



FEDERAL  
HOME LOAN BANK  
DES MOINES

# ADVANCING YOUR SUCCESS

2004 Second Quarter Report

**June 30, 2004 Quarterly Report**  
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**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENTS OF CONDITION**  
(In thousands, except shares)

|  | June 30,<br>2004<br>(Unaudited) | December 31,<br>2003 |
|--|---------------------------------|----------------------|
| <b>ASSETS</b>  |                                 |                      |
| Cash and due from banks  | \$ 121,088                      | \$ 57,118            |
| Interest-bearing deposits  | 212,313                         | 281,228              |
| Securities purchased under agreements to resell  | 305,000                         | 305,000              |
| Federal funds sold   | 1,385,000                       | 1,200,000            |
| Investments:   |                                 |                      |
| Held-to-maturity securities, includes \$0 pledged at June 30, 2004 and \$98,641 pledged at December 31, 2003 (Note 4)                                | 3,118,699                       | 2,155,291            |
| Available-for-sale securities, includes \$516,278 pledged at June 30, 2004 and \$407,515 pledged at December 31, 2003                                | 1,380,379                       | 1,546,215            |
| Securities held at fair value  | 25,468                          | 36,048               |
| Advances (Note 5)  | 26,104,988                      | 23,302,586           |
| Mortgage loans held for portfolio, net of allowance for credit losses on mortgage loans of \$5,941 at June 30, 2004 and \$5,906 at December 31, 2003 | 15,413,189                      | 15,998,742           |
| Accrued interest receivable  | 95,864                          | 97,469               |
| Premises and equipment, net  | 1,203                           | 2,233                |
| Derivative assets  | 198,455                         | 43,070               |
| Other assets   | 20,478                          | 26,001               |
| <b>Total assets</b>  | <b>\$ 48,382,124</b>            | <b>\$ 45,051,001</b> |
| <b>LIABILITIES AND CAPITAL</b>   |                                 |                      |
| <b>LIABILITIES:</b>  |                                 |                      |
| Deposits:  |                                 |                      |
| Demand and overnight   | \$ 1,782,914                    | \$ 968,482           |
| Term   | 229,185                         | 33,570               |
| <b>Total deposits</b>  | <b>2,012,099</b>                | <b>1,002,052</b>     |
| Securities sold under agreements to repurchase   | 500,000                         | 500,000              |
| Consolidated obligations, net:   |                                 |                      |
| Discount notes   | 5,707,068                       | 5,472,370            |
| Bonds  | 36,954,320                      | 34,880,030           |
| <b>Total consolidated obligations</b>  | <b>42,661,388</b>               | <b>40,352,400</b>    |
| Accrued interest payable   | 258,213                         | 248,507              |
| Affordable Housing Program   | 26,721                          | 24,342               |
| Payable to REFCORP   | 7,673                           | 5,182                |
| Derivative liabilities   | 525,583                         | 691,785              |
| Other liabilities  | 22,246                          | 19,595               |
| <b>Total liabilities</b>   | <b>46,013,923</b>               | <b>42,843,863</b>    |
| Commitments and contingencies (Notes 7 and 8)  |                                 |                      |
| <b>CAPITAL:</b>  |                                 |                      |
| Capital stock – Class B (\$100 par value) issued and outstanding:  |                                 |                      |
| 22,479,607 at June 30, 2004 and 21,165,002 at December 31, 2003  | 2,247,961                       | 2,116,500            |
| Retained earnings  | 118,410                         | 90,943               |
| Accumulated other comprehensive income (loss):   |                                 |                      |
| Net unrealized gain on available-for-sale securities   | 2,813                           | 31                   |
| Net unrealized loss relating to hedging activities   | (983)                           | (336)                |
| <b>Total capital</b>   | <b>2,368,201</b>                | <b>2,207,138</b>     |
| <b>Total liabilities and capital</b>   | <b>\$ 48,382,124</b>            | <b>\$ 45,051,001</b> |

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

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

|   | Quarter Ended June 30, |                  | Six Months Ended June 30, |                  |
|---|------------------------|------------------|---------------------------|------------------|
|   | 2004                   | 2003             | 2004                      | 2003             |
| <b>INTEREST INCOME:</b>   |                        |                  |                           |                  |
| Advances  | \$ 105,298             | \$ 121,345       | \$ 207,752                | \$ 247,412       |
| Interest-bearing deposits   | 554                    | 1,739            | 1,295                     | 3,457            |
| Securities purchased under agreements to resell                                 | 798                    | 968              | 1,591                     | 1,619            |
| Federal funds sold  | 4,979                  | 12,136           | 9,559                     | 23,089           |
| Investments:  |                        |                  |                           |                  |
| Held-to-maturity securities   | 14,826                 | 32,339           | 30,183                    | 68,357           |
| Available-for-sale securities   | 4,263                  | 2,834            | 8,783                     | 5,805            |
| Securities held at fair value   | 419                    | 884              | 934                       | 1,904            |
| Mortgage loans held for portfolio   | 94,179                 | 72,466           | 193,230                   | 152,041          |
| Loans to other FHLBanks   | 8                      | 118              | 23                        | 207              |
| Total interest income   | <u>225,324</u>         | <u>244,829</u>   | <u>453,350</u>            | <u>503,891</u>   |
| <b>INTEREST EXPENSE:</b>  |                        |                  |                           |                  |
| Consolidated obligations  | 190,813                | 206,588          | 385,245                   | 425,801          |
| Deposits  | 3,017                  | 4,467            | 5,557                     | 9,166            |
| Borrowings from other FHLBanks  | 3                      | 693              | 3                         | 1,376            |
| Securities sold under agreements to repurchase                                  | 2,141                  | 2,316            | 4,285                     | 3,998            |
| Other borrowings  | 2                      | 7                | 9                         | 14               |
| Total interest expense  | <u>195,976</u>         | <u>214,071</u>   | <u>395,099</u>            | <u>440,355</u>   |
| <b>NET INTEREST INCOME BEFORE PROVISION FOR CREDIT LOSSES ON MORTGAGE LOANS</b> |                        |                  |                           |                  |
|   | 29,348                 | 30,758           | 58,251                    | 63,536           |
| Provision for credit losses on mortgage loans                                   | <u>-</u>               | <u>(7)</u>       | <u>(118)</u>              | <u>(7)</u>       |
| <b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES ON MORTGAGE LOANS</b>  |                        |                  |                           |                  |
|   | <u>29,348</u>          | <u>30,751</u>    | <u>58,133</u>             | <u>63,529</u>    |
| <b>OTHER INCOME (LOSS):</b>   |                        |                  |                           |                  |
| Prepayment fees, net  | 319                    | 3,116            | 335                       | 5,961            |
| Service fees  | 541                    | 583              | 1,110                     | 1,213            |
| Net realized (loss) gain on held-to-maturity securities (Note 4)                | (3)                    | -                | 4,031                     | -                |
| Net realized gain on available-for-sale securities                              | -                      | -                | 2,464                     | -                |
| Net loss on securities held at fair value                                       | (363)                  | (197)            | (499)                     | (407)            |
| Net realized and unrealized gain (loss) on derivatives and hedging activities   | 17,394                 | (6,877)          | 9,960                     | (7,463)          |
| Other, net  | 2,177                  | 851              | 2,851                     | 1,558            |
| Total other income (loss)   | <u>20,065</u>          | <u>(2,524)</u>   | <u>20,252</u>             | <u>862</u>       |
| <b>OTHER EXPENSE:</b>   |                        |                  |                           |                  |
| Operating   | 7,028                  | 5,791            | 13,808                    | 11,529           |
| Finance Board   | 394                    | 335              | 788                       | 671              |
| Office of Finance   | 218                    | 231              | 501                       | 472              |
| Total other expense   | <u>7,640</u>           | <u>6,357</u>     | <u>15,097</u>             | <u>12,672</u>    |
| <b>INCOME BEFORE ASSESSMENTS</b>  |                        |                  |                           |                  |
|   | <u>41,773</u>          | <u>21,870</u>    | <u>63,288</u>             | <u>51,719</u>    |
| Affordable Housing Program  | 3,410                  | 1,785            | 5,166                     | 4,222            |
| REFCORP   | 7,673                  | 4,017            | 11,625                    | 9,499            |
| Total assessments   | <u>11,083</u>          | <u>5,802</u>     | <u>16,791</u>             | <u>13,721</u>    |
| <b>NET INCOME</b>   | <u>\$ 30,690</u>       | <u>\$ 16,068</u> | <u>\$ 46,497</u>          | <u>\$ 37,998</u> |
| Earnings per share  | \$ 1.39                | \$ 0.85          | \$ 2.15                   | \$ 2.03          |
| Dividends declared and paid per share   | \$ 0.45                | \$ 0.74          | \$ 0.88                   | \$ 1.48          |
| Average number of shares of stock outstanding during the period                 | 22,081                 | 18,972           | 21,676                    | 18,684           |

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

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENT OF CHANGES IN CAPITAL**  
**FOR THE THREE MONTHS ENDED JUNE 30, 2004**  
(In thousands)  
(Unaudited)

|  | Capital Stock |                     | Capital Stock |             | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Capital       |
|--|---------------|---------------------|---------------|-------------|-------------------|---|---------------------|
|  | Class B       |                     |               |             |                   |   |                     |
|  | Shares        | Par Value           | Shares        | Par Value   |                   |   |                     |
| BALANCE, MARCH 31, 2004  | <u>21,963</u> | <u>\$ 2,196,242</u> | <u>-</u>      | <u>\$ -</u> | <u>\$ 97,549</u>  | <u>\$ (2,922)</u>                             | <u>\$ 2,290,869</u> |
| Proceeds from sale of capital stock  | 2,137         | 213,680             | -             | -           | -                 | -   | 213,680             |
| Redemption of capital stock  | (1,620)       | (161,961)           | -             | -           | -                 | -   | (161,961)           |
| Comprehensive income:  |               |                     |               |             |                   |   |                     |
| Net income   | -             | -                   | -             | -           | 30,690            | -   | 30,690              |
| Other comprehensive income:  |               |                     |               |             |                   |   |                     |
| Net realized and unrealized gain on available-for-sale securities                          | -             | -                   | -             | -           | -                 | 5,612   | 5,612               |
| Net unrealized loss relating to hedging activities   | -             | -                   | -             | -           | -                 | (885)   | (885)               |
| Reclassification adjustment for loss included in net income relating to hedging activities | -             | -                   | -             | -           | -                 | 25  | 25                  |
| Total comprehensive income   | -             | -                   | -             | -           | 30,690            | 4,752   | 35,442              |
| Cash dividends on capital stock  | -             | -                   | -             | -           | (9,829)           | -   | (9,829)             |
| BALANCE, JUNE 30, 2004   | <u>22,480</u> | <u>\$ 2,247,961</u> | <u>-</u>      | <u>\$ -</u> | <u>\$ 118,410</u> | <u>\$ 1,830</u>                               | <u>\$ 2,368,201</u> |

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

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENT OF CHANGES IN CAPITAL**  
**FOR THE THREE MONTHS ENDED JUNE 30, 2003**  
(In thousands)  
(Unaudited)

|   | Capital Stock<br>Class B |           | Capital Stock |              | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Capital |
|---|--------------------------|-----------|---------------|--------------|----------------------|--|------------------|
|   | Shares                   | Par Value | Shares        | Par Value    |                      |  |                  |
| BALANCE, MARCH 31, 2003                                 | -                        | \$ -      | 18,185        | \$ 1,818,524 | \$ 58,443            | \$ (2,034)   | \$ 1,874,933     |
| Proceeds from sale of capital stock                     | -                        | -         | 2,668         | 266,784      | -                    | -  | 266,784          |
| Redemption of capital stock                             | -                        | -         | (377)         | (37,727)     | -                    | -  | (37,727)         |
| Comprehensive income:                                   |                          |           |               |              |                      |  |                  |
| Net income  | -                        | -         | -             | -            | 16,068               | -  | 16,068           |
| Other comprehensive income:                             |                          |           |               |              |                      |  |                  |
| Net unrealized loss on<br>available-for-sale securities | -                        | -         | -             | -            | -                    | (397)  | (397)            |
| Total comprehensive income (loss)                       | -                        | -         | -             | -            | 16,068               | (397)  | 15,671           |
| Cash dividends on capital stock                         | -                        | -         | -             | -            | (13,968)             | -  | (13,968)         |
| BALANCE, JUNE 30, 2003                                  | -                        | \$ -      | 20,476        | \$ 2,047,581 | \$ 60,543            | \$ (2,431)   | \$ 2,105,693     |

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

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENT OF CHANGES IN CAPITAL**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2004**  
(In thousands)  
(Unaudited)

|   | Capital Stock<br>Class B |                     | Capital Stock |             | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Capital    |
|---|--------------------------|---------------------|---------------|-------------|----------------------|--|---------------------|
|   | Shares                   | Par Value           | Shares        | Par Value   |                      |  |                     |
| BALANCE, DECEMBER 31, 2003  | <u>21,165</u>            | <u>\$ 2,116,500</u> | <u>-</u>      | <u>\$ -</u> | <u>\$ 90,943</u>     | <u>\$ (305)</u>  | <u>\$ 2,207,138</u> |
| Proceeds from sale<br>of capital stock  | 4,228                    | 422,758             | -             | -           | -                    | -  | 422,758             |
| Redemption of capital stock   | (2,913)                  | (291,297)           | -             | -           | -                    | -  | (291,297)           |
| Comprehensive income:   |                          |                     |               |             |                      |  |                     |
| Net income  | -                        | -                   | -             | -           | 46,497               | -  | 46,497              |
| Other comprehensive income:   |                          |                     |               |             |                      |  |                     |
| Net realized and unrealized gain on<br>available-for-sale securities  | -                        | -                   | -             | -           | -                    | 5,246  | 5,246               |
| Reclassification adjustment for gain<br>included in net income relating<br>to available-for-sale securities | -                        | -                   | -             | -           | -                    | (2,464)  | (2,464)             |
| Net unrealized loss relating<br>to hedging activities   | -                        | -                   | -             | -           | -                    | (686)  | (686)               |
| Reclassification adjustment for loss<br>included in net income relating to<br>hedging activities            | -                        | -                   | -             | -           | -                    | 39   | 39                  |
| Total comprehensive income  | -                        | -                   | -             | -           | 46,497               | 2,135  | 48,632              |
| Cash dividends on capital stock   | -                        | -                   | -             | -           | (19,030)             | -  | (19,030)            |
| BALANCE, JUNE 30, 2004  | <u>22,480</u>            | <u>\$ 2,247,961</u> | <u>-</u>      | <u>\$ -</u> | <u>\$ 118,410</u>    | <u>\$ 1,830</u>  | <u>\$ 2,368,201</u> |

