Federal Home Loan Bank of Chicago 2001 Annual Report

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Management Report

2001 Performance

The Federal Home Loan Bank of Chicago ("The Bank") continued to successfully fulfill its housing finance mission in 2001 in an environment of financial volatility. Interest rates in the economy dropped sharply since the end of 2000. The moving average of the one-year Treasury index the Bank uses to benchmark its dividends dropped from 6.10% at December 31, 2000 to 3.90% at the end of the 2001. The weekly average of this index has moved from 5.34% at the end of last year to 2.28% at the end of December. The lower level of interest rates affects all Home Loan Banks directly through lower earnings on invested capital. Federal Home Loan Bank returns on assets will decline in this type of rate environment. In addition, many homeowners took advantage of lower mortgage rates to refinance their homes, resulting in increased prepayments of mortgages, including MORTGAGE PARTNERSHIP FINANCE® Program (MPF) mortgage loans and the recognition of any associated premium or discount. However, the Bank's profits grew significantly and created very attractive returns for the Bank's member shareholders.

Income before REFCORP rose 25.4% to $202.4 million through December 2001 from $161.5 million in 2000. Income after REFCORP also increased 25% to $161.9 million from $129.2 million in 2000. The Bank's ROE before REFCORP was 10.01% in 2001, compared to 10.12% in 2000. Post-REFCORP ROE was 8.01% compared to the prior-years' 8.10% ratio. At year-end, housing finance-related assets had increased 38.1% over 2000. Increased profitability resulted in an increase in the REFCORP charge to $40.5 million from $32.3 million in 2000. The Bank paid an annualized average dividend of 6.34% through December 2001, 135 basis points over the benchmark moving average of the one-year US Treasury Bill.

The Bank has adopted FAS 133 as of January 1, 2001. For 2001, the Bank recorded a net FAS 133 gain of $58.1 million, including the transition adjustment of $573 thousand. Management does not expect that future FAS 133 related gains/losses will be material. The Bank also recognized a change in amortization estimation for premiums and discounts on mortgage loans purchased through the MPF program. The Bank adopted the 'level-yield' method of amortization in January 2001 and, as a result of this method change, recorded a $2.3 million one-time transition expense. Total premium/discount amortization for the year was $31.6 million. This was substantially higher than in 2000 due to the high level of mortgage refinance activity experienced during the year.

Advances to members reached $21.9 billion, 18.6% above the prior year year-end. The Bank continued to attract new member financial institutions. Total membership stood at 857 members, an all-time high, on December 31, 2001, surpassing the prior-year end level of 841 members. Members using any of The Bank's credit products declined slightly from 688 at year end 2000 to 669 at the end of 2001.

The MPF® Program (MPF) has been accepted by the markets as a valuable means of housing finance. The MPF Program continued its rapid expansion to member banks and thrifts throughout the district. Ten of the 12 FHLB districts were approved to participate in MPF as of December 31, 2001. The program ended the quarter with $24.8 billion in loans outstanding, up from $15.4 billion at the end of 2000, with new loan production far outpacing accelerated prepayments.

Results of Operations

Net income before REFCORP of $202.4 million during 2001 was $41.0 million, or 25.4%, above 2000 results. Average earning assets grew 22.3%. Net interest income declined slightly from $212.2 million in 2000 to $210.3 million in 2001, reflecting the sharply lower interest rate environment.

Earning assets yielded 5.24% in 2001 compared to 6.62% in 2000 while costing liabilities decreased to 4.93% in 2001 from 6.28% in 2000. The net balance sheet spread was 0.30% in 2001, compared to 0.33% in 2000. The net interest margin was 0.55% in 2001, down from 0.65% in 2000, primarily reflecting lower interest rates. However, return on equity was steady, as discussed above, due to strong asset growth and increased leverage during the year.

The Bank continued to press for improved efficiency. The majority of the increase in non-interest operating expenses was related to MPF, both due to the continued national development of the program and the increase in MPF volume. In total, operating expenses rose $8.5 million, to $38.3 million in 2001. Total operating expenses as a percentage of average assets were 9.8 basis points.

In 2001, the Bank set aside $18 million, compared to $14.4 million in 2000, to fund affordable housing programs (AHP). Since 1990, the Bank has awarded over $85 million to help over 25,000 families' secure affordable housing.

Financial Condition

Total assets posted 39% growth during 2001, increasing to $49.2 billion at December 31, 2001. Average assets rose to $39.3 billion in 2001, up from $32.1 billion in the prior year, a growth rate of 22.4%. Housing finance-related assets include MPF loans, advances to members, and investments secured by mortgages and mortgage-backed instruments, and other mission-related investments. Total housing finance-related assets increased $12 billion, or 38.1%, to $43.4 billion at December 31, 2001. Total housing finance-related assets accounted for 88% of assets at December 31, 2001. Housing finance-related assets were 100% of consolidated obligations at December 31, 2001.

Advances reached an all-time year-end high of $21.9 billion, up 18.6% over the previous year-end. The MPF Program

posted dramatic growth totaling $24.8 billion at the end of December 2001, up $15.4 billion from the prior year-end. This growth was achieved despite rapidly accelerating prepayments due to the lower interest rate environment. The MPF Program has funded loans in all 50 states and the District of Columbia. Ten Home Loan Bank districts are now approved to participate in the MPF Program.

The mortgage-backed securities (MBS) portfolio averaged $4.1 billion during 2001, 4.2% lower than the 2000 average portfolio as the Bank continues to emphasize mortgage loans purchased through the MPF Program. The MBS-to-equity ratio was 169% compared to 254% in 2000. MBS holdings equal to 300% of capital is the maximum allowed by Federal Housing Finance Board policy. This decrease is the result of higher capital balances as well as increased purchases of MPF loans during the year.

The Bank funds its assets through capital, deposits and the issuance of FHLB consolidated obligations. Average deposits increased in 2001 to $2.1 billion from $2.0 billion in 2000. In total, deposits funded 5.4% of average assets in both 2000 and 2001. FHLB consolidated obligations (CO's) constitute the largest portion of funding. Average consolidated obligations grew $3.7 billion during 2001 to $34.6 billion. CO's financed 88% of average assets in 2001 the same as 2000.

Members are required to purchase capital stock in amounts based on the balance of mortgage assets held by the member institution, or their level of advances outstanding. Member-purchased capital stock accounted for 96% of total equity as of December 31, 2001. This includes a FAS 133 related adjustment to retained earnings of ($1.98) million for other comprehensive income (OCI). As a result of the growth in total membership, advance levels, stock dividends, and stock purchases by members for investment purposes, capital stock increased to $2.4 billion at the end of 2001. On December 31, 2000, capital stock was $1.6 billion. Retained earnings increased to $110.4 million, up from $70.5 million on December 31, 2000. The Bank paid $122 million in dividends to shareholders during the year. Total equity increased 47% to $2.5 billion prior to the previously discussed OCI adjustment.

The Federal Housing Finance Board implemented an acquired member asset rule in 2000. This rule allows the Banks to operate at a capital-to-asset ratio of 4% (25:1) provided the Banks non-core mission assets do not exceed 11% of total assets. The Chicago Banks non-core mission asset ratio at the end 2001 was 3%. The Bank is committed to the spirit of this rule and intends to maintain its non-core mission asset ratio below this 11% threshold. The Bank's year-end capital-to-assets ratio of 5.1% was substantially greater than the required level of 4.00%. At December 31, 2001, the Bank's debt-to-capital ratio stood at 17 times total capital. Total risk-based capital stood at 20.1%.

Risk Management

The Bank maintains a low-risk financial profile. Interest rate risk is the primary market risk faced by the Bank. The average interest-rate spread for 2001 was 30 basis points. The Bank measures its exposure to changing interest rates in several ways, including testing market value sensitivities, gap analysis, and income simulation. The one-year gap at December 31, 2001, defined as the cumulative difference between assets and liabilities scheduled to reprice within one year, stood at 1.5% of rate-sensitive assets.

The Bank regularly engages in interest rate swaps in order to reduce exposure to changing interest rates. As of December 31, 2001, the Bank had engaged in swap agreements totaling $33.8 billion in outstanding notional principal. In addition, the Bank had notional principal of $3.6 billion in outstanding interest rate caps, $1.8 billion in interest rate floors and $5.9 billion in options. These instruments are used to control and manage interest rate risk and minimize variations in income and the market value of financial instruments.

The Bank charges prepayment fees on all advances that would otherwise subject the bank to increased interest rate risk should the advance be prepaid prior to its maturity. The bank recorded $824 thousand in prepayment fees in 2001.

The Bank uses callable debt to mitigate interest rate risk. Excluding discount notes, 66.9% of the Bank's debt at December 31, 2001 was callable by the bank. Further, the Bank issues debt with coupon payment terms (structured debt) and call features. At year-end, 29.8% of the Bank's issued debt was in the form of structured debt. When such debt is issued, the Bank simultaneously enters into an interest rate exchange agreement with coupon and call features that offset the structured features of the bond, effectively converting the instrument into a conventional fixed rate or adjustable rate instrument with a coupon tied to a common index, such as LIBOR.

Credit risk associated with advances is a significantly smaller risk to the Bank, as shown by the fact that the Bank has never experienced a credit loss on advances. Credit risk on advances is minimized by holding collateral against the outstanding balance. Advances are primarily collateralized by single-family residential mortgages, mortgage-backed securities and other high quality collateral. Based on the collateral held and the repayment history of advances, the Bank has no loan loss reserves for advances and believes no loan loss reserve is necessary. The Bank limits its investments to the highest credit grades. The credit quality of borrowing members and the Bank's unsecured credit exposures are regularly monitored by management. With the commencement of the MPF Program in 1997, the Bank instituted a loan loss provision that is consistent with the loss rates experienced by other government-sponsored enterprises investing in residential loans. This reserve totaled $3.3 million at the end of 2001. Charge-offs during 2001 were .001% of the average MPF Program balance while recoveries were .0004%. At year-end 2001, .07% of the MPF Program conventional loans were on non-accrual status.

