ 7,316,676</u>	

The Act authorizes the Secretary of the Treasury, at his or her discretion, to purchase consolidated obligations of the FHLBanks aggregating not more than \$4 billion. The terms, conditions, and interest rates are determined by the Secretary of the Treasury. There were no such purchases by the Secretary of the Treasury during the two years ended December 31, 2002.

#### **Note 14—Capital**

The Gramm-Leach-Bliley Act (GLB Act) will lead to a number of changes in the capital structure of the FHLBanks. The final Finance Board rule was published on January 30, 2001 and required each FHLBank to submit a capital structure plan to the Finance Board by October 29, 2001. The Finance Board approved the Bank's capital plan on July 10, 2002. The GLB Act provides a transition period to the new capital structure of up to three years from the effective date of each FHLBank's capital structure. The Bank plans on converting to the new capital plan on July 1, 2003, although the plan provides for a period until January 10, 2004 for implementation if necessary. Until such time as the Bank fully implements the new capital plan, the current capital rules remain in effect. In particular, the Act, as amended, requires members to own capital stock equal to the greater of 1 percent of their mortgage-related assets or 5 percent of outstanding Bank advances. The GLB Act removed the provision that required a member to purchase additional stock to borrow from the Bank if the member's mortgage-related assets were less than 65 percent of total assets. Members may, at the Bank's discretion, redeem at par value any capital stock greater than their statutory requirement. Members may, with approval of the Bank and the Finance Board, sell capital stock to other Bank members at par value.

The GLB Act made membership voluntary for all members. A member must give six months notice of its intent to withdraw from membership. Members that withdraw from membership may not reapply for membership for 5 years.

When the new capital plan is implemented, the Bank will be subject to risk-based capital rules. Each FHLBank may offer two classes of stock. Members can redeem Class A stock by giving 6 months notice, and members can redeem Class B stock by giving 5 years notice. Only "permanent" capital, defined as retained earnings and Class B stock, can satisfy the risk-based capital requirement. In addition, the GLB Act specifies a 4 percent minimum capital ratio based on total capital and a 5 percent minimum leverage ratio based on 1.5 weighting factor applicable to the permanent capital.

The Bank's board of directors may declare and pay dividends in either cash or capital stock dividends only from previously retained earnings or current net earnings.

## **Note 15—Employee Retirement Plans**

The Bank participates in the Financial Institutions Retirement Fund (FIRF), a defined-benefit plan. The plan covers substantially all officers and employees of the Bank. The Bank's contributions to FIRF through June 30, 1987, represented the normal cost of the plan. The plan reached the full-funding limitation, as defined by the Employee Retirement Income Security Act, for the plan year beginning July 1, 1987, because of favorable investment and other actuarial experience during previous years. As a result, FIRF suspended employer contributions for all plan years ending after June 30, 1987. Contributions to the plan will resume when the plan is no longer in full-funding status based on annual determinations by FIRF. The FIRF is a multiemployer plan and does not segregate its assets, liabilities, or costs by participating employer. As a result, disclosure of the accumulated benefit obligations, plan assets, and the components of annual pension expense attributable to the Bank cannot be made.

The Bank also participates in the Financial Institutions Thrift Plan, a defined-contribution plan. The Bank's contributions are equal to a percentage of participants' compensation and a matching contribution equal to a percentage of voluntary employee contributions, subject to certain limitations. The Bank contributed \$422,000, \$394,000, and \$351,000 in the years ended December 31, 2002, 2001, and 2000.

In addition, the Bank offers the Benefit Equalization Plan (BEP). The BEP is a non-qualified retirement plan restoring benefits offered under the qualified plans which have been limited by laws governing such plans. The Bank expensed \$416,000, \$361,000, and \$340,000 in the years ended December 31, 2002, 2001, and 2000.

## **Note 16—Segment Information**

The Bank has identified two main operating segments based on its method of internal reporting: Traditional Member Finance and Mortgage Finance. The products and services provided reflect the manner in which financial information is evaluated by management. The Traditional Member Finance segment includes products such as advances, investments, and their related funding. Income from the Traditional Member Finance segment is derived primarily from the difference, or spread, between the yield on advances and investments and the borrowing and hedging costs related to those assets. The Mortgage Finance segment includes mortgage loans acquired through the MPF program, mortgage-backed securities, and their related funding. Income from the Mortgage Finance segment is derived primarily from the difference, or spread, between the yield on mortgage loans and mortgage-backed securities and the borrowing and hedging costs related to those assets. Capital is allocated to the segments based on asset size.