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

**FEDERAL HOME LOAN BANK OF DES MOINES**  
**STATEMENT OF CHANGES IN CAPITAL**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2003**  
(In thousands)  
(Unaudited)

|   | Capital Stock<br>Class B |           | Capital Stock |              | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Capital |
|---|--------------------------|-----------|---------------|--------------|----------------------|--|------------------|
|   | Shares                   | Par Value | Shares        | Par Value    |                      |  |                  |
| BALANCE, DECEMBER 31, 2002                              | -                        | \$ -      | 18,582        | \$ 1,858,180 | \$ 50,130            | \$ (3,370)   | \$ 1,904,940     |
| Proceeds from sale of capital stock                     | -                        | -         | 3,472         | 347,230      | -                    | -  | 347,230          |
| Redemption of capital stock                             | -                        | -         | (1,578)       | (157,829)    | -                    | -  | (157,829)        |
| Comprehensive income:                                   |                          |           |               |              |                      |  |                  |
| Net income  | -                        | -         | -             | -            | 37,998               | -  | 37,998           |
| Other comprehensive income:                             |                          |           |               |              |                      |  |                  |
| Net unrealized gain on<br>available-for-sale securities | -                        | -         | -             | -            | -                    | 939  | 939              |
| Total comprehensive income                              | -                        | -         | -             | -            | 37,998               | 939  | 38,937           |
| Cash dividends on capital stock                         | -                        | -         | -             | -            | (27,585)             | -  | (27,585)         |
| BALANCE, JUNE 30, 2003                                  | -                        | \$ -      | 20,476        | \$ 2,047,581 | \$ 60,543            | \$ (2,431)   | \$ 2,105,693     |

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

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

|  | Six Months Ended June 30, |                |
|--|---------------------------|----------------|
|  | <u>2004</u>               | <u>2003</u>    |
| <b>OPERATING ACTIVITIES:</b>   |                           |                |
| Net income   | \$ 46,497                 | \$ 37,998      |
| Adjustments to reconcile net income to net cash (used in)<br>provided by operating activities:   |                           |                |
| Depreciation and amortization:   |                           |                |
| Net premiums and discounts on consolidated<br>obligations, investments, mortgage loans and<br>fees received on interest-rate exchange agreements | (11,784)                  | (76,406)       |
| Concessions on consolidated obligation bonds   | 13,012                    | 19,980         |
| Net deferred loss on interest-rate exchange agreements   | -                         | 380            |
| Premises and equipment   | 195                       | 308            |
| Other  | (338)                     | (236)          |
| Provision for credit losses on mortgage loans held for<br>portfolio  | 118                       | 7              |
| Net realized gain on sale of held-to-maturity securities   | (4,031)                   | -              |
| Net realized gain on sale of available-for-sale securities   | (2,464)                   | -              |
| Decrease in securities held at fair value  | 10,580                    | 16,029         |
| Net change in fair-value adjustment on derivatives<br>and hedging activities   | (62,091)                  | 159,369        |
| Net realized gain on disposal of premises and equipment  | (1,179)                   | (228)          |
| Decrease (increase) in accrued interest receivable   | 1,605                     | (6,533)        |
| Increase in derivative asset accrued interest  | (5,314)                   | (5,852)        |
| (Increase) decrease in derivative liability accrued<br>interest  | (17,002)                  | 55,798         |
| Increase in other assets   | (7,489)                   | (19,814)       |
| Net increase in Affordable Housing Program<br>(AHP) liability and discount on AHP advances   | 2,339                     | 1,581          |
| Increase (decrease) in accrued interest payable  | 9,706                     | (44,108)       |
| Increase (decrease) in payable to REFCORP  | 2,491                     | (77)           |
| Increase in other liabilities  | <u>2,651</u>              | <u>3,373</u>   |
| Total adjustments  | <u>(68,995)</u>           | <u>103,571</u> |
| Net cash (used in) provided by operating activities  | <u>(22,498)</u>           | <u>141,569</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)  
(Unaudited)

|  | Six Months Ended June 30, |                    |
|--|---------------------------|--------------------|
|  | <u>2004</u>               | <u>2003</u>        |
| <b>INVESTING ACTIVITIES:</b>   |                           |                    |
| Net decrease in interest-bearing deposits                                | 68,915                    | 52,144             |
| Net increase in securities purchased under agreements to resell          | -                         | (300,000)          |
| Net (increase) decrease in Federal funds sold                            | (185,000)                 | 2,611,000          |
| Net (increase) decrease in short-term held-to-maturity securities        | (894,602)                 | 958,827            |
| Proceeds from sales of long-term held-to-maturity securities             | 93,320                    | -                  |
| Proceeds from maturities of long-term held-to-maturity securities        | 577,091                   | 1,284,931          |
| Purchases of long-term held-to-maturity securities                       | (730,097)                 | (545,132)          |
| Proceeds from the sale of available-for-sale securities                  | 169,516                   | -                  |
| Purchases of available-for-sale securities                               | (48,701)                  | -                  |
| Principal collected on advances  | 30,969,392                | 21,102,898         |
| Advances made  | (34,061,576)              | (22,164,042)       |
| Principal collected on mortgage loans held for portfolio                 | 1,468,661                 | 1,536,830          |
| Mortgage loans held for portfolio originated or purchased                | (1,072,821)               | (5,764,695)        |
| Net increase in loans to other FHLBanks                                  | -                         | (335,000)          |
| Net decrease in premises and equipment                                   | <u>2,014</u>              | <u>4,239</u>       |
| Net cash used in investing activities                                    | <u>(3,643,888)</u>        | <u>(1,558,000)</u> |
| <b>FINANCING ACTIVITIES:</b>   |                           |                    |
| Net increase (decrease) in deposits                                      | 1,010,047                 | (193,154)          |
| Proceeds from issuance of securities sold under agreements to repurchase | -                         | 200,000            |
| Net proceeds from issuance of consolidated obligations:                  |                           |                    |
| Discount notes   | 100,819,229               | 219,177,349        |
| Bonds  | 13,568,504                | 24,316,193         |
| Payments for maturing and retiring consolidated obligations:             |                           |                    |
| Discount notes   | (100,587,435)             | (220,906,402)      |
| Bonds  | (11,192,420)              | (21,334,197)       |
| Proceeds from issuance of capital stock                                  | 422,758                   | 347,230            |
| Payments for redemption of capital stock                                 | (291,297)                 | (157,829)          |
| Cash dividends paid  | <u>(19,030)</u>           | <u>(27,585)</u>    |
| Net cash provided by financing activities                                | <u>3,730,356</u>          | <u>1,421,605</u>   |
| Net increase in cash and cash equivalents                                | 63,970                    | 5,174              |
| Cash and cash equivalents at beginning of the year                       | <u>57,118</u>             | <u>102,741</u>     |
| Cash and cash equivalents at end of the period                           | <u>\$ 121,088</u>         | <u>\$ 107,915</u>  |
| <b>Supplemental Disclosures:</b>   |                           |                    |
| Cash paid for interest   | \$ 405,960                | \$ 508,221         |

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

## FEDERAL HOME LOAN BANK OF DES MOINES

### NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

#### Note 1—Basis of Presentation

The accompanying unaudited financial statements for the six months ended June 30, 2004, have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, they do not include all of the information required by GAAP and should be read in conjunction with the audited financial statements for the year ended December 31, 2003, which are contained in the Bank's 2003 annual report.

Descriptions of the significant accounting policies of the Bank are included in Note 1 (Summary of Significant Accounting Policies) to the financial statements in the Bank's 2003 annual report.

*Reclassifications.* Certain amounts in the 2003 quarterly financial statements have been reclassified to conform to the second quarter 2004 presentation.

The results of operations for the interim periods are not necessarily indicative of results to be expected for the year ended December 31, 2004.

#### Note 2—Recently Issued Accounting Pronouncements

*Statement of Financial Accounting Standards (SFAS) 150.* In May 2003, the Financial Accounting Standards Board (FASB) issued Statement No. 150, *Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (SFAS 150), which establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of nonpublic entities. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted. For nonpublic entities, mandatorily redeemable financial instruments are subject to the provisions of this Statement for the first fiscal period beginning after December 15, 2004. The Bank will adopt SFAS 150 on January 1, 2005 and is currently in the process of assessing the impact of SFAS 150 on its financial statements.

*Emerging Issues Task Force Issue 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.* In March 2004, the FASB reached a consensus regarding the application of an impairment model to determine whether investments are other-than-temporarily impaired. The provisions of this rule are required to be applied prospectively to all current and future investments accounted for in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and are effective July 1, 2004. New disclosures will also be required beginning December 31, 2004. The Bank does not expect the new rule to have a material impact on its results of operations at the time of adoption.

### **Note 3—Accounting Adjustments**

During the second quarter of 2004, the Bank changed its manner of assessing effectiveness for certain highly effective hedging relationship transactions used since the adoption of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133) on January 1, 2001. Under the prior approach, the Bank assumed no ineffectiveness in these hedging transactions while under the new approach the Bank will measure effectiveness at least quarterly. If the Bank had made this change in prior periods with respect to which the adjustments reflected by this change were measured, this change would not have been material to the results of operations or financial condition of the Bank for any of these prior reporting periods. The Bank recorded an increase of \$2,253,000 to income before assessments included in other income in net realized and unrealized gains (losses) on derivatives and hedging activities in the second quarter of 2004. This change reflects the accounting as if the Bank had employed the new approach from the date of adoption of SFAS 133 until its implementation of the new approach.

### **Note 4—Held-to-Maturity Securities**

The Bank sold certain mortgage-backed securities out of its held-to-maturity portfolio in the first six months of 2004 that had less than 15 percent of the acquired principal outstanding. In accordance with GAAP, such sales are considered maturities for the purposes of security classification. The Bank recognized a gain of \$4,031,000 in other income on the sale and call of held-to-maturity securities in the first six months of 2004.

## Note 5—Advances

*Redemption Terms.* At June 30, 2004 and December 31, 2003, the Bank had advances outstanding, as summarized below (dollars in thousands):

| <u>Year of Maturity</u>                  | <u>June 30, 2004</u> |   | <u>December 31, 2003</u> |   |
|--|----------------------|---|--------------------------|---|
|  | <u>Amount</u>        | <u>Weighted<br/>Average<br/>Interest<br/>Rate</u> | <u>Amount</u>            | <u>Weighted<br/>Average<br/>Interest<br/>Rate</u> |
| Due in one year or less                  | \$ 9,191,433         | 1.64%   | \$ 5,018,997             | 1.85%   |
| Due after one year through two years     | 3,060,312            | 2.71  | 2,549,496                | 2.48  |
| Due after two years through three years  | 1,485,752            | 3.39  | 2,469,964                | 2.55  |
| Due after three years through four years | 1,966,993            | 4.33  | 1,040,049                | 3.67  |
| Due after four years through five years  | 2,057,699            | 4.82  | 3,761,443                | 3.82  |
| Thereafter                               | <u>8,004,459</u>     | 3.73  | <u>7,834,489</u>         | 3.98  |
| Total par value                          | 25,766,648           | 2.97  | 22,674,438               | 3.14  |
| Unamortized commitment fees              | (19)                 |   | (36)                     |   |
| Discounts on AHP advances                | (212)                |   | (253)                    |   |
| Premiums on advances                     | 780                  |   | 858                      |   |
| Discounts on advances                    | (243)                |   | (278)                    |   |
| Hedging fair-value adjustments           | <u>338,034</u>       |   | <u>627,857</u>           |   |
| Total                                    | <u>\$26,104,988</u>  |   | <u>\$23,302,586</u>      |   |

The Bank offers callable advances to members that may be prepaid on pertinent dates (call dates) without incurring prepayment or termination fees. 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 June 30, 2004 and December 31, 2003, the Bank had callable advances of \$425,173,000 and \$555,058,000.

The following table summarizes advances at June 30, 2004 and December 31, 2003, by year of maturity or next call date for callable advances (dollars in thousands):

| <u>Year of Maturity or Next Call Date</u> | June 30,<br>2004 | December 31,<br>2003 |
|---|------------------|----------------------|
| Due in one year or less                   | \$ 9,253,999     | \$ 5,219,443         |
| Due after one year through two years      | 3,119,222        | 2,567,798            |
| Due after two years through three years   | 1,570,911        | 2,588,846            |
| Due after three years through four years  | 2,132,333        | 1,141,920            |
| Due after four years through five years   | 2,110,897        | 3,876,999            |
| Thereafter                                | 7,579,286        | 7,279,432            |
| Total par value                           | \$ 25,766,648    | \$ 22,674,438        |

The Bank also offers fixed-rate convertible advances. With a convertible advance, the Bank effectively purchases a put option from the borrower that allows the Bank to terminate the fixed-rate advance on pertinent dates (put dates). Terminations normally occur when interest rates increase and borrowers have the ability to convert the terminated advance to any available advance product at the then-current rate. At June 30, 2004 and December 31, 2003, the Bank had convertible advances outstanding totaling \$5,748,050,000 and \$8,788,550,000.

The following table summarizes advances at June 30, 2004 and December 31, 2003, by year of maturity or next put date for fixed-rate convertible advances (dollars in thousands):

| <u>Year of Maturity or Next Put Date</u> | June 30,<br>2004 | December 31,<br>2003 |
|--|------------------|----------------------|
| Due in one year or less                  | \$ 14,291,282    | \$ 13,308,347        |
| Due after one year through two years     | 3,180,212        | 1,576,996            |
| Due after two years through three years  | 1,686,052        | 1,488,664            |
| Due after three years through four years | 1,203,193        | 1,063,549            |
| Due after four years through five years  | 579,199          | 704,343              |
| Thereafter                               | 4,826,710        | 4,532,539            |
| Total par value                          | \$ 25,766,648    | \$ 22,674,438        |

*Interest-Rate Payment Terms.* The following table details additional interest-rate payment terms for advances at June 30, 2004 and December 31, 2003 (dollars in thousands):

|                         | June 30,<br>2004     | December 31,<br>2003 |
|-------------------------|----------------------|----------------------|
| Par amount of advances: |                      |                      |
| Fixed-rate              | \$ 18,147,519        | \$ 18,775,209        |
| Variable-rate           | <u>7,619,129</u>     | <u>3,899,229</u>     |
| Total                   | <u>\$ 25,766,648</u> | <u>\$ 22,674,438</u> |

#### **Note 6—Segment Information**

The Bank has identified two main operating segments for internal reporting purposes: Member Finance and Mortgage Finance. The products and services provided reflect the manner in which financial information is evaluated by management.

The Member Finance segment includes products such as advances, investments (excluding mortgage-backed securities) and their related funding and hedging. Income from the 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 Mortgage Partnership Finance® (MPF®, “Mortgage Partnership Finance” and “MPF” are registered trademarks of the Federal Home Loan Bank of Chicago) program, mortgage-backed securities and their related funding and hedging. 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.

Each segment also earns income from invested capital. The Bank allocates invested capital to the Mortgage Finance segment based on its average asset size, and the remaining capital is then allocated to Member Finance.