Marketing Performance

The Mortgage Partnership Finance Program, which the Chicago Bank launched in June 1997, has been successful. With the MPF Program, member financial institutions and the Bank form a unique partnership. The members manage the credit risk

and all aspects of the customer relationship associated with mortgage lending; and the Bank provides the necessary funding and manages interest rate and other financial risks. As of December 31, 2001, 286 institutions had been approved to participate in the MPF Program. At year-end 2001, the MPF Program had outstanding loans of $24.8 billion and had accepted $15.0 billion in master commitments.

The MPF Program's innovative product line enables the Bank to expand on its efforts to assist members who lend to lower income borrowers. At year-end, 50% of all MPF loans funded have been to households with income below the MSA (Metropolitan Statistical Area) median. The MPF Program also completed a link to the Bank's AHP program. Loans made using an AHP grant are now eligible for funding in the MPF Program.

The Bank continues using FIVES (Financial Instrument Valuation and Engineering System). FIVES is an advanced analytical tool that provides market values for financial instruments and off-balance sheet positions. Additionally, FIVES allows the Bank to reverse engineer financial instruments to estimate cash flow patterns and market prices given changes in rates, volatility, spreads, and the term structure of various yield curves.

Total membership reached an all-time high of 857 members at year-end 2001, up from 841 at year-end 2000. Of those members, 78.8% were commercial banks, 18.0% thrift institutions, 2.8% credit unions, and 0.5% insurance companies. At the end of 2001, 49% of all members had less than $100 million in total assets, 47% had assets between $100 million and $1 billion, and 4% had assets in excess of $1 billion. Since 1991, penetration of the thrift and commercial bank market has increased, from 17% to over 72% of eligible institutions.

Credit customers, defined as the number of members who have used advances, lines of credit, or an off-balance sheet product at any point during the year were 669 in 2001 compared to 688 during 2000. As a percentage of total membership, credit customers accounted for 78.1% of members in 2001.

Future Outlook

Management expects credit problems in the economy to continue and market interest rates to begin an upward trend in 2002. MPF Program balances are anticipated to continue strong growth during the year. Advance demand is expected to moderate as many members are experiencing an influx of retail deposits, thus reducing their wholesale funding needs. Management anticipates continuing investments in the Bank's capital stock.

The Bank's Management will continue to focus on assessing and managing credit risk in this higher risk environment. The number of financial institutions reporting net losses has increased. Mortgage delinquencies in the overall market have been rising since the middle of 2001. Delinquencies are not a primary risk to the Bank as the loans purchased include credit enhancements provided by the participating financial institution. The adequacy of the Bank's loan loss reserve is routinely analyzed and monitored by management. In addition to internal analysis, the level of the reserve is benchmarked against other entities that hold large mortgage portfolios. Management is confident that the reserve is sufficient.

Net income is expected to rise in 2002. With regard to dividends paid to members, the Bank is changing the index used to benchmark its dividend in 2002. The Bank will now use a '13-week moving average of the 52-week average of 1-year LIBOR' as its index and will add 75 basis points to that index to determine the target dividend rate. LIBOR stands for London Inter-Bank Offered Rate. Because LIBOR represents the rate at which banks can borrow and lend US dollars globally, it is widely used as a borrowing index on U.S. commercial and corporate loans. The interest-rate swap market where the Bank hedges interest rate risk is predominantly priced using LIBOR, thus it is a better benchmark for the bank's earnings and dividends.

Among the issues the Bank faces are:

Advance growth - Some banking regulators question the increased use of advances as a source of funding by Federal Home Loan Bank members. The Bank's management believes that Advances play an important role in the financing of housing in America. In addition, Bank management very closely monitors the credit quality of our borrowers.

FAS 133 - The Bank made the transition to FAS 133 in January 2001. As a result, the Bank took a $711 thousand FAS 133 charge to January Net Income. For the full year, the FAS 133 effect was a $58.1 million gain. Although the Bank's management believes that the FAS 133 mark-to-market adjustments are manageable and are likely to be material, there remains significant uncertainty as to the future FAS 133 effect..

MPF - The MPF portfolio is a relatively young book of business that now is being exposed to a significant credit and interest rate cycle. The Bank's management maintains its belief that these risks are appropriately managed through hedging and the provision of credit enhancements by MPF Program participating financial institutions.

Regulation - Recent changes in regulation and legislation (Gramm-Leach-Bliley) are in various stages of implementation across the Federal Home Loan Banks. There remains uncertainty as to whether these changes will be revised further by Congress or the Federal Housing Finance Board, and whether the changes will prove beneficial after implementation.

Forward-Looking Information

Statements contained in this report, including statements describing the objectives, projections, estimates, or future predictions of the Finance Board, the Federal Home Loan Bank of Chicago, and the Office of Finance may be "forward-looking

statements." These statements may use forward-looking terminology, such as "anticipates", "believes", "could", "estimates", "may", "should", "will", or their negatives or other variations on these terms. The Federal Home Loan Bank of Chicago cautions that, by their nature, forward-looking statements involve risk or uncertainty and that actual results could differ materially from those expressed or implies in these forward-looking statements or could affect the extent to which a particular objective, projection, estimate, or prediction is realized.

These forward-looking statements involve risks and uncertainties including, but not limited to, the following:

- economic and market conditions;
- volatility of market prices, rates, and indices that could affect the value of collateral held by the Federal Home Loan Bank of Chicago as security for the obligations of FHLBank members and counterparties to interest-rate exchange agreements and similar agreements;
- political events, including legislative, regulatory, judicial, or other developments that affect the FHLBanks, their members, counterparties, and/or investors in the consolidated obligations of the FHLBanks;
- competitive forces, including without limitation other sources of capital available to FHLBank members, other entities borrowing funds in the capital markets, and the ability to attract and retain skilled individuals;
- ability to develop and support technology and information systems, including the Internet, sufficient to manage the risks of the Federal Home Loan Bank of Chicago's business effectively;
- changes in investor demand for consolidated obligations and/or the terms of interest-rate exchange agreements and similar agreements;
- timing and volume of market activity;
- ability to introduce new Federal Home Loan Bank of Chicago products and services and manage successfully the risks associated with those products and services, including new types of collateral securing advances;
- risk of loss arising from litigation filed against one or more of the FHLBanks; and
- inflation/deflation.

Below is a more descriptive summary of the Bank's assets and government-sponsored debt issued. The ratio of mission assets to consolidated obligations illustrates the Bank's continuing commitment to its housing finance mission.

	December 31,	
	2001	2000
	(In thousands)	
Assets		
Cash and due from banks	$ 2,099	$ 4,194
Housing finance related instruments		
Advances	21,901,609	18,462,288
Mortgage loans held, net of loan loss reserves	16,570,308	8,102,680
Mortgage-backed securities held-to-maturity	4,127,435	4,120,626
Other housing finance related instruments	826,543	760,019
Total housing finance related instruments	43,425,895	31,445,613
Other investments	5,341,508	3,341,636
Accrued interest receivable	242,021	578,352
Bank premises	19,455	12,394
Derivatives	149,627	—
Other Assets	5,291	6,589
Total Assets	$ 49,185,897	$ 35,388,778
Consolidated Obligations, net	$ 43,268,658	$ 30,901,848
Housing Finance Related Instruments as Percent of Consolidated Obligations	100.4%	101.8%

Financial Statements

Statements of Condition

	December 31,	
	2001	2000
	(In thousands)	
Assets		
Cash and due from banks (Note 3)	$ 2,099	$ 4,194
Securities purchased under agreements to resell (Note 4)	49,895	45,685
Federal funds sold	3,165,000	2,397,000
Investments:		
Held-to-maturity securities includes $187,895,320 and $181,025,000 pledged in 2001 and 2000 (Note 5)	5,254,416	5,779,596
Securities held at fair value (Note 6)	1,826,176	—
Advances (Note 7)	21,901,609	18,462,288
Mortgage loans net of allowance for credit losses of $3,339,520 in 2001 and $1,502,568 in 2000 (Note 9)	16,570,308	8,102,680
Accrued interest receivable	242,021	578,352
Bank premises and equipment, net	19,455	12,394
Derivative assets (Note 15)	149,627	—
Other assets	5,291	6,589
Total Assets	$ 49,185,897	$ 35,388,778
Liabilities and Capital		
Liabilities		
Deposits: (Note 10)		
Demand and overnight	$ 1,527,712	$ 1,654,290
Term	109,702	155,075
Other	122,802	200,767
Total deposits	1,760,216	2,010,132
Borrowings:		
Securities sold under agreements to repurchase (Note 11)	800,000	—
Total Borrowings	800,000	—
Consolidated obligations, net: (Note 12)		
Discount notes	8,995,376	4,948,713
Bonds	34,273,282	25,953,135
Total consolidated obligations, net	43,268,658	30,901,848
Accrued interest payable	446,532	664,059
Affordable Housing Program (Note 8)	36,816	31,979
Payable to REFCORP (Note 13)	18,053	8,696
Derivative liabilities (Note 15)	330,509	—
Other liabilities	22,329	70,796
Total Liabilities	46,683,113	33,687,510
Commitments and contingencies (Notes 8, 12, 13, 14 and 18)		
Capital (Note 13)		
Capital stock ($100 par value) issued and outstanding shares: 23,943,341 shares in 2001 and 16,308,053 shares in 2000	2,394,334	1,630,805
Retained earnings (subject to restrictions)	110,429	70,463
Accumulated other comprehensive income:		
Unrealized loss relating to hedging activities	(1,979)	—
Total Capital	2,502,784	1,701,268
Total Liabilities and Capital	$ 49,185,897	$ 35,388,778