The following table sets forth the Bank's financial performance by operating segment for the years ended December 31, 2002, 2001, and 2000.

	Traditional Member Finance	Mortgage Finance	Total
<b>2002</b>			
Net interest income	\$ 75,595	\$ 42,269	\$ 117,864
Provision for credit losses on mortgage loans	<u>-</u>	<u>(154)</u>	<u>(154)</u>
Net interest income after provision for credit losses on mortgage loans	<u>\$ 75,595</u>	<u>\$ 42,115</u>	<u>\$ 117,710</u>
Average Assets	\$29,070,588	\$ 8,051,231	\$37,121,819
Total Assets	\$32,519,793	\$ 9,734,579	\$42,254,372
<b>2001</b>			
Net interest income	\$ 92,216	\$ 29,305	\$ 121,521
Provision for credit losses on mortgage loans	<u>-</u>	<u>(1,091)</u>	<u>(1,091)</u>
Net interest income after provision for credit losses on mortgage loans	<u>\$ 92,216</u>	<u>\$ 28,214</u>	<u>\$ 120,430</u>
Average Assets	\$27,528,782	\$ 7,253,667	\$34,782,449
Total Assets	\$27,280,306	\$ 7,540,984	\$34,821,290
<b>2000</b>			
Net interest income	\$ 148,214	\$ 44,366	\$ 192,580
Provision for credit losses on mortgage loans	<u>-</u>	<u>(2,021)</u>	<u>(2,021)</u>
Net interest income after provision for credit losses on mortgage loans	<u>\$ 148,214</u>	<u>\$ 42,345</u>	<u>\$ 190,559</u>
Average Assets	\$28,113,672	\$ 6,711,999	\$34,825,671
Total Assets	\$28,200,404	\$ 7,335,750	\$35,536,154

#### **Note 17—Interest-Rate Exchange Agreements**

The contractual or notional amount of interest-rate exchange agreements reflects the involvement of the Bank in the various classes of financial instruments. The notional amount of interest-rate exchange agreements does not measure the credit risk exposure of the Bank, and the maximum credit exposure of the Bank is substantially less than the notional amount. The Bank requires collateral agreements on all interest-rate exchange agreements which establish collateral delivery thresholds. The maximum credit risk is the estimated cost of replacing favorable interest rate swaps, forward agreements, and purchased caps and floors if the counterparty defaults, and the related collateral, if any, is of no value to the Bank.

At December 31, 2002 and 2001, the Bank's maximum credit risk, as defined above, was approximately \$47,907,000 and \$198,717,000. These totals include \$55,432,000 and \$257,948,000 of net accrued interest receivable. In determining maximum credit risk, the Bank considers accrued interest receivables and payables, and the legal right to offset assets and liabilities by counterparty. The Bank did not hold collateral as of December 31, 2002. The Bank held cash and securities with a fair value of \$73,768,000 as collateral as of December 31, 2001 which were not sold or repledged.

The Bank transacts most of its interest-rate exchange agreements with large highly-rated banks and major broker-dealers. Some of these banks and broker-dealers or their affiliates buy, sell, and distribute consolidated obligations.

### **Note 18—Estimated Fair Values**

*Cash and due from banks and securities purchased under agreements to resell.* The estimated fair value approximates the recorded book balance.

*Interest-bearing deposits and federal funds sold.* The estimated fair value is determined by calculating the present value of the future cash flows for instruments with more than three months to maturity. The discount rates used in these calculations are the rates for federal funds with similar terms. The estimated fair value approximates the recorded book balance of interest-bearing deposits and federal funds with three months or less to maturity.

*Investment securities.* For certain securities, the estimated fair value is determined based on quoted prices, excluding accrued interest, as of the last business day of the year. The estimated fair value of the remaining securities is determined by calculating the present value of expected cash flows and reducing the amount for accrued interest receivable.

*Advances and other loans.* The Bank determines the estimated fair value of advances with fixed rates and more than three months to maturity and advances with complex floating rates by calculating the present value of expected future cash flows from the advances and reducing this amount for accrued interest receivable. The discount rates used in these calculations are the replacement advance rates for advances with similar terms. Following the Finance Board's advances regulations, advances with a maturity and repricing period greater than six months generally require a prepayment fee sufficient to make the Bank financially indifferent to the borrower's decision to prepay the advances. Therefore, the estimated fair value of advances does not assume prepayment risk. The estimated fair value approximates the recorded book balance of advances with floating rates and fixed rates with three months or less to maturity or repricing.