The following table details the Bank's financial performance by operating segment for the three months ended June 30, 2004 and 2003 (dollars in thousands):

| <u>Three months ended June 30,</u>                                      | <u>Member<br/>Finance</u> | <u>Mortgage<br/>Finance</u> | <u>Total</u>     |
|---|---------------------------|-----------------------------|------------------|
| 2004:   |                           |                             |                  |
| Net interest income   | \$ 18,050                 | \$ 11,298                   | \$ 29,348        |
| Provision for credit losses on mortgage loans                           | <u>-</u>                  | <u>-</u>                    | <u>-</u>         |
| Net interest income after provision for credit losses on mortgage loans | <u>\$ 18,050</u>          | <u>\$ 11,298</u>            | <u>\$ 29,348</u> |
| Average assets  | \$29,888,701              | \$17,767,740                | \$47,656,441     |
| Total assets at period end  | \$30,302,201              | \$18,079,923                | \$48,382,124     |
| 2003:   |                           |                             |                  |
| Net interest income   | \$ 20,751                 | \$ 10,007                   | \$ 30,758        |
| Provision for credit losses on mortgage loans                           | <u>-</u>                  | <u>(7)</u>                  | <u>(7)</u>       |
| Net interest income after provision for credit losses on mortgage loans | <u>\$ 20,751</u>          | <u>\$ 10,000</u>            | <u>\$ 30,751</u> |
| Average assets  | \$30,308,478              | \$11,419,344                | \$41,727,822     |
| Total assets at period end  | \$30,761,948              | \$13,202,753                | \$43,964,701     |

The following table details the Bank's financial performance by operating segment for the six months ended June 30, 2004 and 2003 (dollars in thousands):

|   | <u>Member<br/>Finance</u> | <u>Mortgage<br/>Finance</u> | <u>Total</u>     |
|---|---------------------------|-----------------------------|------------------|
| <u>Six months ended June 30,</u>  |                           |                             |                  |
| 2004:   |                           |                             |                  |
| Net interest income   | \$ 34,771                 | \$ 23,480                   | \$ 58,251        |
| Provision for credit losses on mortgage loans                           | <u>-</u>                  | <u>(118)</u>                | <u>(118)</u>     |
| Net interest income after provision for credit losses on mortgage loans | <u>\$ 34,771</u>          | <u>\$ 23,362</u>            | <u>\$ 58,133</u> |
| Average assets  | \$28,965,751              | \$18,066,328                | \$47,032,079     |
| Total assets at period end  | \$30,302,201              | \$18,079,923                | \$48,382,124     |
| 2003:   |                           |                             |                  |
| Net interest income   | \$ 38,352                 | \$ 25,184                   | \$ 63,536        |
| Provision for credit losses on mortgage loans                           | <u>-</u>                  | <u>(7)</u>                  | <u>(7)</u>       |
| Net interest income after provision for credit losses on mortgage loans | <u>\$ 38,352</u>          | <u>\$ 25,177</u>            | <u>\$ 63,529</u> |
| Average assets  | \$30,016,052              | \$10,493,326                | \$40,509,378     |
| Total assets at period end  | \$30,761,948              | \$13,202,753                | \$43,964,701     |

## **Note 7—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 the Bank's interest-rate exchange agreements was \$54,353,100,000 and \$52,759,011,000 at June 30, 2004 and December 31, 2003. The maximum credit exposure of the Bank is substantially less than the notional amount of interest-rate exchange agreements.

At June 30, 2004 and December 31, 2003, the Bank's maximum credit risk was \$198,455,000 and \$43,070,000. These totals included \$24,814,000 and \$19,500,000 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 held cash of \$227,100,000 and \$20,000,000 as collateral at June 30, 2004 and December 31, 2003.

## **Note 8—Commitments and Contingencies**

The Federal Home Loan Banks (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 Federal Housing Finance Board. The Bank does not recognize a liability for its joint-and-several obligations related to other FHLBanks' consolidated obligations. The Bank has never been required to pay any consolidated obligation on behalf of another FHLBank.

There were no commitments that legally bind and unconditionally obligate the Bank for additional advances at June 30, 2004 or December 31, 2003. Commitments generally are for periods up to 12 months. Standby letters of credit are executed on behalf of 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 \$1,254,003,000 and \$1,053,370,000 at June 30, 2004 and December 31, 2003. Standby letters of credit had original terms of nine days to five years with a final expiration in 2008 at June 30, 2004. Unearned fees on standby letters of credit as well as the value of the guarantees related to standby letters of credit are recorded in other liabilities and amounted to \$598,000 and \$549,000 at June 30, 2004 and December 31, 2003. 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 throughout the life of the agreements.

Commitments which unconditionally obligate the Bank to fund/purchase mortgage loans totaled \$35,557,000 and \$46,914,000 at June 30, 2004 and December 31, 2003. Commitments are generally for periods not to exceed forty-five business days. In accordance with *SFAS 149 Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, certain commitments entered into after June 30, 2003 were recorded as derivatives at their fair values on the statements of condition.

The Bank generally executes interest-rate exchange agreements with large highly rated banks and broker-dealers and enters into bilateral collateral agreements. The Bank had cash pledged as collateral to broker-dealers of \$212,200,000 and \$281,080,000 at June 30, 2004 and December 31, 2003 for interest-rate exchange agreements. Cash pledged as collateral is classified as “interest-bearing deposits” on the statements of condition.

The Bank has executed a lease for 20 years with Wells Fargo Financial, Inc., an affiliate of a member. Construction of the new building began in mid 2004, and the Bank expects its new headquarters to be ready for occupancy by no later than February 2007. The Bank has agreed to an annualized cost of \$20.00 per square foot for the first 10 years and \$22.00 per square foot in years 11 through 20. The Bank expects to lease approximately 40,000 square feet. A third-party representative negotiated the transaction on behalf of the Bank.

Note 7 discusses other commitments and contingencies.

## SELECTED FINANCIAL DATA

|                                       | June 30,<br>2004 | December 31,<br>2003 |
|---------------------------------------|------------------|----------------------|
| <b>Statements of Condition</b>        |                  |                      |
| (Dollars in millions)                 |                  |                      |
| Money market investments <sup>1</sup> | \$ 2,801         | \$ 1,936             |
| Mortgage-backed securities            | 2,689            | 2,494                |
| Other investments                     | 937              | 1,094                |
| Advances                              | 26,105           | 23,303               |
| Mortgage loans, net                   | 15,413           | 15,999               |
| Total assets                          | 48,382           | 45,051               |
| Consolidated obligations              | 42,661           | 40,352               |
| Total liabilities                     | 46,014           | 42,844               |
| Capital stock                         | 2,248            | 2,117                |
| Retained earnings                     | 118              | 91                   |
| Capital-to-asset ratio                | 4.89%            | 4.90%                |

| <b>Operating Results and<br/>Performance Ratios</b>                         | Quarter Ended June 30, |          | Six Months Ended June 30, |          |
|---|------------------------|----------|---------------------------|----------|
|   | 2004                   | 2003     | 2004                      | 2003     |
| (Dollars in millions)   |                        |          |                           |          |
| Interest income   | \$ 225.3               | \$ 244.8 | \$ 453.3                  | \$ 503.9 |
| Interest expense  | 196.0                  | 214.0    | 395.1                     | 440.4    |
| Net interest income before provision<br>for credit losses on mortgage loans | 29.3                   | 30.8     | 58.2                      | 63.5     |
| Provision for credit losses on<br>mortgage loans                            | -                      | -        | (0.1)                     | -        |
| Net interest income after provision<br>for credit losses on mortgage loans  | 29.3                   | 30.8     | 58.1                      | 63.5     |
| Other income (loss)   | 20.1                   | (2.5)    | 20.3                      | 0.9      |
| Other expense   | 7.6                    | 6.4      | 15.1                      | 12.7     |
| Total assessments   | 11.1                   | 5.8      | 16.8                      | 13.7     |
| Net income  | 30.7                   | 16.1     | 46.5                      | 38.0     |
| Return on average assets  | 0.26%                  | 0.15%    | 0.20%                     | 0.19%    |
| Return on average equity  | 5.32                   | 3.29     | 4.12                      | 3.98     |
| Net interest margin   | 0.25                   | 0.29     | 0.25                      | 0.32     |
| Operating expenses to average assets  | 0.06                   | 0.06     | 0.06                      | 0.06     |
| Annualized dividend rate  | 1.79                   | 3.00     | 1.78                      | 3.00     |
| Dividend rate spread over average<br>three-month LIBOR <sup>2</sup>         | 0.60                   | 1.69     | 0.60                      | 1.68     |

<sup>1</sup> Money market investments include: interest-bearing deposits, securities purchased under agreements to resell, Federal funds sold, commercial paper and U.S. agency obligations. The maximum money market investment term is 273 days.

<sup>2</sup> LIBOR represents the London Inter-Bank Offered Rate.

## **MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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. Please refer to “Factors that May Affect Future Results” beginning on page 58 of this report for a discussion of some of the factors that may cause results to differ.

This discussion highlights significant factors influencing our results of operations and financial condition. It should be read in conjunction with the financial statements and related notes included in this document. 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.

### **Overview**

The Federal Home Loan Bank of Des Moines (the Bank), a federally chartered corporation exempt from all federal, state and local taxation except real property taxes, is one of 12 district banks (FHLBanks) created under the authority of the Federal Home Loan Bank Act of 1932, as amended. When used in this document, the terms “we,” “our” and “us” refer to the Federal Home Loan Bank of Des Moines. The 12 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).

Each FHLBank is a separate cooperative with its own member institutions, board of directors, management and employees. Each member institution owns capital stock and is entitled to receive dividends, when declared by the Board of Directors, on its investment. The FHLBanks serve the public by enhancing the availability of funds for residential mortgage lending and targeted community development. The principal sources of funding provided by the Bank are making advances to members and purchasing home mortgage loans from members.

The Bank’s financial policies and practices are designed to support the three key components of a cooperative: attractive product prices, reasonable returns on capital and adequate retained earnings to support safe and sound business operations.

In distributing the value of the cooperative to members, the Board of Directors has established an operating principle that lower product prices are preferred to higher dividends. As a result, the Bank charges low credit prices and pays a target dividend indexed to short-term money market rates. The Bank pays dividends quarterly and its dividend index rate is based on the average yield of the three-month London Inter-Bank Offered Rate (LIBOR) during the dividend period.

The Board of Directors continued to target a quarterly dividend of average three-month LIBOR plus 60 basis points in the first and second quarters of 2004. Unlike calendar year 2003, however, the Board removed the dividend floor of 3.00 percent per annum in 2004 to facilitate the build up of retained earnings. The second quarter 2004 dividend was 1.79 percent or 60 basis points over the LIBOR index compared to the second quarter 2003 dividend of 3.00 percent or 169 basis points over LIBOR. Our retained earnings policy is discussed in “Liquidity and Capital Resources” beginning on page 40.

In June 2004, Standard & Poor’s Rating Services, a division of McGraw-Hill Companies, Inc. (Standard & Poor’s) revised the individual counterparty rating outlook of the Bank from stable to negative. Standard & Poor’s reaffirmed the Bank’s individual AAA counterparty rating. This change in outlook does not affect the AAA counterparty rating of consolidated bonds and discount notes issued jointly by the 12 FHLBanks.

The rating agency cited higher interest-rate risk exposure from the growth of the Bank’s Mortgage Partnership Finance® (MPF®) program<sup>1</sup> as changing the Bank’s credit profile. The Standard & Poor’s statement noted that the Bank has grown the MPF loans in line with its ability to hedge the loans with interest-rate swaps to effectively convert the loans to LIBOR floating-rate assets. See further discussion in the “Liquidity and Capital Resources” section of this document beginning on page 40.

Our participation in the MPF program is essential to achieving our mission of serving our members’ housing finance needs. We have built our infrastructure to manage the risks of this changing business profile. See further discussion of risk management related to the MPF loans in the “Risk Management – Mortgage Finance Market Risk” section of this document on page 48.

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<sup>1</sup> “Mortgage Partnership Finance” and “MPF” are registered trademarks of Federal Home Loan Bank of Chicago.

In June 2004, the Finance Board approved a rule requiring each of the 12 FHLBanks to register a class of its equity securities with the United States Securities and Exchange Commission (SEC) under section 12(g)(1) of the Securities Exchange Act of 1934, as amended. The rule requires each of the FHLBanks file its registration statement with the SEC no later than June 30, 2005 to ensure that its registration statement becomes effective by August 29, 2005. In anticipation of registration, we enhanced and expanded disclosures in our 2003 annual report and 2004 quarterly reports. See further discussion in the “Legislative and Regulatory Developments” section of this document beginning on page 43.

### **Financial Highlights**

Net income increased \$14.6 million for the second quarter of 2004 compared to the same period in 2003. This increase resulted primarily from gains on derivatives and hedging activities partially offset by lower levels of advance prepayment fees and net interest income.

Net income increased \$8.5 million for the first six months of 2004 compared to the same period in 2003. This increase resulted primarily from gains on derivatives and hedging activities and realized gains from the sale of securities partially offset by lower levels of advance prepayment fees and net interest income.

Each of these factors impacting net income is discussed in more detail in the “Results of Operations” beginning on page 23.

These higher levels of net income in 2004 relative to 2003 translated to higher returns on equity. Return on average equity increased to 5.32 percent for the quarter ending June 30, 2004 compared to 3.29 percent for the same period of 2003. Return on average equity increased to 4.12 percent for the six months ended June 30, 2004 compared to 3.98 percent for the same period of 2003.

Average equity increased \$0.4 billion in the second quarter of 2004 and during the first six months of 2004 compared to the same periods of 2003 primarily due to higher capital stock requirements for increased advance and mortgage loan activities and secondarily due to growth in retained earnings.

Average assets, liabilities and capital increased in the second quarter of 2004 compared to the same period in 2003. Average assets were \$47.7 billion in the second quarter of 2004, up \$5.9 billion from 2003. The increase in average assets was attributable to increased mortgage assets and advances partially offset by decreased investment balances. Average liabilities were \$45.3 billion in the second quarter of 2004, up \$5.6 billion from 2003 to support the increased asset balances. Average assets, liabilities and capital also increased for the first six months of 2004 compared to the same period in 2003.

Total assets were \$48.4 billion at June 30, 2004, an increase of \$3.3 billion from December 31, 2003. The increase was mainly due to an increase in the Bank's advances and investments outstanding. Liabilities totaled \$46.0 billion at June 30, 2004, an increase of \$3.2 billion since December 31, 2003. The increase was due to higher levels of deposits and consolidated obligations supporting the increased asset balances.

## **Results of Operations**

### *Net Interest Income*

Despite increased revenues generated from higher levels of interest-bearing assets and capital, net interest income declined by \$1.4 million in the second quarter of 2004 and \$5.4 million in the first six months of 2004 over the same periods in 2003. These declines were largely attributable to reductions in earnings from the asset/liability spread and the impact of lower interest rates on earnings from invested capital.

There are two components to the Bank's net interest income: earnings from the spread between yield on total assets and cost of total liabilities and earnings on capital.

*Asset/Liability Spread.* This component equals the yield on total assets minus the cost of total liabilities. Asset/liability spread income declined in both the second quarter of 2004 and the first six months of 2004 compared to the same periods of 2003.