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

Statements of Income

	For the Years Ended December 31,		
	2001	2000	1999
	(In thousands)		
Interest Income:			
Advances	$ 882,358	$ 1,185,628	$ 871,143
Interest-bearing deposits in banks	76	—	—
Securities purchased under agreements to resell	2,200	3,775	23,115
Federal funds sold	96,481	155,326	136,615
Investments:			
Held-to-maturity securities	278,900	409,428	351,548
Securities held at fair value	50,293	-	-
Mortgage loans, including fees	723,983	360,314	81,985
Loans to other FHLBanks	295	541	247
Total interest income	2,034,586	2,115,012	1,464,653
Interest Expense:			
Consolidated obligations	1,740,900	1,797,074	1,127,748
Deposits	82,208	105,705	168,182
Securities sold under agreements to repurchase	1,107	—	—
Borrowings from other FHLBanks	—	4	—
Other borrowings	27	—	188
Total interest expense	1,824,242	1,902,783	1,296,118
Net Interest Income	210,344	212,229	168,535
Provisions for credit losses on mortgage loans	1,810	906	452
Net Interest Income after Provision for Credit Losses	208,534	211,323	168,083
Other Income:			
Service fees	1,033	1,067	1,099
Net loss on securities held at fair values	(4,872)	—	—
Net gain on derivatives and hedging activities	62,996	—	—
Other, net	2,958	1,340	1,105
Total other income	62,115	2,407	2,204
Other Expenses:			
Operating	38,332	29,844	24,434
Finance Board and Office of Finance	2,018	1,641	1,610
Other	10,449	4,567	1,272
Total other expenses	50,799	36,052	27,316
Income before Assessments	219,850	177,678	142,971
Affordable Housing Program	17,996	14,355	12,464
REFCORP (Note 1)	40,478	32,299	—
Total Assessments	58,474	46,654	12,464
Income before Extraordinary Item and cumulative effect of change in accounting principal	161,376	131,024	130,507
Extraordinary loss on early extinguishment of debt	—	(1,870)	—
Cumulative effect of change in accounting principle	573	—	—
Net Income	$ 161,949	$ 129,154	$ 130,507

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

Supplemental Disclosure: (unaudited)

	2001	2000	1999
Net Income	$ 161,949	$ 129,154	$ 130,507
REFCORP capital distribution	—	—	18,718
Income after REFCORP capital distribution	$ 161,949	$ 129,154	$ 111,789

Statements of Capital

For the Years Ended December 31,
(In thousands of shares and dollars)

	Capital Stock		Retained Earnings (Subject to Restrictions)				
	Shares	Par Value	Restricted	Unrestricted	Total Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total Capital
<u>1999</u>							
Balance, December 31, 1998	12,648	$1,264,786	$1,782	$ 32,753	$ 34,535	$	$1,299,321
Proceeds from sale of capital stock	3,513	351,307					351,307
Redemption of capital stock	(1,658)	(165,810)					(165,810)
Net income				130,507	130,507		130,507
Transfers			(1,343)	1,343	—		—
Dividends on capital stock				(91,653)	(91,653)		(91,653)
Capital distribution to REFCORP				(18,718)	(18,718)		(18,718)
<u>2000</u>							
Balance, December 31, 1999	14,503	1,450,283	439	54,232	54,671		1,504,954
Proceeds from sale of capital stock	4,740	474,025					474,025
Redemption of capital stock	(4,066)	(406,643)					(406,643)
Net income				129,154	129,154		129,154
Transfers			(439)	439	—		—
Dividends on capital stock							
Cash				(222)	(222)		(222)
Stock	1,131	113,140		(113,140)	(113,140)		—
<u>2001</u>							
Balance, December 31, 2000	16,308	1,630,805	—	70,463	70,463		1,701,268
Proceeds from sale of capital stock	10,638	1,063,807					1,063,807
Redemption of capital stock	(4,221)	(422,090)					(422,090)
Comprehensive income:							
Net income				161,949	161,949		161,949
Other comprehensive income:							
Net unrealized gain (loss) relating to hedging activities						(1,979)	(1,979)
Comprehensive income				161,949	161,949	(1,979)	159,970
Dividends on capital stock							
Cash				(171)	(171)		(171)
Stock	1,218	121,812		(121,812)	(121,812)		—
Balance, December 31, 2001	23,943	$2,394,334	$ —	$110,429	$110,429	$(1,979)	$2,502,784

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

Statements of Cash Flows

	For the Years Ended December 31,		
	2001	2000	1999
	(In thousands)		
Operating Activities:			
Net income	$ 161,949	$ 129,154	$ 130,507
Extraordinary loss on early extinguishment of debt	—	1,870	—
Cumulative effect of change in accounting principle	573	—	—
Income before extraordinary item and cumulative effect of change in accounting principle	162,522	131,024	130,507
Adjustments to reconcile income before extraordinary item and cumulative effect of change in accounting principle to net cash provided by operating activities:			
Depreciation and amortization:			
Net premiums and discounts on consolidated obligations, investments, and deferred costs and fees received on interest-rate exchange agreements	296,602	318,872	271,153
Net premiums and discounts on mortgage loans	31,629	4,117	1,599
Concessions on consolidated obligation bonds	6,190	6,502	7,478
Other comprehensive income	(4,018)	—	—
Deferred (gains) losses on hedges	(2,053)	1,030	362
Premises and equipment	5,070	2,485	1,471
Other	165	(1,467)	—
Provision for credit losses on mortgage loans	1,810	906	452
Decrease on securities held at fair value, net of transfers and transition adjustments	5,474	—	—
Gain due to change in net fair value adjustment on derivative and hedging activities	(286,736)	—	—
Net realized gain on disposal of premises and equipment	(2)	(6)	(16)
Decrease (increase) in accrued interest receivable	336,331	(17,151)	69,769
Increase in derivative asset-accrued interest	(26,592)	—	—
Decrease in derivative liability-accrued interest	(28,609)	—	—
Decrease (increase) in other assets	1,455	(3,169)	14,926
Net increase in Affordable Housing Program (AHP) liability and discount on AHP advances	4,824	5,008	4,595
(Decrease) increase in accrued interest payable	(217,527)	90,330	(51,464)
(Decrease) increase in REFCORP liability	9,357	3,875	294
(Decrease) increase in other liabilities	(48,457)	60,092	2,113
Total adjustments	84,913	471,424	322,732
Net Cash Provided by Operating Activities	247,435	602,448	453,239
Investing Activities:			
Net (increase) decrease in Federal funds sold	(768,000)	773,000	(904,000)
Net (increase) decrease in securities purchased under agreements to resell	(4,210)	4,705	802,364
Net (increase) decrease in short-term held-to-maturity securities	(49,454)	472,787	(830,127)
Purchases of long-term held-to-maturity securities	(3,239,410)	(658,261)	(2,202,814)
Proceeds from maturities of long-term held-to-maturity securities	1,982,862	1,017,418	1,734,818
Principal collected on advances	23,060,932	31,172,159	25,650,848
Advances made	(26,016,696)	(32,467,157)	(27,919,069)
Principal collected on mortgage loans	3,903,627	252,699	96,328
Mortgage loans funded	(12,406,251)	(6,741,634)	(786,680)
Mortgage loan recoveries	40	—	—
Net increase in premises and equipment	(12,286)	(7,261)	(5,119)
Net Cash Used in Investing Activities	(13,548,846)	(6,181,545)	(4,363,451)

	For the Years Ended December 31,		
	2001	2000	1999
	(In thousands)		
Financing Activities:			
Net decrease in deposits	(249,916)	(866,947)	(1,277,353)
Net increase (decrease) in other borrowings	800,000	—	(200,000)
Net proceeds from sales of consolidated obligation:			
Discount notes	377,411,969	350,489,157	291,672,750
Bonds	47,660,330	36,697,384	9,258,949
Payments for maturing and retiring consolidated obligations:			
Discount notes	(373,662,389)	(352,418,742)	(289,227,562)
Bonds	(39,302,222)	(28,398,881)	(6,368,170)
Proceeds from issuance of capital stock	1,063,807	474,025	351,307
Payments for redemption of capital stock	(422,090)	(406,643)	(165,810)
Cash dividends paid	(173)	(27,497)	(85,011)
Capital distribution to REFCORP	—	—	(18,718)
Net Cash Provided by Financing Activities	13,299,316	5,541,856	3,940,382
Net (decrease) Increase in Cash and Cash Equivalents	(2,095)	(37,241)	30,170
Cash and Cash Equivalents at Beginning of year	4,194	41,435	11,265
Cash and Cash Equivalents at End of Year	$ 2,099	$ 4,194	$ 41,435
Supplemental Disclosures:			
Interest paid	$ 1,741,685	$ 1,489,660	$ 1,078,622
Stock dividends issued	$ 121,812	$ 113,140	$ —

The accompanying notes are an integral part of these financial statements

Notes to Financial Statements

Background Information

The Federal Home Loan Bank of Chicago (the Bank), a federally chartered corporation, is one of twelve Federal Home Loan Banks (the FHLBs) which, with the Federal Housing Finance Board (the Finance Board), and the Office of Finance, comprise the Federal Home Loan Bank System (the System). The mission of the FHLBs and the System is to safely and soundly support residential mortgage finance through a variety of programs and services, primarily credit programs to their financial institution membership, so that their members can provide economical residential mortgage financing, in all phases of widely varying financial and economic cycles. The principal source of credit from the FHLBs is in the form of advances to members. In addition to advances, the FHLBs also invest in other mortgage related investments such as mortgage-backed securities. In 1997, the Bank initiated the MORTGAGE PARTNERSHIP FINANCE® (MPF®) Program, under which the Bank, in partnership with its members, provides funding for home mortgage loans. These instruments help the FHLBs accomplish their mission of supporting housing finance throughout America. All regulated depository institutions and insurance companies engaged in residential housing finance are eligible to apply for membership in FHLBs. All members are required to purchase stock in one or more of the FHLBs and all stock is owned by the FHLBs' members.

The FHLBs are supervised and regulated by the Finance Board which is an independent federal agency in the executive branch of the United States Government. The Finance Board ensures that the FHLBs carry out their housing finance mission, remain adequately capitalized and are able to raise funds in the capital markets and operate in a safe and sound manner. Each Bank operates as a separate entity with its own management, employees, and board of directors. Also, the Finance Board establishes policies and regulations covering certain operations of the FHLBs.