*Mortgage loans held for portfolio.* The estimated fair values for mortgage loans have been determined based on contractual cash flows, adjusted for prepayment assumptions and credit risk factors, discounted using the current market rate for similar loans, reduced by the amount of accrued interest receivable.

*Accrued interest receivable and payable.* The estimated fair value approximates the recorded book value.

*Derivative assets/liabilities.* The Bank bases the estimated fair values of interest-rate exchange agreements on instruments with similar terms or available market prices including accrued interest receivable and payable. However, active markets do not exist for many types of financial instruments. Consequently, fair values for these instruments must be estimated using techniques such as discounted cash flow analysis and comparisons to similar instruments. Estimates developed using these methods are highly subjective and require judgments regarding significant matters such as the amount and timing of future cash flows and the selection of discount rates that appropriately reflect market and credit risks. Changes in these judgments often have a material effect on the fair value estimates. Since these estimates are made as of a specific point in time, they are susceptible to material near term changes. The fair values are netted by counterparty where such legal right exists. If these netted amounts are positive, they are classified as an asset and if negative, a liability.

*Deposits.* The Bank determines fair values of deposits with fixed rates and more than three months to maturity by calculating the present value of expected future cash flows from the deposits and reducing this amount for accrued interest payable. The discount rates used in these calculations are the cost of deposits with similar terms. The estimated fair value approximates the recorded book balance for deposits with floating rates and fixed rates with three months or less to maturity or repricing.

*Consolidated obligations.* The Bank estimates fair values based on the cost of raising comparable term debt. The estimated cost of issuing debt includes non-interest selling costs.

*Borrowings.* The Bank determines the estimated fair value of borrowings with fixed rates and more than three months to maturity by calculating the present value of expected future cash flows from the borrowings and reducing this amount for accrued interest payable. The discount rates used in these calculations are the cost of borrowings with similar terms. For borrowings with floating rates and fixed rates with three months or less to maturity or repricing, the estimated fair value approximates the recorded book balance.

*Commitments.* The fair value of the Bank's commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of standby letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties.

The carrying value and estimated fair values of the Bank's financial instruments at December 31, 2002, were as follows (in thousands):

**2002 FAIR VALUE SUMMARY TABLE**

<u>Financial Instruments</u>	<u>Carrying Value</u>	<u>Net Unrealized Gains (Losses)</u>	<u>Estimated Fair Value</u>
<b>Assets:</b>			
Cash and due from banks	\$ 102,741	\$ -	\$ 102,741
Interest-bearing deposits	494,000	1	494,001
Federal funds sold	5,751,000	-	5,751,000
Held-to-maturity securities	5,253,996	63,216	5,317,212
Available-for-sale securities	778,628	-	778,628
Securities held at fair value	65,750	-	65,750
Advances	24,008,170	272,976	24,281,146
Mortgage loans held for portfolio, net	5,660,662	169,279	5,829,941
Accrued interest receivable	65,680	-	65,680
Derivative assets	47,907	-	47,907
<b>Liabilities:</b>			
Deposits	(1,634,200)	(2)	(1,634,202)
Borrowings from other FHLBanks	(50,000)	(1,555)	(51,555)
Securities sold under agreements to repurchase	(300,000)	(204)	(300,204)
<b>Consolidated obligations:</b>			
Discount notes	(7,758,105)	(1,339)	(7,759,444)
Bonds	<u>(29,573,346)</u>	<u>(575,753)</u>	<u>(30,149,099)</u>
Consolidated obligations, net	<u>(37,331,451)</u>	<u>(577,092)</u>	<u>(37,908,543)</u>
Accrued interest payable	(292,112)	-	(292,112)
Derivative liabilities	(710,280)	-	(710,280)
<b>Other:</b>			
Commitments to extend credit	-	208	208
Standby letters of credit	-	(43)	(43)

The carrying value and estimated fair values of the Bank's financial instruments at December 31, 2001, were as follows (in thousands):