The decline in net interest income was primarily impacted by compressed spreads on the mortgage portfolio and secondarily due to lower profit margins on advances in 2004. Lower profit margins on advances were implemented January 1, 2003 as part of the Bank's strategic plan for allocating value to our members. Compressed spreads on the mortgage portfolio were caused primarily by two factors:

1. Higher net earnings were recognized on the mortgage portfolio funded with fixed-rate bonds early in 2003. We fund certain mortgage loans with a combination of callable and non-callable fixed-rate bonds of varying maturity and call lockout dates. Each of the bonds has a different yield with the shorter-term non-callable bonds having a lower yield and the longer-term callable bonds having a higher yield. As a result of these differing yields, the cost of funds will vary over time and interest-rate scenarios. The related mortgage loans maintain a constant yield, resulting in changes in the portfolios interest spread relationship over time.

This changing spread relationship generally results in higher income spreads realized in early years and lower spreads in later years. In a stable to rising interest-rate environment, the lower-rate short-term bonds mature while the higher-rate callable bonds remain resulting in an increasing cost of funds and a lower income spread as time passes. Conversely, in a falling interest-rate environment, the higher-rate callable bonds are called away reducing the cost of funds and improving income spreads. In addition, during the falling interest-rate environments we experienced during early 2003, income spreads were further enhanced when the Bank exercised its option to terminate callable bonds roughly two to three months prior to receiving the related mortgage prepayments.

2. During the last nine months of 2003, a large portion of our fixed-rate mortgage loan portfolio was hedged with interest-rate swaps in order to reduce the Bank's market risk and avoid the varying income spreads inherent in a mortgage portfolio funded with fixed-rate bonds. Net interest spread income generated by the mortgage portfolio hedged with interest-rate swaps is somewhat lower than our historical spreads but tends to be more stable over time.

*Earnings on Capital.* A considerable portion of our net interest income was derived from interest earnings on assets supported by capital. Earnings on capital declined in the second quarter of 2004 and the first six months of 2004 due to the Bank's risk reduction strategy of hedging fixed-rate mortgage loans with interest-rate swaps indexed to LIBOR. In addition, the lower interest-rate environment in 2004 relative to 2003 reduced the earnings from investment of capital despite the higher levels of capital in 2004.

The following tables present average balances and rates of major earning asset and liability categories for the three and six months ended June 30, 2004 and 2003. The tables also present the net interest spread between yield on total earning assets and cost of interest-bearing liabilities and the net interest margin between yield on total assets and the cost of total funding sources (i.e., interest-bearing liabilities plus capital plus other interest-free liabilities) (dollars in millions).

|   | For the Three Months Ended June 30, 2004 |                |                           | For the Three Months Ended June 30, 2003 |                |                           |
|---|--|----------------|---------------------------|--|----------------|---------------------------|
|   | Average Balance                          | Rate           | Interest Income / Expense | Average Balance                          | Rate           | Interest Income / Expense |
| <b>Interest-earning assets:</b>                                 |  |                |                           |  |                |                           |
| Advances  | \$ 24,979                                | 1.70%          | \$ 105.3                  | \$ 23,705                                | 2.05%          | \$ 121.3                  |
| Mortgage-backed securities <sup>1</sup>                         | 2,131                                    | 2.71%          | 14.4                      | 3,641                                    | 3.15%          | 28.6                      |
| Federal funds sold  | 1,963                                    | 1.02%          | 5.0                       | 3,881                                    | 1.25%          | 12.1                      |
| Securities purchased under agreements to resell                 | 305                                      | 1.05%          | 0.8                       | 300                                      | 1.29%          | 1.0                       |
| Other investments <sup>1</sup>                                  | 2,286                                    | 1.00%          | 5.6                       | 2,066                                    | 1.78%          | 9.2                       |
| Mortgage loans <sup>2</sup>                                     | 15,660                                   | 2.42%          | 94.2                      | 7,809                                    | 3.72%          | 72.5                      |
| Other interest-earning assets                                   | <u>3</u>                                 | <u>1.06%</u>   | <u>-</u>                  | <u>37</u>                                | <u>1.29%</u>   | <u>0.1</u>                |
| Total interest-earning assets                                   | 47,327                                   | 1.91%          | 225.3                     | 41,439                                   | 2.37%          | 244.8                     |
| Non-interest earning assets                                     | <u>329</u>                               | <u>-</u>       | <u>-</u>                  | <u>289</u>                               | <u>-</u>       | <u>-</u>                  |
| Total assets  | <u>\$47,656</u>                          | <u>1.90%</u>   | <u>\$ 225.3</u>           | <u>\$41,728</u>                          | <u>2.35%</u>   | <u>\$ 244.8</u>           |
| <b>Interest-bearing liabilities:</b>                            |  |                |                           |  |                |                           |
| Consolidated obligations:                                       |  |                |                           |  |                |                           |
| Bonds   | 37,085                                   | 1.92%          | 177.1                     | 29,030                                   | 2.56%          | 184.9                     |
| Discount notes  | 5,257                                    | 1.05%          | 13.7                      | 7,137                                    | 1.22%          | 21.7                      |
| Deposits  | 1,556                                    | 0.78%          | 3.0                       | 1,843                                    | 0.97%          | 4.5                       |
| Other interest-bearing liabilities                              | <u>501</u>                               | <u>1.72%</u>   | <u>2.2</u>                | <u>553</u>                               | <u>2.19%</u>   | <u>3.0</u>                |
| Total interest-bearing liabilities                              | 44,399                                   | 1.77%          | 196.0                     | 38,563                                   | 2.23%          | 214.1                     |
| Non-interest bearing liabilities                                | <u>938</u>                               | <u>-</u>       | <u>-</u>                  | <u>1,207</u>                             | <u>-</u>       | <u>-</u>                  |
| Total liabilities   | 45,337                                   | 1.74%          | 196.0                     | 39,770                                   | 2.16%          | 214.1                     |
| Capital   | <u>2,319</u>                             | <u>-</u>       | <u>-</u>                  | <u>1,958</u>                             | <u>-</u>       | <u>-</u>                  |
| Total liabilities and capital                                   | <u>\$47,656</u>                          | <u>1.65%</u>   | <u>\$ 196.0</u>           | <u>\$41,728</u>                          | <u>2.06%</u>   | <u>\$ 214.1</u>           |
| Net interest income and spread                                  |  | <u>0.14%</u>   | <u>\$ 29.3</u>            |  | <u>0.14%</u>   | <u>\$ 30.7</u>            |
| Net interest margin   |  | <u>0.25%</u>   |                           |  | <u>0.29%</u>   |                           |
| Average interest-earning assets to interest-bearing liabilities |  | <u>106.59%</u> |                           |  | <u>107.46%</u> |                           |
| Composition of net interest income:                             |  |                |                           |  |                |                           |
| Asset/liability spread  |  | 0.16%          | \$ 19.3                   |  | 0.19%          | \$ 20.2                   |
| Earnings on capital   |  | 1.74%          | <u>10.0</u>               |  | 2.16%          | <u>10.5</u>               |
| Net interest income   |  |                | <u>\$ 29.3</u>            |  |                | <u>\$ 30.7</u>            |

<sup>1</sup> Available-for-sale investment securities are based on their amortized costs and hedging fair-value adjustments. The yield information does not give effect to changes in fair value that are reflected as a component of capital.

<sup>2</sup> Nonperforming loans are included in average balances used to determine average rate.

|   | For the Six Months Ended June 30, 2004 |                |                                 | For the Six Months Ended June 30, 2003 |                |                                 |
|---|--|----------------|---------------------------------|--|----------------|---------------------------------|
|   | Average<br>Balance                     | Rate           | Interest<br>Income /<br>Expense | Average<br>Balance                     | Rate           | Interest<br>Income /<br>Expense |
| Interest-earning assets:  |  |                |                                 |  |                |                                 |
| Advances  | \$ 24,283                              | 1.72%          | \$ 207.8                        | \$ 23,615                              | 2.11%          | \$ 247.4                        |
| Mortgage-backed securities <sup>1</sup>                         | 2,248                                  | 2.73%          | 30.5                            | 3,762                                  | 3.24%          | 60.4                            |
| Federal funds sold  | 1,892                                  | 1.02%          | 9.6                             | 3,650                                  | 1.28%          | 23.1                            |
| Securities purchased under agreements to resell                 | 305                                    | 1.05%          | 1.6                             | 252                                    | 1.30%          | 1.6                             |
| Other investments <sup>1</sup>                                  | 2,145                                  | 1.00%          | 10.7                            | 2,148                                  | 1.80%          | 19.2                            |
| Mortgage loans <sup>2</sup>                                     | 15,843                                 | 2.45%          | 193.2                           | 6,762                                  | 4.53%          | 152.0                           |
| Other interest-earning assets                                   | <u>4</u>                               | <u>1.04%</u>   | <u>-</u>                        | <u>32</u>                              | <u>1.30%</u>   | <u>0.2</u>                      |
| Total interest-earning assets                                   | 46,720                                 | 1.95%          | 453.4                           | 40,221                                 | 2.53%          | 503.9                           |
| Non-interest earning assets                                     | <u>312</u>                             | <u>-</u>       | <u>-</u>                        | <u>288</u>                             | <u>-</u>       | <u>-</u>                        |
| Total assets  | <u>\$47,032</u>                        | <u>1.94%</u>   | <u>\$ 453.4</u>                 | <u>\$40,509</u>                        | <u>2.51%</u>   | <u>\$ 503.9</u>                 |
| Interest-bearing liabilities:                                   |  |                |                                 |  |                |                                 |
| Consolidated obligations:                                       |  |                |                                 |  |                |                                 |
| Bonds   | 36,611                                 | 1.97%          | 358.3                           | 28,354                                 | 2.73%          | 383.6                           |
| Discount notes  | 5,206                                  | 1.04%          | 26.9                            | 6,701                                  | 1.27%          | 42.2                            |
| Deposits  | 1,464                                  | 0.76%          | 5.6                             | 1,912                                  | 0.97%          | 9.2                             |
| Other interest-bearing liabilities                              | <u>501</u>                             | <u>1.73%</u>   | <u>4.3</u>                      | <u>483</u>                             | <u>2.25%</u>   | <u>5.4</u>                      |
| Total interest-bearing liabilities                              | 43,782                                 | 1.81%          | 395.1                           | 37,450                                 | 2.37%          | 440.4                           |
| Non-interest bearing liabilities                                | <u>979</u>                             | <u>-</u>       | <u>-</u>                        | <u>1,133</u>                           | <u>-</u>       | <u>-</u>                        |
| Total liabilities   | 44,761                                 | 1.78%          | 395.1                           | 38,583                                 | 2.30%          | 440.4                           |
| Capital   | <u>2,271</u>                           | <u>-</u>       | <u>-</u>                        | <u>1,926</u>                           | <u>-</u>       | <u>-</u>                        |
| Total liabilities and capital                                   | <u>\$47,032</u>                        | <u>1.69%</u>   | <u>\$ 395.1</u>                 | <u>\$40,509</u>                        | <u>2.19%</u>   | <u>\$ 440.4</u>                 |
| Net interest income and spread                                  |  | <u>0.14%</u>   | <u>\$ 58.3</u>                  |  | <u>0.16%</u>   | <u>\$ 63.5</u>                  |
| Net interest margin   |  | <u>0.25%</u>   |                                 |  | <u>0.32%</u>   |                                 |
| Average interest-earning assets to interest-bearing liabilities |  | <u>106.71%</u> |                                 |  | <u>107.40%</u> |                                 |
| Composition of net interest income:                             |  |                |                                 |  |                |                                 |
| Asset/liability spread  |  | 0.16%          | \$ 38.3                         |  | 0.21%          | \$ 41.5                         |
| Earnings on capital   |  | 1.78%          | <u>20.0</u>                     |  | 2.30%          | <u>22.0</u>                     |
| Net interest income   |  |                | <u>\$ 58.3</u>                  |  |                | <u>\$ 63.5</u>                  |

<sup>1</sup> Available-for-sale investment securities are based on their amortized costs and hedging fair-value adjustments. The yield information does not give effect to changes in fair value that are reflected as a component of capital.

<sup>2</sup> Nonperforming loans are included in average balances used to determine average rate.

Changes in volumes and rates influence changes in net interest income. The following table presents the changes in interest income and interest expense for the second quarters of 2004 and 2003 and the first six months of 2004 and 2003. 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 For the Three Months Ended<br>June 30, 2004 vs June 30, 2003 |                 |                                 | Variance For the Six Months Ended<br>June 30, 2004 vs June 30, 2003 |                  |                                 |
|--|---|-----------------|---------------------------------|---|------------------|---------------------------------|
|  | Total Increase<br>(Decrease) Due to                                   |                 | Total<br>Increase<br>(Decrease) | Total Increase<br>(Decrease) Due to                                 |                  | Total<br>Increase<br>(Decrease) |
|  | Volume  | Rate            |                                 | Volume  | Rate             |                                 |
|  |   |                 |                                 |   |                  |                                 |
| Interest income:                                   |   |                 |                                 |   |                  |                                 |
| Advances   | \$ 6.2  | \$ (22.2)       | \$ (16.0)                       | \$ 6.9  | \$ (46.5)        | \$ (39.6)                       |
| Mortgage-backed securities                         | (10.7)  | (3.5)           | (14.2)                          | (21.5)  | (8.4)            | (29.9)                          |
| Federal funds sold                                 | (5.2)   | (1.9)           | (7.1)                           | (9.5)   | (4.0)            | (13.5)                          |
| Securities purchased<br>under agreements to resell | -   | (0.2)           | (0.2)                           | 0.3   | (0.3)            | -                               |
| Other investments                                  | 0.9   | (4.5)           | (3.6)                           | -   | (8.5)            | (8.5)                           |
| Mortgage loans                                     | 53.7  | (32.0)          | 21.7                            | 135.0   | (93.8)           | 41.2                            |
| Other interest-earning assets                      | <u>(0.1)</u>  | <u>-</u>        | <u>(0.1)</u>                    | <u>(0.1)</u>  | <u>(0.1)</u>     | <u>(0.2)</u>                    |
| Total interest income                              | 44.8  | (64.3)          | (19.5)                          | 111.1   | (161.6)          | (50.5)                          |
| Interest expense:                                  |   |                 |                                 |   |                  |                                 |
| Consolidated obligations:                          |   |                 |                                 |   |                  |                                 |
| Bonds  | 44.2  | (52.0)          | (7.8)                           | 96.6  | (121.9)          | (25.3)                          |
| Discount notes                                     | (5.2)   | (2.8)           | (8.0)                           | (8.4)   | (6.9)            | (15.3)                          |
| Deposits   | (0.6)   | (0.9)           | (1.5)                           | (1.9)   | (1.7)            | (3.6)                           |
| Other interest-bearing liabilities                 | <u>(0.3)</u>  | <u>(0.5)</u>    | <u>(0.8)</u>                    | <u>0.2</u>  | <u>(1.3)</u>     | <u>(1.1)</u>                    |
| Total interest expense                             | <u>38.1</u>   | <u>(56.2)</u>   | <u>(18.1)</u>                   | <u>86.5</u>   | <u>(131.8)</u>   | <u>(45.3)</u>                   |
| Net interest income                                | <u>\$ 6.7</u>   | <u>\$ (8.1)</u> | <u>\$ (1.4)</u>                 | <u>\$ 24.6</u>  | <u>\$ (29.8)</u> | <u>\$ (5.2)</u>                 |

### *Net Interest Income by Segment*

The Bank manages its operations by grouping its products and services within business segments. We have identified two main business segments: Member Finance and Mortgage Finance.