A primary source of funds for the FHLBs is the proceeds from the sale to the public of System debt instruments (consolidated obligations) which are the joint and several obligations of all the FHLBs. Additional funds are provided by deposits, other borrowings and the issuance of capital stock. Deposits are received from both member and non-member financial institutions and federal instrumentalities. The FHLBs also provides members and non-members with operating services such as safekeeping, collection, and settlement.

In accordance with the Finance Board's regulations and the Gramm-Leach-Bliley Act of 1999 (1999 Act), the Bank has established a formal policy governing the compensation and travel reimbursement provided its Directors. The goal of the policy is to appropriately compensate members of the Board of Directors for work performed on behalf of the Bank. Under this policy, compensation is comprised of per-meeting fees which are subject to an annual statutory cap. The fees compensate Directors for time spent reviewing materials sent to them on a periodic basis by the Bank, for preparing for meetings, for participating in any other activities for the Bank and for actual time spent attending the meetings of the Board or its committees. Directors are also reimbursed for reasonable Bank-related travel expenses. Total Directors' fees and other travel expenses paid by the Bank during 2001, 2000 and 1999, were $258,914 and $38,751, $250,535 and $45,789, and $293,749 and $53,048, respectively.

Note 1 - Summary of Significant Accounting Policies

Use of Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

Investments -The accounting for investments is described in the "Hedging Activities" section of this footnote.

Advances - Advances to members are net of discounts on advances for the Affordable Housing Program, as discussed below. In addition, prior to implementing Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended by SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities - Deferral of Effective Date of FASB Statement No. 133, and as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities (collectively referred to as "SFAS 133") in 2001, the carrying value of advances is adjusted for the unamortized cost of, and deferred gains and losses from, associated interest-rate exchange agreements. Interest on advances is credited to income as earned. Following the requirements of the Federal Home Loan Bank Act of 1932 (the Act), as amended, the Bank obtains sufficient collateral on advances to protect it from losses. As Note 7 more fully describes, the Act limits eligible collateral to certain investment securities, residential mortgage loans, cash or deposits with the Bank, and other eligible real- estate-related assets, but "community financial institutions," (FDIC-insured institutions with assets of $517 million or less) are subject to more liberal statutory collateral rules for small business and agricultural loans. The Bank has not experienced any losses on advances since its inception in 1932. Based upon the collateral held as security on the advances and prior repayment history, no allowance for losses on advances is deemed necessary by management.

Mortgage Loans - The Bank has developed the Mortgage Partnership Finance (MPF) Program under which the Bank invests in mortgage loans which are funded by the Bank through or purchased from its participating members. The Bank manages the liquidity, interest rate and options risk of the loans, while the members retain the marketing and servicing activities. The Bank and the members share in the credit risk of the loans with the Bank assuming the first loss obligation limited by the

First Loss Account (FLA), and the members assuming credit losses in excess of the FLA, up to the amount of the Credit Enhancement obligation as specified in the master agreement.

The Bank classifies loans as held for investment and reports them at their principal amount outstanding net of deferred loan fees and premiums and discounts. Loans that qualify for fair value hedge accounting under SFAS 133 are recorded at fair value with changes in fair value recorded in current period earnings.

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

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

The Bank places a loan on nonaccrual status when the collection of the contractual principal or interest is 90 days or more past due. When a loan is placed on nonaccrual status, accrued but uncollected interest is reversed against interest income. The Bank records cash payments received on nonaccrual loans as interest income and a reduction of principal.

The Bank bases the allowance for credit losses on management's analysis of credit losses inherent in the Bank's mortgage loan portfolio. Actual losses greater than defined levels are offset by the members' credit enhancement up to their respective limits. The analysis includes consideration of various data observations such as past performance, current performance, loan portfolio characteristics, collateral valuations, and prevailing economic conditions.

Affordable Housing Program - As more fully discussed in Note 8, the Bank is required to establish and fund an Affordable Housing Program (AHP). The required AHP funding of direct subsidies is charged to earnings and an offsetting liability established. Advances that qualify under the Bank's AHP are made at interest rates below the customary interest rate for non-subsidized advances or contain other forms of subsidies to promote the use of AHP advances. When an AHP advance is made, the subsidy is determined to be the present value of the difference in the interest rates between the AHP advance rate and the System's related cost of funds rate for a funding liability with a comparable maturity.

Prepayment Fees - The Bank generally charges its members prepayment fees when advances are repaid prior to original maturity. Such fees are credited to earnings when received.

Commitment Fees - Commitment fees for advances are deferred and amortized to interest income using the straight-line method over the life of the related advance. Refundable fees are deferred until the commitment expires or the advance is made. Commitment fees for letters of credit are recorded as a deferred credit when received and are amortized over the term of the letter of credit.

Derivatives - Effective with the Bank's adoption of SFAS 133 on January 1, 2001, all derivatives are recognized on the balance sheet at their fair value and are designated as (1) a hedge of the fair value of (a) a recognized asset or liability or (b) an unrecognized firm commitment (a "fair-value" hedge); (2) a hedge of (a) a forecasted transaction or (b) the variability of cash flows that are to be received or paid in connection with a recognized asset or liability (a "cash-flow" hedge); (3) a hedge of the foreign currency component of a hedged item is a fair-value or cash-flow hedge; (4) a non-SFAS 133 hedge of an asset or liability (stand-alone derivative) for asset-liability management. Changes in the fair value of a derivative that is effective as - and that is designated and qualifies as - a fair-value hedge, along with changes in the fair value of the hedged asset or liability that are attributable to the hedged risk (including changes that reflect losses or gains on firm commitments), are recorded in current-period earnings. Changes in the fair value of a derivative that is effective as - and that is designated and qualifies as - a cash-flow hedge, to the extent that the hedge is effective, are recorded in other comprehensive income, until earnings are affected by the variability of cash flows of the hedged transaction (e.g., until periodic settlements of a variable-rate asset or liability are recorded in earnings). Changes in the fair value of a derivative that is effective as - and that is designated and qualifies as - a foreign-currency hedge is recorded in either current-period earnings or other comprehensive income, depending on whether the hedging relationship satisfies the criteria for a fair-value or cash-flow hedge. Any hedge ineffectiveness (which represents the amount by which the changes in the fair value of the derivative exceed the variability in the cash flows of the forecasted transaction) is recorded in current-period earnings. Amounts recorded in other comprehensive income are amortized to interest income / expense during the period in which the hedged transaction impacts earnings. Changes in the fair value of a stand-alone derivative are recorded in current-period earnings. Hedge ineffectiveness and changes in the fair value of stand-alone derivatives are recorded in other income as "Net gain (loss) on derivatives and hedging activities."

The Bank occasionally purchases financial instruments in which a derivative instrument is "embedded" that is not remeasured at fair value with changes in fair value reported in earnings as they occur. Upon purchasing the financial instrument, the Bank assesses whether the economic characteristics of the embedded derivative are clearly and closely related to the economic characteristics of the remaining component of the financial instrument (i.e., the host contract) and whether a separate, non-embedded instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. When it is determined that (1) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract and (2) a separate, stand-alone instrument with the same terms would qualify as a derivative instrument, the embedded derivative is separated from the host contract, carried at fair value, and designated as either (1) a hedging instrument in a fair-value, cash-flow, or foreign-currency hedge or (2) a stand-alone derivative instrument. However, if the entire contract were to be measured at fair value, with changes in fair value reported in current earnings (e.g., an investment security classified as "trading" under SFAS 115, Accounting for Certain Investments in Debt and Equity Securities), or if the Bank could not reliably identify and measure the embedded derivative for purposes of separating that derivative from its host contract, the entire contract would be carried on the balance sheet at fair value and no portion of the contract would be designated as a hedging instrument.

The Bank formally documents all relationships between derivative hedging instruments and hedged items, as well as its risk-management objectives and strategies for undertaking various hedge transactions. This process includes linking all derivatives that are designated as fair-value, cash-flow, or foreign-currency hedges to (1) assets and liabilities on the balance sheet, (2) firm commitments or (3) forecasted transactions. The Bank also formally assesses (both at the hedge's inception and at least quarterly on an ongoing basis) whether the derivatives that are used in hedging transactions have been effective in offsetting changes in the fair value or cash flows of hedged items and whether those derivatives may be expected to remain effective in future periods. The Bank typically uses regression analysis or other statistical analysis to assess the effectiveness of its hedges. When it is determined that a derivative has not been or is not expected to be effective as a hedge, the Bank discontinues hedge accounting prospectively, as discussed below.

The Bank discontinues hedge accounting prospectively when (1) it determines that the derivative is no longer effective in offsetting changes in the fair value or cash flows of a hedged item (including hedged items such as firm commitments or forecasted transactions); (2) the derivative and/or the hedged item expires or is sold, terminated, or exercised; (3) it is no longer probable that the forecasted transaction will occur; (4) a hedged firm commitment no longer meets the definition of a firm commitment; or (5) management determines that designating the derivative as a hedging instrument is no longer appropriate.

When hedge accounting is discontinued due to the Bank's determination that the derivative no longer qualifies as an effective fair-value hedge, the Bank will continue to carry the derivative on the balance sheet at its fair value, cease to adjust the hedged asset or liability for changes in fair value, and begin amortizing the cumulative basis adjustment on the hedged item into earnings over the remaining life of the hedged item. When hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, the Bank will continue to carry the derivative on the balance sheet at its fair value, removing from the balance sheet any asset or liability that was recorded to recognize the firm commitment and recording it as a gain or loss in current-period earnings. When the Bank discontinues hedge accounting because it is no longer probable that the forecasted transaction will occur in the originally expected period due to extenuating circumstances, the gain or loss on the derivative remains in accumulated other comprehensive income and is reclassified into earnings when the forecasted transaction affects earnings. However, if it is probable that a forecasted transaction will not occur by the end of the originally specified time period or within an additional two-month period of time thereafter, the gain or loss that were accumulated in other comprehensive income will be recognized immediately in earnings. When hedge accounting is discontinued due to the Bank's determination that the derivative no longer qualifies as an effective cash-flow hedge of an existing hedged item, the Bank will continue to carry the derivative on the balance sheet at its fair value and begin amortizing the cumulative other comprehensive income adjustment to earnings when earnings are affected by the original forecasted transaction. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, the Bank will carry the derivative at its fair value on the balance sheet, recognizing changes in the fair value of the derivative in current-period earnings.