### 2001 FAIR VALUE SUMMARY TABLE

<u>Financial Instruments</u>	<u>Carrying Value</u>	<u>Net Unrealized Gains (Losses)</u>	<u>Estimated Fair Value</u>
<b>Assets:</b>			
Cash and due from banks	\$ 63,820	\$ -	\$ 63,820
Interest-bearing deposits	135,296	-	135,296
Securities purchased under agreements to resell	4,000,000	-	4,000,000
Federal funds sold	1,470,000	-	1,470,000
Held-to-maturity securities	4,013,036	13,199	4,026,235
Available-for-sale securities	213,753	-	213,753
Securities held at fair value	147,646	-	147,646
Advances	20,756,072	107,506	20,863,578
Mortgage loans, net	3,741,776	84,535	3,826,311
Accrued interest receivable	56,262	-	56,262
Derivative assets	198,717	-	198,717
<b>Liabilities:</b>			
Deposits	(1,977,890)	(30)	(1,977,920)
Borrowings from other FHLBanks	(50,000)	(1,949)	(51,949)
<b>Consolidated obligations:</b>			
Discount notes	(7,316,676)	32,304	(7,284,372)
Bonds	<u>(23,444,343)</u>	<u>(62,352)</u>	<u>(23,506,695)</u>
Consolidated obligations, net	<u>(30,761,019)</u>	<u>(30,048)</u>	<u>(30,791,067)</u>
Accrued interest payable	(293,766)	-	(293,766)
Derivative liabilities	(118,111)	-	(118,111)
<b>Other:</b>			
Commitments to extend credit	-	10	10
Standby letters of credit	-	(51)	(51)

#### Note 19—Commitments and Contingencies

As described in Note 13, the FHLBanks have joint and several liability for all the consolidated obligations issued on their behalf. Accordingly, should one or more of the FHLBanks be unable to repay their participation in the consolidated obligations, each of the other FHLBanks could be called upon to repay all or part of such obligations, as determined or approved by the Finance Board. The Bank does not recognize a liability for its joint and several obligation related to other FHLBanks' consolidated obligations. Notes 1, 8, 9, 13, 15, and 17 discuss other commitments and contingencies.

Commitments that legally bind and unconditionally obligate the Bank for additional advances totaled approximately \$8,643,000 at December 31, 2001. There were no such commitments at December 31, 2002. Commitments generally are for periods up to 12 months. Standby letters of credit are executed for members for a fee. A standby letter of credit is a financing agreement between the Bank and its member. If the Bank is required to make payment for a beneficiary's draw, these amounts may be converted into a collateralized advance to the member. Outstanding standby letters of credit were approximately \$909,956,000 and \$726,978,000 at December 31, 2002 and 2001 and had original terms of 9 days to five years with a final expiration in 2005. Unearned fees on standby letters of credit are recorded in other liabilities and amounted to \$43,000 and \$51,000 at December 31, 2002 and 2001. Based on management's credit analyses and collateral requirements, the Bank does not deem it necessary to have any provision for credit losses on these commitments and letters of credit. Commitments and letters of credit are fully collateralized at the time of issuance (see Note 8). The estimated fair value of commitments and letters of credit as of December 31, 2002 and 2001 is reported in Note 18.

Commitments which unconditionally obligate the Bank to fund/purchase mortgage loans totaled \$22,080,000 and \$1,579,000 at December 31, 2002 and 2001. Commitments are generally for periods not to exceed forty-five business days.

The Bank generally executes interest-rate exchange agreements with large highly-rated banks and broker-dealers and enters bilateral collateral agreements. The Bank had cash pledged as collateral to broker-dealers of \$263,800,000 and \$8,800,000 at December 31, 2002 and 2001 for interest-rate exchange agreements. Cash pledged as collateral is classified as "Interest-bearing deposits" in the statements of condition.

The Bank charged to operating expenses net rental costs of approximately \$381,000, \$327,000, and \$317,000 for the years ending December 31, 2002, 2001, and 2000. Future minimum rentals at December 31, 2002, were \$350,000, \$202,000, \$45,000, \$34,000, and \$17,000 for the years ending December 31, 2003, 2004, 2005, 2006, and 2007.

Lease agreements for Bank premises generally provide for increases in the basic rentals resulting from increases in property taxes and maintenance expenses. Such increases are not expected to have a material effect on the Bank.

The Bank is subject to legal proceedings arising in the normal course of business. After consultation with legal counsel, management does not anticipate that the ultimate liability, if any, arising out of these matters will have a material effect on the Bank's financial condition or results of operations.





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