The Member Finance segment includes products such as advances, investments (excluding mortgage-backed securities) and their related funding and hedging. Income from the 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 and hedging. 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.

Each segment also earns income from invested capital. We allocate invested capital to the Mortgage Finance segment based on its average asset size, and the remaining capital is then allocated to Member Finance.

The Member Finance segment net interest income declined \$2.7 million in the second quarter of 2004 and \$3.6 million in the first six months of 2004 compared to the same periods of 2003. The declines in both periods were from the impact of lower profit margins on advances and lower returns on invested capital due to lower interest rates. This impact was partially offset by the benefit of higher capital balances.

The Mortgage Finance segment net interest income before provision for credit losses on mortgage loans increased \$1.3 million in the second quarter of 2004 compared to the same period of 2003. This increase was attributable to higher asset and capital balances, even though we recognized lower profit margins on mortgage assets and lower returns on invested capital.

The Mortgage Finance segment net interest income before provision for credit losses on mortgage loans decreased \$1.7 million in the first six months of 2004 compared to the same period of 2003 due mainly to lower profit margins on mortgage assets and lower returns on invested capital.

Average assets and capital for Mortgage Finance for both the second quarter and first six months of 2004 were greater than the prior year due to the substantial growth in the MPF program that occurred in the last nine months of 2003. Factors influencing the decline in profit margins on mortgages and lower returns on invested capital are discussed in “Results of Operations – Net Interest Income” beginning on page 23.

At June 30, 2004, 74 percent of our fixed-rate mortgage portfolio was hedged with interest-rate swaps and funded with variable-rate debt. This funding strategy provides a more stable net income spread across various interest-rate scenarios and effectively hedges mortgage loan prepayment risk. Prior to employing the mortgage interest-rate swap hedge strategy, our fixed-rate mortgage portfolio was funded with a mix of fixed-rate callable and non-callable bonds. This funding strategy tended to result in more variability in the earnings than hedging loans with interest-rate swaps.

### Other Income

We reported other income of \$20.1 million in the second quarter of 2004 compared to a loss of \$2.5 million in the same period of 2003. The primary reason for this year-over-year increase was due to gains on derivatives and hedging activities partially offset by lower advance prepayment fees.

We reported other income of \$20.3 million and \$0.9 million in the first six months of 2004 and 2003. The primary reason for the increase was due to gains on derivatives and hedging activities and realized gains from the sale of securities partially offset by decreased advance prepayment fees.

The following table summarizes the effect on other income due to derivatives and hedging activities and the gains and losses on securities held at fair value for the three and six months ended June 30, 2004 and 2003 (dollars in millions):

|  | Quarter Ended June 30, |                 | Six Months Ended June 30, |                 |
|--|------------------------|-----------------|---------------------------|-----------------|
|  | 2004                   | 2003            | 2004                      | 2003            |
| Net realized and unrealized gain (loss) on derivatives and hedging activities:                   |                        |                 |                           |                 |
| Hedge ineffectiveness  | \$ 13.8                | \$ (6.0)        | \$ 11.1                   | \$ (5.4)        |
| Economic hedges  | 3.6                    | (0.9)           | (1.1)                     | (2.1)           |
| Net gain (loss) on securities held at fair value   | <u>(0.4)</u>           | <u>(0.2)</u>    | <u>(0.5)</u>              | <u>(0.4)</u>    |
| Net effect of derivative and hedging activities and gain (loss) on securities held at fair value | <u>\$ 17.0</u>         | <u>\$ (7.1)</u> | <u>\$ 9.5</u>             | <u>\$ (7.9)</u> |

Net gains (losses) in the table above related to economic hedges includes net interest (expense) income of \$(0.3) million and \$3.9 million in second quarters of 2004 and 2003. Net gains (losses) related to economic hedges includes net interest (expense) income of \$(0.7) million and \$3.5 million in the first six months of 2004 and 2003.

Hedge ineffectiveness gains for the second quarter and six months ended 2004 were primarily due to hedge relationships between mortgage loans and consolidated obligations. Hedge ineffectiveness occurs when changes in fair value for the derivative and hedged item do not perfectly offset.

Included in other income for the second quarter of 2004 is a \$2.3 million increase in net unrealized gains on derivatives and hedging activities resulting from changes in our accounting for certain highly effective hedging relationship transactions used since the adoption of Statement on Financial Accounting Standards (SFAS) 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133) on January 1, 2001. If we had made these changes in prior periods with respect to which the adjustments reflected by these changes were measured, these changes would not have been material to the results of operations or financial

condition of the Bank for any of these prior reporting periods. These changes could lead to more variability in reported net income in future periods. However, the cumulative amount of these changes will offset each other if the derivative and hedged item are both held to maturity or their call dates, which is generally the case for the Bank. See additional discussion regarding the accounting adjustment at Note 3 to the accompanying financial statements on page 11.

In 2003, we began using a mortgage interest-rate swap hedge strategy to more effectively manage the market and prepayment risks associated with mortgage loans. This strategy significantly increased our hedge relationships that have potential to generate gains and losses from ineffectiveness.

Economic hedges are primarily used in our mortgage loan portfolio and to manage basis risk between our assets and liabilities. These hedges constituted approximately 3 percent of the total notional value of our derivative portfolio at June 30, 2004. We recognize realized and unrealized gains or losses on our economic hedges in current period earnings including the derivative net interest income or expense. However, in all instances, the associated changes in the value of assets being hedged were not afforded similar treatment in the financial statements. As a result, the change in accounting for derivatives and hedging activities has materially changed both the timing of income recognition and the financial statement line-item classification of a significant portion of our hedging activities. There is more variability in reported earnings due to changes in market prices and interest rates, and this variability could continue in the future.

Prepayment fees declined \$2.8 million in the second quarter of 2004 compared to the same period in 2003 and declined \$5.6 million in the first six months of 2004 compared to the same period in 2003. We charge borrowers prepayment fees when they prepay certain advances before the original maturity. These fees are intended to make us financially indifferent to the decisions of borrowers to prepay. Advance prepayments are not predictable from year-to-year because they are based on the liability restructuring needs of borrowers.

Realized gains on held-to-maturity securities changed due to the sale of \$89.4 million of mortgage-backed securities in the first six months of 2004 compared to no sales in the same period in 2003. We sold fixed and floating rate agency securities to increase operational efficiencies and to take advantage of market conditions. We continue to monitor held-to-maturity securities with minimal remaining principal balances and may sell more securities. We also sold \$167.1 million of available-for-sale agency securities in the first six months of 2004 and terminated the related interest-rate exchange agreements.

“Other, net” increased \$1.3 million in the first six months of 2004 compared to the same period in 2003. The primary reason for the increase was a gain on the sale of land in the second quarter of 2004. The Bank sold the land to Wells Fargo Financial, Inc., an affiliate of a member.

### *Other Expenses*

The following table presents our other expenses for the quarters ended June 30, 2004 and 2003 and the first six months of 2004 and 2003 (dollars in millions):

|                                     | Quarter Ended June 30, |               | Six Months Ended June 30, |                |
|-------------------------------------|------------------------|---------------|---------------------------|----------------|
|                                     | 2004                   | 2003          | 2004                      | 2003           |
| Salaries and employee benefits      | \$ 4.3                 | \$ 3.7        | \$ 8.5                    | \$ 7.4         |
| Occupancy cost                      | 0.2                    | 0.2           | 0.4                       | 0.5            |
| Other operating                     | <u>2.5</u>             | <u>1.9</u>    | <u>4.9</u>                | <u>3.7</u>     |
|                                     | 7.0                    | 5.8           | 13.8                      | 11.6           |
| Finance Board and Office of Finance | <u>0.6</u>             | <u>0.6</u>    | <u>1.3</u>                | <u>1.1</u>     |
| Total                               | <u>\$ 7.6</u>          | <u>\$ 6.4</u> | <u>\$ 15.1</u>            | <u>\$ 12.7</u> |

The increases in salaries and employee benefits in the second quarter of 2004 and the first six months of 2004 compared to the same periods of 2003 reflect (1) increases from funding our portion of the Financial Institutions Retirement Plan for the first time since 1987, (2) general pay and benefit increases and (3) increases from planned staff additions.

The increases in other operating expenses in the second quarter of 2004 and the first six months of 2004 compared to the same periods of 2003 resulted from the following activities: (1) resources required to sponsor the Capitalizing on Rural America symposium and (2) increased fees from consulting services. We increased consulting services due to the growth in the mortgage portfolio and from initiatives related to registration of a class of equity securities with the SEC.

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

Our Affordable Housing Program expense and Resolution Funding Corporation assessment increased for the second quarter of 2004 compared to the second quarter of 2003 and the first six months of 2004 compared to the same period in 2003. Both assessments fluctuate directly with net income, resulting in higher assessments in 2004.

## Statements of Condition

### Advances

Our traditional “mission asset” is our program of advances to members and eligible housing associates (collectively known as “borrowers”) to provide funds for home mortgage financing, community lending and small business, small farm and small agri-business lending. The primary benefit of Bank membership is the value of access to funds for liquidity and lending at competitive terms. Advances increased \$2.8 billion in the first six months of 2004.

Advance originations in the first six months of 2004 outpaced payments by \$3.1 billion. Most of the increase was attributable to increases in fixed- and variable-rate borrowings partially offset by decreases in convertible advances.

Convertible advances are fixed-rate advances in which we purchase put options from borrowers that allow us to terminate the advances on predetermined put dates. These terminations normally occur when interest rates increase. A convertible advance carries an interest rate lower than a comparable-maturity advance that does not have the conversion feature.

The composition of our advances, based on remaining term to scheduled maturity, at June 30, 2004 and December 31, 2003 is as follows (dollars in millions):

|  | June 30,<br>2004 | December 31,<br>2003 |
|--|------------------|----------------------|
| Fixed-rate:                              |                  |                      |
| Maturity less than one month             | \$ 2,978         | \$ 1,794             |
| Maturity one month to one year           | 2,138            | 2,148                |
| Maturity greater than one year           | 6,858            | 5,489                |
| Variable-rate:                           |                  |                      |
| Maturity less than one month             | 32               | 169                  |
| Maturity one month to one year           | 3,963            | 851                  |
| Maturity greater than one year           | 3,625            | 2,879                |
| Callable advances                        | 425              | 555                  |
| Convertible (putable) advances           | 5,748            | 8,789                |
| Total par value                          | <u>25,767</u>    | <u>22,674</u>        |
| Hedging fair value and other adjustments | <u>338</u>       | <u>629</u>           |
| Total advances                           | <u>\$ 26,105</u> | <u>\$ 23,303</u>     |

The following table presents our five largest member borrowers on June 30, 2004 (dollars in millions):

| Name  | City         | State | Advances <sup>1</sup> | Percent of<br>Total<br>Advances |
|---|--------------|-------|-----------------------|---------------------------------|
| Wells Fargo Bank, N.A.                            | Sioux Falls  | SD    | \$ 5,000              | 19.4%                           |
| Transamerica Life Insurance Company               | Cedar Rapids | IA    | 1,300                 | 5.0                             |
| TCF National Bank                                 | Minneapolis  | MN    | 1,223                 | 4.7                             |
| Transamerica Occidental Life Insurance<br>Company | Cedar Rapids | IA    | 1,100                 | 4.3                             |
| AmerUs Life Insurance Company                     | Des Moines   | IA    | 973                   | 3.8                             |
|   |              |       | 9,596                 | 37.2                            |
| All other borrowers                               |              |       | 16,165                | 62.8                            |
| Housing associates                                |              |       | 6                     | -                               |
| Total advances (at par value)                     |              |       | \$ 25,767             | 100.0%                          |

<sup>1</sup> Represents par value before considering unamortized commitment fees, premiums and discounts and hedging fair-value adjustments.

## Mortgage Loans

We acquire 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 traditional secondary market. Under the terms of the MPF program, we manage the liquidity, interest-rate and prepayment risks of the mortgage loans while the members retain the customer relationship and loan servicing activities. The Bank and its members share in the credit risk of the loans. During 2003, the MPF program introduced a servicing released program in which those members that do not wish to service loans owned by the Bank can transfer servicing rights to a third-party provider.

The following table presents information as of June 30, 2004 and December 31, 2003 on mortgage loans held for portfolio (dollars in millions):

|   | June 30,<br>2004 | December 31,<br>2003 |
|---|------------------|----------------------|
| Single-Family Mortgages:                            |                  |                      |
| Fixed-rate conventional loans                       |                  |                      |
| Contractual maturity less than or equal to 15 years | \$ 4,063         | \$ 4,282             |
| Contractual maturity greater than 15 years          | <u>10,529</u>    | <u>10,481</u>        |
| Subtotal  | 14,592           | 14,763               |
| Fixed-rate government-insured loans                 |                  |                      |
| Contractual maturity less than or equal to 15 years | 4                | 4                    |
| Contractual maturity greater than 15 years          | <u>1,018</u>     | <u>1,242</u>         |
| Subtotal  | <u>1,022</u>     | <u>1,246</u>         |
| Total par value                                     | 15,614           | 16,009               |
| Premiums  | 165              | 181                  |
| Discounts   | (149)            | (149)                |
| Hedging fair-value adjustments                      | (211)            | (36)                 |
| Allowance for credit losses on mortgage loans       | <u>(6)</u>       | <u>(6)</u>           |
| Total mortgage loans held for portfolio             | <u>\$ 15,413</u> | <u>\$ 15,999</u>     |

Mortgage loans decreased by 4 percent from December 31, 2003. In the first six months of 2004, we purchased \$1.1 billion of member mortgage loans through the MPF program and received principal repayments of \$1.5 billion. The annualized pay-down rate for mortgage loans in the first six months of 2004 was approximately 17 percent compared to approximately 38 percent in the first six months of 2003.

Mortgage loan purchases in 2004 declined due to lower acquisitions of mortgages from large members. This trend is expected to continue into the third quarter of 2004.

Hedging fair-value adjustments are made up of market value adjustments from hedge accounting as well as basis adjustments created from terminated hedge relationships. In 2004, we terminated certain interest-rate swaps and established new hedge relationships with mortgage loans to adjust prepayment protection. As of June 30, 2004, the unamortized balance of these basis adjustments totaled \$192 million compared to \$0 at December 31, 2003. The basis adjustments will amortize to income over the estimated lives of the related mortgage loans.

We either receive or pay an upfront fee on interest-rate swaps to offset the premium, discount or other book-value adjustments (including the basis adjustment created from terminated hedges) on the mortgage loans. This cash payment equates to the initial fair value of the interest-rate swap and is amortized over the life of the interest-rate swap to net interest income as the book-value adjustments on the mortgage loans are recognized. The market value of the interest-rate swaps hedging the mortgage loans are presented in the “Statements of Condition – Interest-Rate Exchange Agreements” section of this document beginning on page 38.