Hedging Activities

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

Investments - Investments which the Bank has both the ability and intent to hold to maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts using a method which approximates level yield. In addition, the Bank adjusted the carrying value of these investments for the unamortized costs of, and deferred gains and losses from, associated derivative financial instruments for periods prior to the implementation of SFAS 133.

The Bank classifies certain investments that it may sell before maturity as securities held at fair value and carries them at fair value. The Bank records changes in the fair value of these investments through other income.

Gains and losses on sales of investment securities are computed using the specific identification method and are included in other income. Sales of securities under agreements to repurchase the same or substantially the same securities are treated as collateralized financings.

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

In a typical transaction, fixed-rate consolidated obligations are issued for one or more FHLBs, and each of those FHLBs simultaneously enters into a matching interest-rate exchange agreement in which the counterparty pays fixed cash flows to the

Bank designed to mirror in timing and amount the cash outflows the Bank pays on the consolidated obligation. Such transactions are treated as fair-value hedges under SFAS 133. In this typical transaction, the Bank pays a variable cash flow that closely matches the interest payments it receives on short-term or variable-rate advances. This intermediation between the capital and swap markets permits the Bank to raise funds at lower costs than would otherwise be available through the issuance of simple fixed- or floating-rate consolidated obligations in the capital markets.

Advances - With issuances of convertible advances, an Bank may purchase from the member an embedded option(s) that enables the Bank to convert an advance from fixed rate to floating rate if interest rates increase or to terminate the advance and extend additional credit on new terms. An Bank may hedge a convertible advance by entering into a cancelable interest-rate exchange agreement where the Bank pays fixed and receives variable. This type of hedge is treated as a fair value hedge under SFAS 133. The swap counterparty can cancel the interest-rate exchange agreement on the call date, which would normally occur in a rising rate environment, and the Bank can convert the advance to a floating rate.

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

Mortgage Loans - The Bank invests in mortgage assets. The prepayment options embedded in mortgage assets can result in extensions or contractions in the expected maturities of these investments, depending on changes in interest rates. The Finance Board's Financial Management Policy limits this source of interest-rate risk by restricting the types of mortgage assets the Bank may own to those with limited average life changes under certain interest-rate shock scenarios. The Bank may manage against prepayment and duration risk by funding some mortgage assets with consolidated obligations that have call features. In addition, the Bank may use derivative financial instruments to manage the prepayment and duration variability of mortgage assets. Net income could be reduced if the Bank replaces the mortgages with lower-yielding assets and if the Bank's higher funding costs are not reduced concomitantly.

The Bank manages the interest-rate and prepayment risk associated with mortgages through a combination of debt issuance and derivatives. The Bank issues both callable and non-callable debt to achieve cash-flow patterns and liability durations similar to those expected on the mortgage loans. The Bank also uses derivatives to match the expected prepayment characteristics of the mortgages. Interest-rate swaps, to the extent the payments on the mortgages result in simultaneous reduction of the notional amount on the swaps, may receive fair-value hedge accounting under which changes in the fair value of the swaps and changes in the fair value of the mortgages that are attributable to the hedged risk, are recorded in current-period earnings. Options may also be used to hedge prepayment risk on the mortgages, many of which are not identified to specific mortgages and, therefore, do not receive fair-value or cash-flow hedge accounting treatment. The options are marked-to-market through current earnings. The Bank also purchases interest-rate caps and floors, swaptions, callable swaps, calls, and puts to minimize the prepayment risk embedded in the mortgage loans. Although these derivatives are valid economic hedges against the prepayment risk of the loans, they are not specifically identified to individual loans and, therefore, do not receive either fair-value or cash-flow hedge accounting. The derivatives are marked-to-market through earnings.

The Bank analyzes the risk of the mortgage portfolio on a regular basis and considers the interest-rate environment under various rate scenarios and also performs analysis of the duration and convexity of the portfolio.

Forecasted Debt Issuance - The Bank enters into interest rate swap agreements as hedges of anticipated issuance of debt to effectively “lock in” a spread between the earning asset and the cost of funding. All amounts deemed effective, as defined in SFAS 133, are recorded in OCI while amounts deemed ineffective are recorded in current earnings. The swap is terminated upon issuance of the debt instrument, and amounts reported in accumulated other comprehensive income are reclassified into earnings over the periods in which earnings are affected by the variability of the cash flows of the debt that was issued.

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

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

The Bank has issued some consolidated obligations denominated in currencies other than U.S. dollars, and the Bank uses forward exchange contracts to hedge currency risk. These contracts are agreements to exchange different currencies at specified future dates and at specified rates. The use of these contracts effectively simulates the conversion of these consolidated obligations denominated in foreign currencies to ones denominated in U.S. dollars. Such transactions are treated as foreign currency fair-value hedges under SFAS 133, whereby the fair value changes of the foreign-currency-denominated obligation and the forward contract are recorded in current period earnings. At December 31, 2001, consolidated obligations denominated in foreign currencies represented less than 1 percent of consolidated obligations outstanding. Therefore, the Bank is not exposed to material amounts of currency risk.

To meet the off-balance-sheet hedging needs of its members, the Bank enters into offsetting derivative financial instruments, acting as an intermediary between members and other counterparties. This intermediation allows smaller members

indirect access to the swap market. The derivatives used in intermediary activities do not receive SFAS 133 hedge accounting and are separately marked-to-market through earnings. The net result of the accounting for these derivatives does not significantly affect the operating results of the Bank.

Bank Premises and Equipment - Depreciation is recognized on a straight-line basis over the estimated useful lives of assets ranging from three to ten years. Leasehold improvements are amortized on a straight-line basis over the estimated useful life of the improvement or the remaining term of the lease, whichever is shorter. Improvements and major renewals are capitalized; ordinary maintenance and repairs are expensed as incurred. Gains and losses on disposal are included in other income.

Real Estate Owned - Real estate owned includes assets that have been received in satisfaction of debt. Real estate owned is initially recorded and subsequently carried at the lower of cost or fair value less estimated selling cost as an other asset in the statements of financial condition. Any valuation adjustments required at the date of transfer are charged to the allowance for credit losses. Subsequently, unrealized gains and losses on sale typically are included in other expense. Operating results from real estate owned are recorded in other expense.

Concessions on Consolidated Obligations - The amounts paid to dealers in connection with the sale of consolidated obligation bonds are deferred and amortized using the level yield method over the average life of the bond. The amount of the concession is allocated to the Bank from the Office of Finance based upon the percentage of the debt issued by the Bank. Concessions applicable to the sale of consolidated obligation discount notes are charged to expense as incurred, due to the short-term maturities of these notes.

Discounts and Premiums on Consolidated Obligations - The discounts and premiums on consolidated obligation bonds are amortized to expense using the level yield method over the average life of the bond. The discounts on consolidated obligation discount notes are amortized to expense using the straight-line method throughout the term of the related notes due to their short-term maturity.

Resolution Funding Corporation Assessments - Although the Bank is exempt from ordinary federal, state, and local taxation except for local real estate tax, it is required to make payments to the Resolution Funding Corporation (REFCORP). Each Bank is required to pay 20 percent of net earnings after AHP to REFCORP. The FHLBs will expense these amounts until the aggregate amounts actually paid by all 12 FHLBs are equivalent to a $300 million annual annuity whose final maturity date is April 15, 2030, at which point the required payment of each Bank to REFCORP will be fully satisfied. For years through 1999, the FHLBs charged the $300 million annual capital distribution to REFCORP directly to retained earnings (see Note 13).

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

Estimated Fair Values - The estimated fair value of the Bank's financial instruments is primarily determined by an in-house valuation system. The fair values are then compared to the secondary market for similar instruments and other indications from dealers. The estimated fair values of the Bank's financial instruments are detailed in Note 15.

Forward Exchange Contracts - The Bank uses forward exchange contracts to manage foreign currency risk associated with certain assets and liabilities. Concurrent with the purchase of the assets or incurrence of the liabilities, the Bank exchanges the foreign denominated interest and principal payments related to the financial instrument for equivalent amounts denominated in U.S. dollars. The financial instrument and related forward exchange contract are translated into U.S. dollars with unrealized gains and losses reported on the statements of condition as an adjustment to the carrying value of the associated financial instrument.

Cash Flows - For purposes of the statement of cash flows, the Bank considers cash on hand and due from banks as cash and cash equivalents.

Reclassifications - Certain amounts in the 2000 and 1999 financial statements have been reclassified to conform with the 2001 presentation.

Note 2 - Change in Accounting Principle and Recently Issued Accounting Standards

Adoption of SFAS 133 - The Bank adopted SFAS 133 on January 1, 2001. SFAS 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. The gains and losses on derivative instruments that are reported in other comprehensive income will be reclassified as earnings in the periods in which earnings are affected by the variability of the cash flows of the hedged item. The ineffective portion of all hedges will be recognized in current period earnings.

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

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

Net adjustments related to fair-value hedges and derivative transactions either not designated as hedges under SFAS 133 or not meeting the requirements for fair-value or cash-flow hedges	$ 1,175
Unrealized net losses on investments transferred from "held-to-maturity" to "securities held at fair value"	(602)
Total cumulative effect of accounting change on earnings	$ 573

On January 1, 2001, the Bank transferred held-to-maturity securities with an amortized cost of $702,769,000 and an estimated fair value of $702,167,000 into the securities held at fair value category. The unrealized loss related to the transfer of certain held-to-maturity securities into the securities held at fair value category was $602,000, and has been shown as a decrease to the Bank's results of operations in 2001 as a cumulative effect of a change in accounting principle. The remaining cumulative effect of adjustments related to fair-value hedges and derivative transactions either not designated as hedges under SFAS 133 or not meeting the requirements for fair value or cash-flow hedges have been shown as a credit to the Bank's results of operations in 2001 as part of the cumulative effect of a change in accounting principle, increasing net income by $1,175,000. These factors combined resulted in a net gain at transition on January 1, 2001, totaling $573,000.