### *Investments*

The following table summarizes investments at June 30, 2004 and December 31, 2003 (dollars in millions):

|   | June 30,<br>2004 | December 31,<br>2003 |
|---|------------------|----------------------|
| Interest-bearing deposits                       | \$ 212           | \$ 281               |
| Securities purchased under agreements to resell | 305              | 305                  |
| Federal funds sold                              | 1,385            | 1,200                |
| Commercial paper                                | 250              | -                    |
| U.S. agency discount notes                      | 649              | 150                  |
| Total money market investments                  | <u>2,801</u>     | <u>1,936</u>         |
| U.S. agency mortgage-backed securities          | 2,144            | 1,824                |
| Other mortgage-backed securities                | 545              | 670                  |
| Total mortgage-backed securities                | <u>2,689</u>     | <u>2,494</u>         |
| U.S. agency bonds                               | 916              | 1,068                |
| State or local housing agency obligations       | 13               | 19                   |
| Other   | 8                | 7                    |
| Total other investments                         | <u>937</u>       | <u>1,094</u>         |
| Total investments                               | <u>\$ 6,427</u>  | <u>\$ 5,524</u>      |

Investment balances increased approximately 16 percent in the first six months of 2004. The level of short-term investments will vary based on changes in other asset classes, levels of capital and leverage. The increase in investment balances was primarily caused by purchases outpacing our pay downs during the first six months of 2004.

The annualized pay-down rate for mortgage-backed securities in the first six months of 2004 was approximately 32 percent compared to approximately 50 percent in the same period of 2003. Pay downs were offset by the purchase of \$730 million of agency mortgage-backed securities in the first six months of 2004. Slower mortgage loan acquisitions led to the capacity to purchase mortgage-backed securities.

Purchases of mortgage-backed securities supported our contingent liquidity requirements. See additional discussion of our contingent liquidity requirements in the “Liquidity and Capital Resources” section of this document beginning on page 40.

### *Consolidated Obligations*

Consolidated obligations are the joint-and-several obligations of the 12 FHLBanks, backed by the financial resources of the FHLBanks. 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.

Consolidated obligations 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 June 30, 2004, the Bank’s consolidated obligations totaled \$42.7 billion compared with \$40.4 billion at December 31, 2003. Consolidated obligations increased in response to the increase in advance activity during the first six months of 2004.

*Discount Notes.* The following table summarizes the Bank’s participation in consolidated discount notes, all of which are due within one year (dollars in millions):

|                                | June 30,<br>2004 | December 31,<br>2003 |
|--------------------------------|------------------|----------------------|
| Par value                      | \$ 5,722         | \$ 5,483             |
| Discounts                      | (13)             | (11)                 |
| Hedging fair-value adjustments | (2)              | -                    |
| Total discount notes           | <u>\$ 5,707</u>  | <u>\$ 5,472</u>      |

*Bonds.* The following table summarizes the Bank's consolidated bonds based on remaining term to maturity at June 30, 2004 and December 31, 2003 (dollars in millions):

| <u>Year of Maturity</u>                  | <u>June 30,<br/>2004</u> | <u>December 31,<br/>2003</u> |
|--|--------------------------|------------------------------|
| Due in one year or less                  | \$ 8,147                 | \$ 4,489                     |
| Due after one year through two years     | 10,237                   | 8,495                        |
| Due after two years through three years  | 6,520                    | 7,836                        |
| Due after three years through four years | 2,220                    | 2,359                        |
| Due after four years through five years  | 2,480                    | 2,995                        |
| Thereafter                               | <u>7,734</u>             | <u>8,789</u>                 |
| Total par value                          | 37,338                   | 34,963                       |
| Premiums                                 | 46                       | 57                           |
| Discounts                                | (14)                     | (17)                         |
| Hedging fair-value adjustments           | <u>(416)</u>             | <u>(123)</u>                 |
| Total bonds                              | <u>\$ 36,954</u>         | <u>\$ 34,880</u>             |

Substantially all of the hedging fair-value adjustment gains on the bonds are offset by net estimated fair market value losses on the related derivative contracts. See additional discussion regarding our derivative contracts in the "Statements of Condition – Interest-Rate Exchange Agreements" section of this document beginning on page 38.

The Bank's bonds outstanding include the following (dollars in millions):

|                             | <u>June 30,<br/>2004</u> | <u>December 31,<br/>2003</u> |
|-----------------------------|--------------------------|------------------------------|
| Par amount of bonds:        |                          |                              |
| Non-callable or non-putable | \$ 17,500                | \$ 15,468                    |
| Callable                    | <u>19,838</u>            | <u>19,495</u>                |
| Total par value             | <u>\$ 37,338</u>         | <u>\$ 34,963</u>             |

### *Capital*

As of June 30, 2004 total capital (including capital stock, retained earnings and accumulated other comprehensive income) increased \$0.2 billion from December 31, 2003. The primary factor contributing to this growth was activity stock supporting increased advance activity, and the secondary factor was growth in retained earnings.

### *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 financial 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.

We use interest-rate exchange agreements to manage mismatches of interest rates between assets and liabilities. In addition, we use interest-rate exchange agreements to manage embedded options in assets and liabilities, to hedge the market value of existing assets, liabilities and anticipated transactions, to reduce funding costs and to offer products to members.

The notional amount of interest-rate exchange agreements reflects the volume of our hedges, but it does not measure the credit exposure of the Bank because there is no principal at risk. The following table categorizes the notional amount of our interest-rate exchange agreements as of June 30, 2004 and December 31, 2003 (dollars in millions):

|   | <u>June 30,<br/>2004</u> | <u>December 31,<br/>2003</u> |
|---|--------------------------|------------------------------|
| Notional amount of interest-rate exchange agreements: |                          |                              |
| Interest-rate swaps:                                  |                          |                              |
| Non-cancelable  | \$ 17,201                | \$ 13,961                    |
| Cancelable by counterparty                            | 24,028                   | 25,760                       |
| Cancelable by Bank                                    | <u>12,353</u>            | <u>10,914</u>                |
|   | 53,582                   | 50,635                       |
| <br>  |                          |                              |
| Interest-rate caps                                    | 725                      | 2,040                        |
| Mortgage delivery commitments                         | 34                       | 46                           |
| Forward settlement agreements                         | <u>12</u>                | <u>38</u>                    |
| <br>  |                          |                              |
| Total notional amount                                 | <u>\$ 54,353</u>         | <u>\$ 52,759</u>             |

Derivatives are recorded on the balance sheet at fair value. After netting the fair market values and accrued interest of the derivative instruments by counterparty, positive counterparty balances were classified as derivative assets and negative counterparty balances were classified as derivative liabilities. Derivative assets represent our maximum credit risk to counterparties; whereas derivative liabilities represent exposures to us by counterparties. Substantially all of the net estimated fair market value losses on our derivative contracts are offset by net hedging fair-value adjustment gains or other book-value adjustments 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 “cash flow” represents hedges that qualify for cash-flow hedge accounting. The category “economic” represents hedge strategies that do not qualify for hedge accounting. Amounts at June 30, 2004 and December 31, 2003 are as follows (dollars in millions):

|   | June 30,<br>2004 |                                 | December 31,<br>2003 |                                 |
|---|------------------|---------------------------------|----------------------|---------------------------------|
|   | <u>Notional</u>  | <u>Estimated<br/>Fair Value</u> | <u>Notional</u>      | <u>Estimated<br/>Fair Value</u> |
| Advances:   |                  |                                 |                      |                                 |
| Fair value  | \$ 11,124        | \$ (339)                        | \$ 12,707            | \$ (628)                        |
| Investments:  |                  |                                 |                      |                                 |
| Fair value  | 1,394            | 1                               | 1,495                | (50)                            |
| Economic  | 450              | -                               | 810                  | (1)                             |
| Mortgage loans:                                       |                  |                                 |                      |                                 |
| Fair value  | 12,353           | 277                             | 10,914               | 61                              |
| Economic  | 300              | -                               | 1,265                | 9                               |
| Mortgage delivery commitment derivatives:             |                  |                                 |                      |                                 |
| Cash flow   | 23               | -                               | 8                    | -                               |
| Economic (including forward settlement<br>agreements) | 23               | -                               | 76                   | -                               |
| Consolidated obligations:                             |                  |                                 |                      |                                 |
| Fair value  | 26,487           | (348)                           | 24,957               | (102)                           |
| Economic  | 1,000            | -                               | -                    | -                               |
| Discount notes:                                       |                  |                                 |                      |                                 |
| Fair value  | <u>1,199</u>     | <u>(2)</u>                      | <u>527</u>           | <u>-</u>                        |
| Total notional and fair value                         | <u>\$ 54,353</u> | <u>\$ (411)</u>                 | <u>\$ 52,759</u>     | <u>\$ (711)</u>                 |
| Total derivatives, excluding accrued interest         |                  | (411)                           |                      | (711)                           |
| Accrued interest                                      |                  | <u>84</u>                       |                      | <u>62</u>                       |
| Net derivative balance                                |                  | <u>\$ (327)</u>                 |                      | <u>\$ (649)</u>                 |
| Net derivative assets                                 |                  | 198                             |                      | 43                              |
| Net derivative liabilities                            |                  | <u>(525)</u>                    |                      | <u>(692)</u>                    |
| Net derivative balance                                |                  | <u>\$ (327)</u>                 |                      | <u>\$ (649)</u>                 |

## Liquidity and Capital Resources

Funds raised in the capital markets by issuing consolidated obligations (bonds and discount notes) provide our principal source of liquidity. Because of the FHLBanks' credit quality, efficiency and standing in the capital markets, the FHLBanks have ready access to funding. In the first six months of 2004, we received proceeds from the issuance of short-term consolidated discount notes of \$100.8 billion and proceeds from the issuance of intermediate- to long-term consolidated bonds of \$13.6 billion.

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 \$2.9 billion at June 30, 2004, compared with \$2.0 billion at December 31, 2003.

Under Finance Board regulations, we are required to 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. Bank policy requires that we maintain additional overnight investments of at least \$250 million to fund new lending. Overnight investments amounted to \$1.4 billion at June 30, 2004.

As contingent liquidity, we maintain liquid assets of unencumbered Treasury and agency securities (including mortgage-backed securities) in an amount at least equal to 100 percent of the Bank's capital that can be used as collateral for repurchase agreements. Contingent liquidity as of June 30, 2004 consisted of the following unencumbered securities:

- Agency mortgage-backed securities of \$2.1 billion or 90% of capital; and
- Other agency securities of \$1.1 billion or 44% of capital.

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.

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 and housing associates to facilitate business transactions with third parties. Letters of credit may be used to facilitate residential housing finance or other housing activities, facilitate community lending, assist with asset/liability management and provide liquidity or other funding. Members and housing associates must fully collateralize letters of credit with eligible collateral. As of June 30, 2004 and December 31, 2003, we had \$1.3 billion and \$1.1 billion in letters of credit outstanding.

At June 30, 2004, we had \$35.6 million in outstanding commitments to purchase mortgage loans compared to \$46.9 million at December 31, 2003. We did not have outstanding commitments for additional advances at June 30, 2004 or December 31, 2003.

We had 22.5 million shares of stock outstanding at June 30, 2004 compared to 21.2 million shares outstanding at December 31, 2003. We issued 4.2 million shares of capital stock to members and redeemed 2.9 million shares of capital stock from members in the first six months of 2004. Our capital stock fluctuates based on the asset size of members and their transaction balances with the Bank. Our minimum capital stock requirements are designed so that we remain adequately capitalized as member activity changes.

At June 30, 2004, approximately 95 percent of our total capital was capital stock. The Bank was in compliance with all of its capital requirements on June 30, 2004. The following table summarizes the Bank's compliance with the Finance Board's capital requirements as of June 30, 2004 (dollars in millions):

|                                  | <u>Required</u> | <u>Actual</u> |
|----------------------------------|-----------------|---------------|
| Capital Requirements:            |                 |               |
| Risk-based capital               | \$ 412          | \$ 2,366      |
| Aggregate capital-to-asset ratio | 4.00%           | 4.89%         |
| Permanent capital                | \$ 1,935        | \$ 2,366      |
| Leverage ratio                   | 5.00%           | 7.34%         |
| Weighted leverage capital        | \$ 2,419        | \$ 3,550      |

We paid cash dividends of \$19.0 million in the first six months of 2004. In April 2004, our Board of Directors approved a policy focused on continuing to build retained earnings. The policy strives to further protect our members' investment in the Bank from losses under most plausible stress scenarios, and it provides an amount sufficient to make the next quarterly dividend payment to our stockholders. We do not believe that our retained earnings policy will impact our ability to pay the target dividend of average three-month LIBOR plus 60 basis points in 2004.

In June 2004, Standard & Poor's revised the individual counterparty rating outlook of the Bank from stable to negative. Standard & Poor's reaffirmed the Bank's individual AAA counterparty rating. We do not expect a significant change in our business from this action. This change in outlook does not affect the AAA counterparty rating of consolidated bonds and discount notes issued jointly by the 12 FHLBanks. As a result, we do not expect an impact to our cost of funds.

## **Recently Issued Accounting Standards**

*SFAS 150.* In May 2003, the Financial Accounting Standards Board (FASB) issued Statement No. 150, *Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (SFAS 150), which establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of nonpublic entities. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted. For nonpublic entities, mandatorily redeemable financial instruments are subject to the provisions of this Statement for the first fiscal period beginning after December 15, 2004. The Bank will adopt SFAS 150 on January 1, 2005 and is currently in the process of assessing the impact of SFAS 150 on its financial statements.

*Emerging Issues Task Force Issue (EITF) 03-1.* In March 2004, the FASB reached a consensus on EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which clarifies the application of an impairment model to determine whether investments are other-than-temporarily impaired. The provisions of this rule are required to be applied prospectively to all current and future investments accounted for in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and are effective July 1, 2004. New disclosures will also be required beginning December 31, 2004. The Bank does not expect the new rule to have a material impact on its results of operations at the time of adoption.

## **Critical Accounting Policies**

The Bank's accounting policies are fundamental to understanding "Management's Discussion and Analysis" and "Results of Operations and Financial Condition." The Bank has identified certain policies as being critical because they require management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

Several of these accounting policies involve the use of estimates that we consider critical as: (1) they are likely to change from period to period because they require significant management judgment and assumptions about highly complex and uncertain matters and (2) the use of a different estimate or a change in estimate could have a material impact on our reported results of operations or financial condition.

Estimates and assumptions that are significant to the results of operations and financial condition include: (1) derivatives and hedging activities, (2) fair values, (3) consolidated obligations, (4) amortization/accretion of mortgage loans, advances, investments and consolidated obligations, (5) provision for credit losses on advances and mortgage loans and (6) liability for Resolution Funding Corporation assessments. These critical accounting estimates are described in “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies” beginning on page 50 of our 2003 annual report.