As a result of SFAS 133, for the year ended December 31, 2001, the Bank recorded derivative assets of $149,627,000 and derivative liabilities of $330,509,000. In addition, the Bank recorded a net gain on derivatives and hedging activities of $62,996,000 in other income, a net loss of $4,018,000 in net interest income and a net loss on securities held at fair value of $4,872,000 in other income at December 31, 2001. For fair value hedges and their related hedged items, the Bank recognized a net gain of $8,977,000 in earnings, which represented the amount of the hedges' ineffectiveness. For cash flow hedges and their related hedged items, the Bank recognized a net gain of $29,248,000 in earnings, of which $243,000 loss represents the amount of the hedges' ineffectiveness. There was a gain of $20,753,000 as a result of derivatives not receiving hedge accounting. There was $11,629,000 gain reclassified from accumulated other comprehensive income into earnings as a result of (a) the anticipated transaction resulted in the acquisition of an asset or the incurrence of a liability that affects earnings or (b) the hedged item was terminated. It is estimated that $7,800,000 in gains will be reclassified into earnings over the next 12 months. There was $17,862,000 gain that was reclassified from accumulated other comprehensive income into earnings as a result of the discontinuance of the cash flow hedges because it became probable that the original forecasted transaction would not occur by the end of the originally specified time period or within a two month period thereafter. The maximum length of time over which the Bank is hedging the exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments is five years.

Certain notes included herein are adjusted to accommodate the effect of SFAS 133. Comparative information for prior years, which is no longer relevant in 2001, is not disclosed in accordance with the transition provisions of SFAS 133. Other disclosures for 2001 resulting from the implementation of SFAS 133 have been added, and comparative information for 2000 may not be relevant and therefore not disclosed.

Recently Issued Accounting Standard - In September 2000, Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 140) was issued. SFAS 140 provides accounting and reporting requirements for all transfers and the servicing of financial assets and the extinguishment of liabilities, effective for all transfers and extinguishments beginning after March 31, 2001. SFAS 140 is also effective for the recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Management of the Bank has evaluated the effect of adopting SFAS 140 and has determined that the effect of adoption is not material.

Note 3 - Cash and Due from Banks

Compensating Balances - The Bank has agreed to maintain compensating balances based upon average daily collected cash balances with various commercial banks in consideration for certain services. There are no legal restrictions under these agreements as to the withdrawal of funds. The average compensating balances maintained for the years ended December 31, 2001 and 2000 were approximately $515,000 and $679,000, respectively.

In addition, the Bank maintained average collected balances with various Federal Reserve Banks and branches of approximately $2,000,000 for the years ended December 31, 2001 and 2000. The Bank was required to maintain minimum average daily clearing balances of $2,000,000 for the years ended December 31, 2001 and 2000. Earnings credits on these balances may be used to pay for services received from the Federal Reserve.

Pass-through Deposit Reserves - The Bank acts as a pass-through correspondent for member institutions required to deposit reserves with the Federal Reserve Banks. Pass-through reserves deposited with Federal Reserve Banks were approximately $11,113,000 and $279,000 as of December 31, 2001 and 2000, respectively. Member reserve balances are included in deposits in the statement of condition.

Note 4 - Securities Purchased Under Agreements To Resell

The Bank has entered into purchases of securities purchased under agreements to resell. The amounts advanced under these agreements represent short-term loans and are reflected as assets in the statements of condition. The securities purchased under agreements to resell are held in safekeeping in the name of the Bank by one of the Federal Reserve Banks. Should the market value of the underlying securities decrease below the market value required as collateral, the counterparty is required to place an equivalent amount of additional securities in safekeeping in the name of the Bank or the dollar value of the resale agreement will be decreased accordingly.

Note 5 - Held-To-Maturity Securities

Major Security Types - Held-to-maturity securities as of December 31, 2001 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
	(In thousands)			
Commercial paper	$ 399,800	$ —	$ (25)	$ 399,775
State or local housing agency obligations	236,671	820	(5,523)	231,968
SBA/SBIC Loans	483,755	2,161	(7,299)	478,617
Other	6,755	166	—	6,921
	1,126,981	3,147	(12,847)	1,117,281
Mortgage-backed securities	4,127,435	44,340	(5,949)	4,165,826
Total	$ 5,254,416	$ 47,487	$ (18,796)	$ 5,283,107

Major Security Types - Held-to-maturity securities as of December 31, 2000 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
	(In thousands)			
U.S. Treasury obligations	$ 24,603	$ —	$ (20)	$ 24,583
Commercial paper	297,676	—	(6)	297,670
U.S. agency obligations	377,121	4,739	(4,838)	377,022
Investments in consolidated obligations of other FHLBs	196,223	1,979	(7,376)	190,826
State or local housing agency obligations	233,331	—	(10,572)	222,759
SBA/SBIC Loans	526,687	104	(1,461)	525,330
Other	379	—	—	379
	1,656,020	6,822	(24,273)	1,638,569
Mortgage-backed securities	4,120,626	19,512	(24,858)	4,115,280
Total	5,776,646	26,334	(49,131)	5,753,849
Deferred losses on terminated or re-designated interest rate exchange agreements	230	—	(230)	—
Associated interest rate exchange agreements, net	2,720	13,961	(10,095)	6,586
	$ 5,779,596	$ 40,295	$ (59,456)	$ 5,760,435

Redemption Terms - The amortized cost and estimated fair value of held-to-maturity securities, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities as issuers have the right to call or prepay obligations with or without call or prepayment fees:

	2001 (In thousands)		2000 (In thousands)	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 782,600	$ 782,804	$ 757,749	$ 757,827
Due after one year through five years	35,632	36,408	347,157	342,896
Due after five years through ten years	99,447	101,400	359,119	355,516
Due after ten years	209,302	196,669	191,995	182,330
	1,126,981	1,117,281	1,656,020	1,638,569
Mortgage-backed securities	4,127,435	4,165,826	4,120,626	4,115,280
Total	$ 5,254,416	$ 5,283,107	$ 5,776,646	$ 5,753,849

The amortized cost of the Bank's held-to-maturity securities is net of discounts of $1,529,042 and $8,392,446 at December 31, 2001 and 2000, respectively.

Interest-Rate Payment Terms - Interest rate payment terms for investment securities classified as held-to-maturity and the notional amount of interest rate exchange agreements associated with these securities at December 31, 2001 and 2000 are detailed in the following table:

	2001	2000
	(In thousands)	
Amortized cost of held-to-maturity securities other than mortgage-backed securities:		
Fixed-rate	$ 1,067,824	$ 1,430,147
Variable-rate	59,157	225,873
	1,126,981	1,656,020
Amortized cost of held-to-maturity mortgage-backed securities:		
Pass-through securities:		
Fixed-rate	96,333	265,607
Variable-rate	330,270	559,793
Collateralized mortgage obligations:		
Fixed-rate	2,343,795	2,501,549
Variable-rate	1,357,037	793,677
	4,127,435	4,120,626
Total	$ 5,254,416	$ 5,776,646
Notional principal of interest rate exchange agreements by class type associated with held-to-maturity securities:		
Interest rate swaps	$ —	$ 705,414
Interest rate caps purchased	—	465,000
Total	$ —	$ 1,170,414

Note 6 - Securities Held at Estimated Fair Value

Major Security Types - Securities held at fair value as of December 31, 2001, were as follows :

	Estimated Fair Value (In Thousands)
U.S. agency obligations	$ 1,519,820
Other FHLBs' bonds	200,238
Total	1,720,058
Mortgage-backed securities	106,118
Total	$ 1,826,176

Net loss on securities held at fair value during the year ended December 31, 2001, included a change in net unrealized holding loss of $4,872,000.

Note 7 - Advances

Redemption Terms - At December 31, 2001 and 2000, the Bank had advances outstanding to members, including AHP advances (see Note 8), at interest rates ranging from 1.74% to 8.47% and 4.30% to 8.47%, respectively, as summarized below. AHP subsidized advances have an average interest rate of 5.13% and 5.06% as of December 31, 2001 and 2000 respectively.

	2001		2000	
Year of Maturity	Amount (In thousands)	Weighted Average Interest Rate	Amount (In thousands)	Weighted Average Interest Rate
2001	—	—	$ 9,385,503	6.45%
2002	$ 6,849,625	4.38%	1,648,012	6.57
2003	3,452,028	4.88	1,621,174	6.13
2004	2,343,147	5.27	1,419,819	5.86
2005	1,644,721	5.86	1,427,611	6.13
2006	3,188,769	2.81	230,308	6.00
Thereafter	3,940,072	5.18	2,730,605	5.50
Total par value	21,418,362	4.59%	18,463,032	6.21%
Discount on AHP advances	(309)		(452)	
SFAS 133 hedging adjustments	483,556		—	
Deferred gains on interest rate exchange agreements	—		(350)	
Associated interest rate exchange agreements, net	—		58	
Total with interest rate exchange agreements	$ 21,901,609		$ 18,462,288	

In general, some of the Bank's advances to members are callable at the member's option. Members are charged a prepayment fee when certain advances are prepaid. Other advances may be repaid on pertinent call dates without incurring prepayment fees (Callable Advances). At December 31, 2001 and 2000 the Bank had Callable Advances outstanding totaling $75,100,000 and $3,000,000.