## **Legislative and Regulatory Developments**

### *Final Rule on Registration under the Securities Exchange Act of 1934*

In June 2004, the Finance Board approved a rule requiring each of the 12 FHLBanks to register a class of its equity securities with the SEC under section 12(g)(1) of the Securities Exchange Act of 1934, as amended. The rule requires each of the FHLBanks file its registration statement with the SEC no later than June 30, 2005 to ensure that its registration statement becomes effective by August 29, 2005 subject to the possibility of a Finance Board order extending the deadline. Once we have a class of equity securities registered with the SEC, we will file periodic reports with the SEC, including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. In anticipation of registration, we enhanced and expanded disclosures in our 2003 annual report and 2004 quarterly reports. We expect to complete registration by the required date.

### *Proposed Changes to Government-Sponsored Enterprise Regulation*

On April 1, 2004, a bill that would have created a new regulator for Federal National Mortgage Association, Federal Home Loan Mortgage Corporation and the FHLBanks passed the Senate Banking Committee; however, the bill has not come up for a vote in the full Senate. The bill would combine the Office of Federal Housing Enterprise Oversight and the Finance Board into a new regulatory agency. It is impossible to predict what, if any, provisions relating to the Finance Board and the FHLBanks will be included in any such legislation, whether the House and Senate would approve such legislation, whether any such change in regulatory structure will be signed into law, when any such change would go into effect if enacted or what effect the legislation would have on the Finance Board or the FHLBanks.

### *Proposed Change in Federal Reserve Bank Policy Statement on Payments System Risk*

The Federal Reserve Board in February 2004 announced that it intends, beginning in July 2006, to require Federal Reserve Banks to release interest and principal payments on securities issued by government-sponsored enterprises and international organizations only when the issuer’s Federal Reserve account contains sufficient funds to cover these payments. The Federal Reserve Banks have been processing and posting these payments to depository institutions’ Federal Reserve accounts by 9:15 a.m. Eastern Time, the same posting time as for U.S. Treasury interest and principal payments, even if the issuer has not fully funded its payments. The Federal Reserve Board requested comment by April 16, 2004 on how best to promote a smooth market adjustment while implementing this change in its Policy Statement on Payments System Risk.

The Bank is evaluating the impact of this proposed change on its operations. If the proposed changes are made, they will impact the Bank. However, it is not possible to predict what, if any, changes will be made and what effect the changes would have on the Bank.

## **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 and, where appropriate, conform with Finance Board regulations. Our primary 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 volatilities. The secondary objective is to pay a reasonable rate of return to stockholders.

### *Market Risk*

We define market risk, also known as interest-rate risk, 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 and volatilities. Interest-rate risk was the predominant type of market risk incurred in the first six months of 2004 and 2003. 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.

*Net Market Value of Capital Stock.* Net market value of capital stock, at a point in time, is defined as the present value of assets minus the present value of liabilities plus the net present value of derivatives.

Interest-rate risk analysis using net market value of capital stock involves instantaneous parallel shifts in interest rates. The resulting percentage change in market value of capital stock from the base case value is an indication of longer-term repricing risk and option risk embedded in the balance sheet.

These tables summarize our net market value of capital stock at June 30, 2004 and December 31, 2003 (dollars in millions):

| <u>As of June 30, 2004</u>                               | <u>Net Market Value of<br/>Capital Stock</u> | <u>Percent Change<br/>from Base Case</u> |
|--|--|--|
| Base case  | \$ 2,175                                     |  |
| Assuming a 100 basis point<br>increase in interest rates | 2,158  | -0.8%                                    |
| Assuming a 100 basis point<br>decrease in interest rates | 2,161  | -0.6%                                    |
|  |  |  |
| <u>As of December 31, 2003</u>                           | <u>Net Market Value of<br/>Capital Stock</u> | <u>Percent Change<br/>from Base Case</u> |
| Base case  | \$ 2,103                                     |  |
| Assuming a 100 basis point<br>increase in interest rates | 2,102  | -0.1%                                    |
| Assuming a 100 basis point<br>decrease in interest rates | 2,096  | -0.4%                                    |

The increase in net market value of capital stock from year end is primarily due to growth in our capital stock. Changes in the Bank's market value profile from year end across interest-rate scenarios resulted from the sharp rate increase during the first six months of 2004 offset by our hedging activity. The Bank utilizes hedging transactions to protect the net market value of capital stock. This may include entering into or canceling interest-rate swaps on existing debt. Adjustments to the market-value profile may also be accomplished by altering the funding structures of new mortgage purchases. Bank policy requires that the net market value of capital stock, adjusted for certain factors, be greater than \$90 per share in the base case interest scenario. The Bank was in compliance with this policy throughout 2003 and in the first six months of 2004.

*Value-at-Risk.* In addition to quantifying changes in the net market value of capital stock with instantaneous parallel interest rate changes, management estimates the changes in the market value of total equity using value-at-risk methodology. Our internal value-at-risk calculations use a statistical technique to estimate potential one-month loss in the market value of our total equity. Principal Components Analysis <sup>1</sup> is used to summarize historical yield curve dynamics, and we add a spread risk factor and a volatility risk factor. Spread risk refers to the potential loss due to changes in the difference between our cost of funds curve and the LIBOR-swap curve. Volatility risk refers to the potential loss due to changes in interest-rate volatilities.

Our value-at-risk estimate excludes changes resulting from the widening or narrowing of LIBOR option-adjusted spreads (LOAS) on mortgage assets. Fluctuations in LOAS result in changes in liquidation value of the mortgage assets and tend to move back to their average levels over time (mean reversion). We exclude the impact of changes in LOAS from value-at-risk estimates because LOAS tends to be mean reverting and virtually all of our mortgage assets are held to maturity to earn spread income. Bank earnings are impacted by the LOAS on mortgage assets at the time of purchase. Subsequent fluctuations in mortgage LOAS do not affect Bank earnings on held-to-maturity assets.

Value-at-risk is useful to establish risk tolerance limits and is commonly used in asset/liability management; however, it does not imply a forecast of future interest rate behavior. We maintain value-at-risk below a level which ranges from 4 percent to 10 percent of total equity depending upon the level of mortgage assets acquired from mortgage purchase programs to total assets, as specified by the Board of Directors. The value-at-risk policy limit was 9.8 percent at June 30, 2004 and 10.0 percent at December 31, 2003. We examined historical changes in prices and market rates for the past 10 years to calculate our value-at-risk. We estimate with 99 percent confidence that our market value of total equity would decline by less than 1.1 percent at June 30, 2004 compared to 1.2 percent at December 31, 2003.

Value-at-risk levels are regularly back-tested to validate the model by comparing predictions with actual results. Stress tests are conducted regularly using stressful market scenarios. The scenarios are reviewed to reflect changing market and economic conditions.

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<sup>1</sup> Principal Components Analysis is a statistical technique used to transform a complex set of correlated variables into a new set of independent variables called principal components, e.g. the eight points of the Treasury yield curve (three month, six month, one year, two year, three year, five year, 10 year, and 30 year) are transformed into two principal components, level and slope shifts.

We also report value-at-risk results to the Finance Board as part of risk-based capital. The Finance Board defines its regulatory value-at-risk measure as the potential six-month loss of market value at the 99 percent confidence level. The methodology used in this calculation is historical simulation<sup>1</sup> using market data of yields, spreads and volatilities since 1978. We estimate that market value of total equity would, with 99 percent confidence, decline by less than 6.7 percent at June 30, 2004 and 7.4 percent at December 31, 2003 using the regulatory methodology prescribed by the Finance Board. Like management's value-at-risk methodology, this regulatory estimate excludes changes resulting from the widening or narrowing of LIBOR option-adjusted spreads on mortgage assets.

*Duration Gap.* The net market value of our assets, liabilities and derivatives is primarily affected by changes in the level of interest rates. Duration measures the sensitivity of an instrument's market value to interest rate changes. Duration is the weighted-average life (typically measured in years) of an instrument's cash flows weighted by the present value of those cash flows. As duration lengthens, sensitivity to changes in interest rates increases.

The duration gap measures the difference between the estimated durations of assets and liabilities and summarizes the extent to which sensitivities to changes in interest rates for assets and liabilities are matched. A duration gap of zero indicates that the durations of assets and liabilities are equal. A positive duration gap indicates that the duration of assets is longer than the duration of liabilities, whereas a negative duration gap indicates that the duration of liabilities is longer than the duration of assets. This table summarizes our duration gap at June 30, 2004 and December 31, 2003 in months:

|                   | <u>Rates Decrease</u><br><u>100 Basis Points</u> | <u>Base Case</u> | <u>Rates Increase</u><br><u>100 Basis Points</u> |
|-------------------|--|------------------|--|
| June 30, 2004     | (1.6)  | (0.2)            | 0.3  |
| December 31, 2003 | (0.7)  | (0.4)            | (0.4)  |

The duration gap between assets and liabilities in the base case narrowed slightly from year end to June 30, 2004 due to management's decision to adjust the funding and hedging profile for our assets. Bank policy requires that we maintain base case duration gap of the total Bank within a range of plus or minus six months, and the Bank was in compliance with this policy throughout 2003 and in the first six months of 2004.

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<sup>1</sup> Historical simulation involves valuing the Bank's current holdings based on actual market conditions that existed over a specific historical period of time.

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 items.

*Mortgage Finance Market Risk.* On a daily basis, we maintain the duration gap of the Mortgage Finance segment within specified ranges through management of the durations of our assets, liabilities and interest-rate exchange agreements. Bank policy limits the duration gap to plus or minus six months, and the Asset/Liability Committee operating guidelines further limit the range. The Bank may utilize hedging transactions to adjust the duration gap within the target range. This may include entering into or canceling interest-rate swaps on existing debt. Adjustments to duration may also be accomplished by altering the funding structures of new mortgage purchases. Portfolio duration movements relative to the target range and hedge transactions are documented for monthly review by the Asset/Liability Committee. Our duration gap for Mortgage Finance at June 30, 2004 was (0.5) months compared to (0.8) months at December 31, 2003. Mortgage Finance duration gap moved closer to zero at June 30, 2004 due to management's decision to adjust the funding profile for our assets given the increase in interest rates during the first six months of 2004.

*Mortgage Finance Typical Funding Structures.* We may hedge against contraction risk by funding some mortgage-related investments with consolidated obligations that have call features. We issue both callable and non-callable debt to achieve cash-flow patterns and liability durations similar to those expected on the mortgage loans. A combination of bond maturities and call lockout dates are chosen to provide a cash-flow match between bond principal pay-downs and mortgage principal pay-downs. As of June 30, 2004, 26 percent of the fixed-rate mortgage asset portfolio was funded with callable and non-callable fixed-rate debt.

During 2003, we began using interest-rate swaps to hedge mortgage loans where the Bank pays fixed rates and receives variable rates, effectively converting the fixed-rate loans to a floating rate indexed to LIBOR. The interest-rate swaps are designed to have amortizing notional balances that match the actual pay-down of the mortgage loans within a wide range of pay-down scenarios. We either receive or pay an upfront fee on the interest-rate swap in an amount comparable to the premium, discount or other book-value adjustments on the hedged mortgage loans. This cash payment equates to the initial fair value of the interest-rate swap and is amortized over the life of the interest-rate swap to net interest income as the book-value adjustments on the mortgage loans are recognized. The interest-rate swap is marked-to-market through net realized and unrealized gain (loss) on derivatives and hedging activity on the statements of income.

These transactions provide a more stable net income spread across various interest-rate scenarios and effectively hedge mortgage loan prepayment risk. The interest-rate swap market tends to provide more flexibility than the bond market for the structures needed to fund and hedge mortgage assets. As of June 30, 2004, 74 percent of the fixed-rate mortgage asset portfolio was hedged with interest-rate swaps and funded with variable-rate debt.

At the total mortgage portfolio level, callable bonds and swaps usually represent from 50 percent to 70 percent of the funding and hedging mix, with non-callable bonds and swaps constituting the rest.

Our funding of mortgage assets is designed to be flexible in order to handle changes in mortgage asset prepayment speeds. The following table summarizes the base case projection of remaining fixed-rate mortgage asset balances assuming a 15 percent constant prepayment rate and the supporting funding based on the “slowest” and “fastest” contractual pay down scenarios as of June 30, 2004:

|  | Projected Remaining Balances as a Percent<br>of June 30, 2004 Balances |                |                |                 |                 |                 |
|--|--|----------------|----------------|-----------------|-----------------|-----------------|
|  | <u>1 year</u>  | <u>3 years</u> | <u>5 years</u> | <u>10 years</u> | <u>13 years</u> | <u>15 years</u> |
| Mortgage assets (base case)                      | 83%  | 58%            | 40%            | 15%             | 8%              | 5%              |
| Mortgage liabilities <sup>1</sup> :              |  |                |                |                 |                 |                 |
| Assuming pay off at maturity (slowest)           | 88%  | 68%            | 55%            | 21%             | 7%              | 0%              |
| Assuming pay off on earliest call date (fastest) | 39%  | 17%            | 7%             | 0%              | 0%              | 0%              |

<sup>1</sup> Mortgage liabilities consist of callable and non-callable fixed-rate debt and hedges of the mortgage assets, with the hedges consisting of callable and amortizing interest-rate swaps funded with a variable-rate debt pool.

- Callable and non-callable fixed-rate debt and hedges are assumed to pay off based on the earliest call date, if applicable, in the “fastest” scenario and on the final maturity date in the “slowest” scenario.
- The hedged mortgage assets are funded with a variable-rate debt pool. For this analysis, we assume that the debt pool will change based on the size of the hedged mortgage assets being funded.

*Interest-Rate Exchange Agreements.* 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 or cash-flow hedge accounting treatment and economic hedges that are used to reduce market risk at the balance sheet or portfolio level. Economic hedges do not qualify for hedge accounting treatment and, as a result, only the derivative instrument is marked-to-market. For more information on interest-rate exchange agreements, see page 64 of the Bank's 2003 annual report.

The following table categorizes the earnings impact of our hedging activities by product for the six months ended June 30, 2004 and 2003 (dollars in millions):

| <u>Six Months Ended June 30, 2004</u>  | <u>Advances</u> | <u>Mortgage<br/>Assets</u> | <u>Consolidated<br/>Bonds</u> | <u>Total</u>   |
|--|-----------------|----------------------------|-------------------------------|----------------|
| Amortization/accretion of hedging activities in net margin                       | \$ (1.5)        | \$ 7.6                     | \$ 11.3                       | \$ 17.4        |
| Net realized and unrealized gains (losses) on derivatives and hedging activities | 1.5             | 3.9                        | 4.6                           | 10.0           |
| Net gains (losses) on securities held at fair value                              | -               | (0.5)                      | -                             | (0.5)          |
| Total  | <u>\$ -</u>     | <u>\$ 11.0</u>             | <u>\$ 15.9</u>                | <u>\$ 26.9</u> |
|  |                 |                            |                               |                |
| <u>Six Months Ended June 30, 2003</u>  | <u>Advances</u> | <u>Mortgage<br/>Assets</u> | <u>Consolidated<br/>Bonds</u> | <u>Total</u>   |
| Amortization/accretion of hedging activities in net margin                       | \$ (0.9)        | \$ 4.6                     | \$ 30.1                       | \$ 33.8        |
| Net realized and unrealized (losses) gains on derivatives and hedging activities | -               | (7.2)                      | (0.3)                         | (7.5)          |
| Net gains (losses) on securities held at fair value                              | -               | (0.4)                      | -                             | (0.4)          |
| Total  | <u>\$ (0.9)</u> | <u>\$ (3.0)</u>            | <u>\$ 29.8</u>                | <u>\$ 25.9</u> |

Consolidated obligation amortization/accretion income (expense) results from the amortization of fees received on interest-rate swaps hedging consolidated obligations and basis adjustments on consolidated obligations. Basis adjustments are recorded when a hedge relationship terminates or becomes ineffective. We terminated certain debt hedge relationships to manage our duration gap throughout 2003 and 2004.

Consolidated obligation amortization/accretion income decreased in 2004 primarily because we recognized more income in 2003 from basis adjustments on terminated hedge relationships. As of June 30, 2004, without considering the impact of future basis adjustments created, we expect to generate more interest expense than income from such basis adjustments for the remainder of the year.

The decrease in consolidated obligation amortization/accretion was somewhat offset by an increase related to mortgage assets. In 2003, we implemented a new hedging strategy for mortgage loans in which we either receive or pay an upfront fee on the interest-rate swap approximating the premium, discount or book-value adjustments on the purchased loans.

### *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 these objectives, we establish liquidity management requirements and maintain liquidity in accordance with Finance Board regulations and our own liquidity policy. For information on how we manage liquidity risk, see page 68 of the Bank's 2003 annual report.

### *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. 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.

*Advances.* We engage in secured lending activities with eligible borrowers. 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.

For information on how we manage advance credit risk, see page 69 of the Bank's 2003 annual report. As of June 30, 2004, four borrowers had outstanding advances greater than \$1 billion. These advance holdings represented approximately 33 percent of the total par value of advances outstanding at June 30, 2004. As of December 31, 2003, two borrowers had outstanding advances greater than \$1 billion. Those advance holdings represented approximately 26 percent of the total par value of advances outstanding at December 31, 2003.

We assign discounted values to collateral pledged to the Bank based on its relative risk. As of June 30, 2004, borrowers reported \$50 billion of collateral (net of applicable discount or margin factors) to support \$26 billion of advances and other activities with the Bank. Borrowers report collateral in excess of their collateral requirement mainly to demonstrate liquidity and to borrow in the future.

The following table shows the dollar and percentage composition (net of applicable discount and margin factors) of collateral pledged to the Bank as of June 30, 2004 and December 31, 2003 (dollars in billions):

| <u>Collateral Type</u>  | <u>June 30,</u><br><u>2004</u> |                | <u>December 31,</u><br><u>2003</u> |                |
|---|--------------------------------|----------------|------------------------------------|----------------|
|   | <u>Dollars</u>                 | <u>Percent</u> | <u>Dollars</u>                     | <u>Percent</u> |
| Residential mortgage loans  | \$ 32.1                        | 63.8%          | \$ 32.4                            | 67.2%          |
| Investment securities/insured loans                                 | 6.7                            | 13.2           | 6.0                                | 12.4           |
| Other real estate related collateral                                | 11.1                           | 22.1           | 9.5                                | 19.6           |
| Secured small business, small farm<br>and small agri-business loans | 0.5                            | 0.9            | 0.4                                | 0.8            |

*Mortgage Assets.* We invest in mortgage-backed securities that are issued or guaranteed by government-sponsored housing enterprises and other mortgage-backed securities rated AAA by one of the nationally recognized statistical rating organizations. We are exposed to credit risk to the extent that the credit enhancement structures fail to perform adequately. We perform ongoing analysis to evaluate the investments and creditworthiness of the issuers, trustees and servicers for potential credit issues. As of June 30, 2004, we owned \$2,144 million of mortgage-backed securities that were issued or guaranteed by government-sponsored housing enterprises. In addition, we had \$545 million of other mortgage-backed securities; \$542 million rated AAA and \$3 million rated AA by a nationally recognized statistical rating organization.

The Bank also invests in state housing finance agency bonds. As of June 30, 2004, we had \$12.8 million of state agency bonds rated AA or higher.

The Bank acquires mortgage loans from participating members through the MPF program. For information on how we manage credit risk for mortgage loans, see page 71 of the Bank's 2003 annual report. Our MPF portfolio totaled \$15.6 billion par value at June 30, 2004. The portfolio consisted of approximately 93 percent conventional loans and 7 percent government-insured loans. Because our participating members are required to repurchase any government-insured loan from the Bank that is 90 days or more past due, our credit risk is minimal on that segment of the portfolio. The following table summarizes portfolio characteristics of the conventional loan portfolio at June 30, 2004 and December 31, 2003. Portfolio concentrations are calculated based on unpaid principal balances.

| Portfolio Characteristics                               | June 30,<br>2004 | December 31,<br>2003 |
|---|------------------|----------------------|
| Regional concentration <sup>1</sup>                     |                  |                      |
| Midwest   | 31.8%            | 31.9%                |
| West  | 22.4%            | 22.7%                |
| Southeast   | 17.5%            | 17.5%                |
| Southwest   | 15.0%            | 14.6%                |
| Northeast   | 13.3%            | 13.3%                |
| State concentration                                     |                  |                      |
| Minnesota   | 12.0%            | 12.1%                |
| California  | 11.8%            | 12.1%                |
| Illinois  | 6.3%             | 6.6%                 |
| Florida   | 4.3%             | 4.3%                 |
| Washington  | 4.1%             | 4.1%                 |
| Weighted average FICO score at origination <sup>2</sup> | 730              | 729                  |
| Weighted average loan to value at origination           | 69%              | 69%                  |
| Average loan amount at origination                      | \$ 161,679       | \$ 162,280           |
| Original loan term                                      |                  |                      |
| Less than or equal to 15 years                          | 28%              | 29%                  |
| Greater than 15 years                                   | 72%              | 71%                  |

<sup>1</sup> Midwest includes IA, IL, IN, MI, MN, ND, NE, OH, SD and WI.

West includes AK, CA, Guam, HI, ID, MT, NV, OR, WA and WY.

Southeast includes AL, District of Columbia, FL, GA, KY, MD, MS, NC, SC, TN, VA and WV.

Southwest includes AR, AZ, CO, KS, LA, MO, NM, OK, TX and UT.

Northeast includes CT, DE, MA, ME, NH, NJ, NY, PA, Puerto Rico, RI, U.S. Virgin Islands and VT.

<sup>2</sup> FICO® is a widely used, credit-industry model developed by Fair, Isaac, and Company, Inc. to assess borrower credit quality with scores ranging from a low of 150 to a high of 950.

The allowance for credit losses on mortgage loans totaled \$5.9 million at June 30, 2004 and December 31, 2003 and \$3.2 million at June 30, 2003. Periodically, the Credit Committee reviews the adequacy of the allowance for credit losses on mortgage loans 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 allowance for credit losses on mortgage loans to the Board of Directors. Management believes we have policies and practices in place to appropriately manage this credit risk.

The allowance for credit losses on mortgage loans is as follows (dollars in thousands):

|   | Quarter Ended   |                 | Six Months Ended |                 |
|---|-----------------|-----------------|------------------|-----------------|
|   | June 30,        |                 | June 30,         |                 |
|   | 2004            | 2003            | 2004             | 2003            |
| Balance, beginning of period                  | \$ 5,991        | \$ 3,255        | \$ 5,906         | \$ 3,255        |
| Charge-offs                                   | (50)            | (14)            | (83)             | (14)            |
| Recoveries                                    | -               | -               | -                | -               |
| Net charge-offs                               | <u>(50)</u>     | <u>(14)</u>     | <u>(83)</u>      | <u>(14)</u>     |
| Provision for credit losses on mortgage loans | <u>-</u>        | <u>7</u>        | <u>118</u>       | <u>7</u>        |
| Balance, end of period                        | <u>\$ 5,941</u> | <u>\$ 3,248</u> | <u>\$ 5,941</u>  | <u>\$ 3,248</u> |

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 income and a reduction of principal. A government-insured loan that is 90 days or more past due is not placed on nonaccrual status because participating lenders 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 June 30, 2004 follows (dollars in millions):

|  | <u>Unpaid Principal Balance</u> |                                |                  |
|--|---------------------------------|--------------------------------|------------------|
|  | <u>Conventional</u>             | <u>Government-<br/>Insured</u> | <u>Total</u>     |
| 30 days  | \$ 102                          | \$ 37                          | \$ 139           |
| 60 days  | 14                              | 10                             | 24               |
| 90 days  | 3                               | 2                              | 5                |
| Greater than 90 days   | 1                               | 1                              | 2                |
| Foreclosures and bankruptcies  | 28                              | 9                              | 37               |
| Total delinquencies  | <u>\$ 148</u>                   | <u>\$ 59</u>                   | <u>\$ 207</u>    |
| Total mortgage loans outstanding                                       | <u>\$ 14,592</u>                | <u>\$ 1,022</u>                | <u>\$ 15,614</u> |
| Delinquencies as a percent of total mortgage loans                     | <u>1.0%</u>                     | <u>5.8%</u>                    | <u>1.3%</u>      |
| Delinquencies 90 days and greater as a percent of total mortgage loans | <u>0.2%</u>                     | <u>1.2%</u>                    | <u>0.3%</u>      |

At December 31, 2003, delinquencies as a percentage of total mortgage loans were 1.0 percent for conventional, 7.7 percent for government-insured and 1.5 percent in total. Delinquencies 90 days and greater as a percentage of total mortgage loans at December 31, 2003 were 0.2 percent for conventional, 2.3 percent for government-insured and 0.4 percent in total.

*Investments.* We maintain an investment portfolio to provide liquidity and promote asset diversification. Finance Board regulations and policies adopted by the Board of Directors limit the type of investments we may purchase.

The largest unsecured exposure to any single non-agency money market counterparty as of June 30, 2004 was \$325 million. The following table summarizes our unsecured credit exposure to investment counterparties (including accrued interest receivable) as of June 30, 2004 (dollars in millions):

| <u>Credit Rating</u> <sup>1</sup> | <u>Commercial Paper</u> | <u>Overnight Money Market Investments</u> <sup>2</sup> | <u>U.S. Government/ Government Agency</u> | <u>Derivatives</u> | <u>Total</u>    |
|-----------------------------------|-------------------------|--|---|--------------------|-----------------|
| AAA                               | \$ 250                  | \$ -   | \$ 1,576                                  | \$ -               | \$ 1,826        |
| AA                                | -                       | 510  | -   | 7                  | 517             |
| A                                 | -                       | 875  | -   | -                  | 875             |
| Total                             | <u>\$ 250</u>           | <u>\$ 1,385</u>  | <u>\$ 1,576</u>                           | <u>\$ 7</u>        | <u>\$ 3,218</u> |

<sup>1</sup> Credit rating is the lowest of Standard & Poor's, Moody's and Fitch, Inc. ratings stated in terms of the Standard & Poor's equivalent.

<sup>2</sup> Unsecured money market investments include Federal funds sold.

This compares to total unsecured investment exposure of \$2.4 billion at December 31, 2003. Our unsecured investment portfolio had a credit rating of A or higher at June 30, 2004 and December 31, 2003.

*Derivatives.* Most of our hedging strategies use over-the-counter derivatives instruments that expose us to counterparty credit risk because the transactions are executed and settled between two parties. When the over-the-counter 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. For information on how we manage the derivative counterparty credit risk see page 74 of the Bank's 2003 annual report.

Excluding mortgage delivery commitments that are fully collateralized, we had 24 active derivative counterparties as of June 30, 2004, most of which are large highly rated banks and broker-dealers. At June 30, 2004, five counterparties represented approximately 62 percent of the total notional amount of outstanding derivative transactions, and each had a credit rating of A or better. We did not have net exposures to any of these counterparties. In addition, we had mortgage delivery commitment derivatives with notional of \$34 million at June 30, 2004. Exposures for mortgage delivery commitments are offset by pair-off fees from the participating lenders.

The following table summarizes our derivative counterparty credit exposure, excluding mortgage delivery commitments, after applying netting agreements and collateral, at June 30, 2004 (dollars in millions):

| Credit Rating <sup>1</sup> | Active Counterparties | Notional Amount <sup>2</sup> | Total Exposure at Fair Value <sup>3</sup> | Value of Collateral Pledged | Exposure, Net of Collateral <sup>4</sup> |
|----------------------------|-----------------------|------------------------------|---|-----------------------------|--|
| AAA                        | 3                     | \$ 3,015                     | \$ -                                      | \$ -                        | \$ -                                     |
| AA                         | 12                    | 25,348                       | 117                                       | 110                         | 7  |
| A                          | 9                     | 25,956                       | 81  | 81                          | -  |
| Total                      | <u>24</u>             | <u>\$ 54,319</u>             | <u>\$ 198</u>                             | <u>\$ 191</u>               | <u>\$ 7</u>                              |

<sup>1</sup> Credit rating is the lower of the Standard & Poor's and Moody's ratings stated in terms of a Standard & Poor's equivalent.

<sup>2</sup> 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.

<sup>3</sup> For each counterparty, this amount includes derivatives with a net positive market value including the related accrued interest receivable/payable (net).

<sup>4</sup> Amount equals "Total Exposure at Fair Value" less "Value of Collateral Pledged" as determined at the counterparty level.

At December 31, 2003, we had \$52.7 billion in notional amount outstanding with 24 counterparties. Of these counterparties, three were rated AAA, 12 were rated AA, and nine were rated A. The total exposure at fair value was \$43 million and exposure net of collateral was \$23 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. For additional information on operational risk, see page 76 of the Bank's 2003 annual report.

## Factors That May Affect Future Results

There are several factors, many beyond our control, which could cause results to differ significantly from our expectations. We describe some of these factors below.

- economic and market conditions, including changes in interest rates that affect the housing market;
- our exposure to interest-rate, credit 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 or other factors that could affect the value of investments or collateral we hold as security for the obligations of our borrowers and counterparties to interest-rate exchange agreements and other contracts, which could result from the effects of, and changes in, various monetary or fiscal policies and regulations, including those determined by the Federal Reserve Board and the Federal Deposit Insurance Corporation;
- political events, including legislative, regulatory, judicial or other developments that affect us, our members, our regulator, counterparties and/or investors in the consolidated obligations of the Bank System, such as changes in the Federal Home Loan Bank Act or Finance Board regulations that affect FHLBank operations and regulatory oversight;
- 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, competitive pressure in the secondary mortgage market and the ability to attract and retain skilled individuals;
- technology, information systems and models sufficient to quantify the risks of our business effectively;
- changes in investor demand for consolidated obligations and/or interest-rate exchange agreements, including without limitation changes in the relative attractiveness of consolidated obligations as compared to other investment opportunities;
- 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 and new acquired member asset programs;
- risk of loss arising from litigation filed against one or more of the FHLBanks;
- risk that we may become liable for a portion of the consolidated obligations of other FHLBanks;
- the effects of inflation or deflation; and
- changes in accounting standards and practices and application of such new standards and practices to the manner in which we conduct our business.

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.

## **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See “Management’s Discussion and Analysis of Results of Operations and Financial Condition – Market Risk” beginning on page 44 and the sections referenced therein for Quantitative and Qualitative Disclosures about Market Risk.