The following table summarizes advances to member institutions at December 31, 2001 and 2000 by year of maturity or next call date for Callable Advances:

Year of Maturity or Next Call Date	2001	2000
	(In thousands)	
2001	—	$ 9,385,503
2002	$ 6,924,724	1,648,012
2003	3,452,028	1,621,174
2004	2,343,147	1,419,819
2005	1,644,721	1,427,611
2006	3,163,770	230,308
Thereafter	3,889,972	2,730,605
Total par value	$ 21,418,362	$ 18,463,032

The Bank also issues advances to members in which the Bank has the right to cancel after a specified lockout period, in whole or in part, at par with five calendar days notice. If the Bank exercises the right to cancel the advance, the member may convert the advance to another advance product offered by the Bank at existing market prices for that member on the date of conversion (Convertible Advances). At December 31, 2001 and 2000, the Bank had Convertible Advances outstanding totalling $6,015,086,000 and $5,550,938,000, respectively.

The following table summarizes advances to member institutions at December 31, 2001 and 2000 by year of maturity or next conversion date for Convertible Advances:

Year of Maturity or Next Conversion Date	2001	2000
	(In thousands)	
2001	—	$ 12,670,521
2002	$ 10,641,505	2,034,412
2003	4,153,678	1,902,199
2004	2,254,349	747,796
2005	737,722	483,111
2006	3,037,586	150,608
Thereafter	593,522	474,385
Total par value	$ 21,418,362	$ 18,463,032

Security Terms - The Bank lends to financial institutions in Illinois and Wisconsin involved in housing finance, in accordance with federal statutes, including the Federal Home Loan Bank Act of 1932, as amended (the Act). The Bank is required by statute to obtain sufficient collateral on advances to protect against losses and to accept certain investment securities, residential mortgage loans, deposits in the Bank, and other real estate related assets as collateral on such advances. However, "community financial institutions" are subject to more liberal statutory collateral provisions dealing with loans to small business and agriculture under the provisions of the 1999 Act. The capital stock of the Bank owned by borrowing members is also pledged as additional collateral on advances. The Act requires that the aggregate advances from the Bank to any single member not exceed 20 times the amount paid by that member for capital stock of the Bank. At December 31, 2001 and 2000, the Bank had rights to collateral with an estimated value in excess of outstanding advances. Based upon the financial condition of the member, the Bank:

1. Allows a member to physically retain collateral assigned to the Bank, provided that the member executes a written security agreement and agrees to hold such collateral for the benefit of and subject to the direction and control of the Bank; or
2. Requires the member to specifically assign or place physical possession of such collateral with the Bank or its safekeeping agent.

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

Credit Risk - The Bank's potential credit risk from advances is primarily to commercial and savings institutions. The Bank has experienced no losses on advances since it was founded, nor does management anticipate any future losses on advances. Accordingly, no allowance for losses on advances has been provided.

The Bank holds sufficient collateral to cover the advances to these institutions. The Bank does not expect to incur any credit losses on these advances.

As of December 31, 2001, the Bank had advances of $3,351,726,000 outstanding to one member institution, and this represents 16% of total advances outstanding. The income from advances to this member institution amounted to $137,822,000

during 2001. The Bank held sufficient collateral to cover the advances to this institution, and the Bank does not expect to incur any credit losses on these advances.

Interest Rate Payment Terms - Additional interest rate payment terms for advances and the notional amount of interest rate exchange agreements associated with advances at December 31, 2001 and 2000 are detailed in the following table:

	2001	2000
	(In thousands)	
Par amount of advances:		
Fixed-rate	$ 17,617,766	$ 14,883,360
Variable-rate	3,800,596	3,579,672
Total par value	$ 21,418,362	$ 18,463,032
Notional principal of interest rate exchange agreements by class type associated with advances:		
Interest rate swaps	$ 15,685,078	$ 13,832,304
Interest rate floors purchased	1,800,000	240,000
Total	$ 17,485,078	$ 14,072,304

The estimated fair value of advances, including the estimated fair value and discussion of related interest rate exchange agreements, as of December 31, 2001 and 2000 is disclosed in Note 17.

Note 8 - Affordable Housing Program

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) contains provisions for the establishment of an Affordable Housing Program (AHP) by each Bank. Each Bank provides subsidies in the form of direct grants or below-market interest-rate advances for members who use the funds for qualifying affordable housing projects. Annually, the FHLBs must set aside for the AHPs the greater of $100 million or ten percent of the current year's income before charges for AHP but after the charge to REFCORP (see Note 13). The amount set aside is charged to income and recognized as a liability. As subsidies are provided, the AHP liability is relieved.

If the results of the aggregate ten percent calculation described above is less than $100 million, the shortfall is allocated among the FHLBs based on the ratio of each Bank's income before AHP and REFCORP to the sum of the income before AHP and REFCORP of the 12 district FHLBs. There was no shortfall in either 2001 or 2000. The Bank had outstanding principal in AHP-related advances of $5,297,958 and $7,638,804 at December 31, 2001 and 2000.

Note 9 - Mortgage Loans

The Mortgage Partnership Finance Program involves investment by the Bank in mortgage loans which are either funded by the Bank through or purchased from its participating members. The total loans represent held-for-investment loans under the MPF Program whereby the Bank's members create, service and credit enhance home mortgage loans which are owned by the Bank. The following table presents information as of December 31, 2001 and 2000 on mortgage loans:

	2001	2000
	(In thousands)	
Mortgages:		
Fixed medium-term* single-family mortgages	$ 2,088,350	$ 511,241
Fixed long-term single-family mortgages	14,430,880	7,559,059
Unamortized premiums, net	44,494	29,701
Plus: deferred loan costs, net	11,442	3,850
Total mortgage loans	16,575,166	8,103,851
Associated interest rate exchange agreements, net	(1,518)	332
Total with interest rate exchange agreements	$ 16,573,648	$ 8,104,183

* Medium-term is defined as a term of 15 years or less.

The par value of mortgage loans outstanding at December 31, 2001 and December 31, 2000, was comprised of government guaranteed loans totaling $5,747,293,174 and $5,667,733,919 and conventional loans totaling $10,771,936,844 and $2,402,566,717 respectively.

The allowances for credit losses on MPF Program loans was as follows:

	2001	2000	1999
		(In thousands)	
Allowance for credit loss:			
Balance, beginning of year	$ 1,503	$ 687	$ 235
Chargeoffs	(13)	(90)	—
Recoveries	40	—	—
Net recoveries (chargeoffs)	27	(90)	—
Provisions for credit losses	1,810	906	452
Balance, end of year	$ 3,340	$ 1,503	$ 687

The estimated fair value of the mortgage loans held as of December 31, 2001 and 2000 is reported in Note 17.
At December 31, 2001 and 2000, the Bank did not have any recorded investment in impaired loan pools.

	2001	2000
	(In thousands)	
Notional principal of interest rate exchange agreements by class type associated with mortgage loans:		
Interest rate swaps	$ 1,247,460	$ 238,178
Forward contracts	2,775,000	2,820,000
	$ 4,022,460	$ 3,058,178

Note 10 - Deposits

The Bank offers demand, overnight and short-term deposit programs for members and qualifying non-members. A member that services mortgage loans may deposit in the Bank the funds collected in connection with the mortgage loans pending disbursement of such funds to the owners of mortgage loans; these items are classified as other deposits on the statements of condition.

The Bank had no interest rate exchange agreements associated with deposits at December 31, 2001 and 2000.

Note 11 - Borrowings

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

Note 12 - Consolidated Obligations

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

The par value of outstanding consolidated obligation bonds and discount notes for all of the FHLBs was approximately $637,332,000,000 and $614,065,000,000 at December 31, 2001 and 2000, respectively. Regulations require the FHLBs to maintain, in the aggregate, unpledged qualifying assets in an amount equal to the consolidated obligations outstanding. Qualifying assets are defined as cash; secured advances; assets with an assessment or rating at least equivalent to the current assessment or rating of the Bank consolidated obligations; obligations, participations, mortgages, or other securities of or issued by the United States government or an agency of the United States government; and such securities as fiduciary and trust funds may invest in under the laws of the state in which each Bank is located.

On June 2, 2000, the Finance Board adopted a final rule amending the FHLBs' leverage limit requirements. Effective July 1, 2000, each FHLBs' leverage limit will be based on a ratio of assets to capital, rather than a ratio of liabilities to capital. The Finance Board's former regulations prohibited the issuance of consolidated obligations if such issuance would bring the Bank's outstanding consolidated obligations and other unsecured senior liabilities above 20 times the Bank's total capital. The Finance

Board's Financial Management Policy also applied this limit on an Bank-by-Bank basis. The final rule deletes the Bank's overall leverage limit from the regulations, but, limits each Bank's assets generally to no more than 21 times its capital. Nevertheless, an Bank whose non-mortgage assets, after deducting deposits and capital, do not exceed 11% of its assets may have total assets in an amount not greater than 25 times its capital.

In order to provide the holders of consolidated obligations issued prior to January 29, 1993 (prior bondholders) protection equivalent to that provided under the Bank's previous leverage limit of twelve times Bank Capital stock, prior bondholders have a singular claim on a certain amount of the Qualifying Assets (Special Asset Account (SAA)) if capital stock is less than 8.33% of consolidated obligations. At December 31, 2001 and 2000, the Bank's capital stock was 5.22% and 4.96% of consolidated obligations and the SAA balance was approximately $28,300,000 and $37,100,000. Each Bank is required to transfer Qualifying Assets in the amount of its allocated share of the Bank's SAA balance to a trust for the benefit of the prior bondholders if that Bank's capital-to-assets ratio falls below 2%. The Bank's capital-to-assets ratio was greater than 2% at December 31, 2001, and 2000.

General Terms - Consolidated obligations are generally issued with either fixed or floating-rate payment terms that use a variety of indices for interest rate resets including the London Interbank Offered Rate (LIBOR), Constant Maturity Treasury (CMT), 11th District Cost of Funds, and others. In addition, to meet the specific needs of certain investors in consolidated obligations, fixed-rate bonds and variable-rate bonds may also contain certain embedded features, which may result in complex coupon payment terms and call features. When such consolidated obligations are issued, the Bank concurrently enters into interest rate exchange agreements containing offsetting features, effectively to alter the terms of the bond to a straightforward variable-rate bond tied to an index.

These consolidated obligation bonds have the following broad terms:

Indexed Principal Redemption Bonds (Index Amortizing Notes) - Repay principal according to predetermined amortization schedules that are linked to the level of a certain index. In general, as market interest rates increase (decrease), the maturity of the Index Amortizing Notes extends (contracts).

Optional Redemption Bonds (Callable Bonds) - May be redeemed in whole or in part at the discretion of the Bank on predetermined call dates in accordance with terms of bond offerings.

Variable Principal Bonds - The principal amount of the bond varies based upon a predetermined index linked, for instance, to changes in interest rates for foreign currency exchange rates.

Range Bonds - Pay interest at variable rates provided a specified index (such as stock market indices or foreign currency exchange rates) is within a specified range. The computation of variable interest rate varies for each bond issued but generally pays zero interest if the specified index is outside the specified range.

Step-Up Bonds - Pay interest at increasing fixed rates for specified intervals over the life of the bond. These bonds generally contain provisions enabling the bonds to be called at the Bank's option on the step-up dates.

Inverse Floating Bonds - Coupon rates increase as an index declines and decrease as an index rises.

Comparative-Index Bonds - Coupon rates are determined by the difference between two or more market indices, typically CMT and LIBOR.

Redemption Terms - The following is a summary of the Bank's participation in consolidated obligation bonds at December 31, 2001 and 2000 by year of maturity.

Year of Maturity	2001 Amount (In thousands)	2001 Weighted Average Interest Rate	2000 Amount (In thousands)	2000 Weighted Average Interest Rate
2001	—		$ 7,541,000	5.94%
2002	$ 7,373,950	5.94%	6,413,150	6.28
2003	8,254,530	4.17	4,069,030	6.25
2004	3,131,000	4.71	795,000	6.23
2005	2,806,560	6.51	2,477,560	6.91
2006	3,558,200	5.16	400,200	5.89
Thereafter	9,326,365	6.20	4,166,050	6.95
Total par value	34,450,605	5.44%	25,861,990	6.33%
Concessions	(8,297)		(5,796)	
Bond premiums	77,310		11,937	
Bond discounts	(195,295)		(32,538)	
SFAS 133 hedging adjustments	(46,205)			
Forward exchange contracts associated with bonds denominated in foreign currencies	—		120,800	
Deferred net loss on terminated interest rate exchange agreements	(4,836)		(6,889)	
Associated interest rate rate exchange agreements	—		3,631	
Total with interest rate exchange agreements	$ 34,273,282		$ 25,953,135	

The Bank makes significant use of fixed-rate callable debt to finance MPF Program mortgage loans, Callable Advances (see Note 7) and mortgage-backed securities. Contemporaneous with such a debt issue, the Bank may also enter into a swap (in which the Bank pays variable and receives fixed) with a call feature that mirrors the option embedded in the debt (a sold callable swap). The combined sold callable swap and callable debt allows the Bank to provide its members with priced advances, while converting its own payment to a variable-rate.

The Bank's consolidated bonds outstanding includes:

	2001 Amount (In thousands)	2001 Percentage of Callable/ Non Callable Bonds To Total	2000 Amount (In thousands)	2000 Percentage of Callable Non Callable Bonds To Total
Par amount of consolidated bonds:				
Non-callable or non-putable	$ 11,404,000	33.10%	$ 20,756,940	80.26%
Callable	23,046,605	66.90	5,105,050	19.74
Total par value	$ 34,450,605	100.00%	$ 25,861,990	100.00%

The following table summarizes the Bank's participation in consolidated bonds outstanding at December 31, 2001 and 2000, by year of maturity or next call date:

Year of Maturity or Next Call Date	2001	2000
	(in thousands)	
2001	—	$ 10,018,050
2002	$ 13,704,950	7,555,150
2003	11,549,530	4,139,030
2004	3,038,000	605,000
2005	2,106,560	2,036,560
2006	1,138,200	223,200
Thereafter	2,913,365	1,285,000
Total par value	$ 34,450,605	$ 25,861,990

Interest Rate Payment Terms - Interest rate payment terms for consolidated bonds and the notional principal amount of interest rate exchange agreements associated with consolidated bonds at December 31, 2001 and 2000 are detailed in the following table. Range bonds are classified as comparative-index bonds.

	2001	2000
	(In thousands)	
Par amount of consolidated bonds:		
Fixed rate	$ 30,873,555	$ 25,369,940
Variable rate	3,400,000	270,000
Inverse floating rate	50,000	50,000
Fixed that converts to variable	—	25,000
Variable that converts to fixed	30,000	30,000
Comparative-index	97,050	117,050
Total par value	$ 34,450,605	$ 25,861,990
Notional principal of interest rate exchange agreements by class type associated with consolidated bonds:		
Interest rate swaps	$ 12,891,700	$ 16,526,200
Interest rate caps purchased	1,120,000	350,000
Total	$ 14,011,700	$ 16,876,200

Bonds Denominated in Foreign Currencies - Consolidated bonds issued can be denominated in foreign currencies. Concurrent with these issuances, the FHLBs exchanged the interest and principal payment obligations related to the issues for equivalent amounts denominated in U.S. dollars. These bonds and related exchange contracts are translated into U.S. dollars at the exchange rate as of December 31, 2001 and 2000 respectively, in the preceding tables that presented the Bank's bonds by year of maturity, by year of maturity or next call date, and by interest rate payment terms.

The Bank's participation in bonds denominated in foreign currencies as of December 31, 2001 and 2000 was as follows:

	Amount Denominated in Foreign Currency (In thousands)		Effective Terms of Bonds Combined with Exchange Contracts (In thousands)		
Foreign Currency Description	2001	2000	Year of Maturity	Par Amount in U.S. Dollars	Interest Rate
British Pound	300,000	300,000	2002	$ 488,700	6.88%
British Pound	300,000	300,000	2003	507,900	5.63%
British Pound	100,000	100,000	2003	169,300	5.63%

Discount Notes - The Bank's participation in consolidated discount notes, all of which are due within one year, is as follows:

	Book Value	Par Value	Weighted Average Interest Rate
		(In thousands)	
December 31, 2001	$ 8,995,376	$ 9,015,850	2.13%
December 31, 2000	4,948,713	4,967,212	6.18%

Section II of the Act authorizes the Secretary of the Treasury, in his or her discretion, to purchase consolidated obligations of the FHLBs aggregating not more than $4,000,000,000; terms, conditions, and interest rates are to be determined by the Secretary of the Treasury. There were no such purchases by the U.S. Treasury during the two years ended December 31, 2001 and 2000.

Extraordinary Item-Early Extinguishment of Debt - During 2000, the Bank extinguished consolidated bonds by purchasing consolidated bonds in the open market. Further, some of these bonds had associated derivative financial instruments, which were terminated or marked at the date of the extinguishment. The Bank netted the resulting realized gain or loss with the realized gain or loss on the early extinguishment of the debt. The Bank extinguished consolidated bonds with net realized losses on associated derivative financial instruments of $1,870,000, for the year ended December 31, 2000. The corresponding principal retired for the year ended December 31, 2000, was $1,286,700,000.

Note 13 - Capital

The 1999 Act will lead to a number of changes in the capital structure of the FHLBs. The final Finance Board rule was published on January 30, 2001, and required each Bank to submit a capital structure plan to the Finance Board by October 29, 2001. The Bank submitted its proposed capital plan structure on October 29, 2001. The 1999 Act also provides a transition period to the new capital structure of up to three years from the effective date of each Bank's capital structure. Until such time as the FHLBs fully implement the new capital regulations, which may not be for several years, the current capital rules remain in effect. In particular, the Act requires members to purchase capital stock equal to the greater of 1 percent of their mortgage-related assets or 5 percent of outstanding Bank advances. However, the 1999 Act removed the provision that required, a nonthrift member to purchase additional stock to borrow from its Bank if the nonthrift member's mortgage-related assets were less than 65 percent of total assets. Members may, at the Bank's discretion, redeem at par value any capital stock greater than their statutory requirement or sell it to other Bank members at par value.

When the capital structure plans have been approved by the Finance Board and implemented at each Bank, the FHLBs will be subject to risk-based capital rules. Each Bank may offer two classes of stock. Providing the Bank is adequately capitalized, members can redeem Class A stock by giving six months notice, and members can redeem Class B stock by giving five years notice. Only "permanent" capital, defined as retained earnings and Class B stock, can satisfy the risk-based capital requirement. In addition, the 1999 Act specifies a 5 percent minimum leverage ratio including a 1.5 weighting factor applicable to Class B stock. It also specifies a 4 percent minimum capital ratio that does not include the 1.5 weighting factor applicable to Class B stock used in determining compliance with the 5 percent leverage ratio.

The 1999 Act established voluntary membership for all members. All members may withdraw from membership and redeem their capital six months after giving notice to do so. Members that withdraw from membership may not re-apply for membership for five years.

On June 22, 2000, the Finance Board rescinded its dividend policy applicable to the FHLBs. This action has the effect of no longer requiring an Bank to hold as restricted retained earnings that portion of prepayment fee income that, if prorated over the maturity of the advances prepaid, would be allocated to future dividends. The Bank's board of directors may declare and pay in either cash or capital stock dividends only from retained earnings or current net earnings.

Before the 1999 Act, the Act required the FHLBs to pay $300 million annually through 2030 to fund part of the interest on REFCORP debt. Before paying dividends, each Bank was assessed up to 20 percent of its net income after AHP contributions to meet these required payments. If 20 percent of net income was less than the $300 million assessment in any year, the Act allocated the shortfall among all the FHLBs based on the percentage equal to the ratio of each Bank's average advances to insured depository institutions, which are Savings Association Insurance Fund (SAIF) members, to the Bank's total average advances to SAIF-insured members. If the initial 20 percent assessment calculation exceeded the required $300 million, the $300 million is allocated among the FHLBs based on their net income after their AHP contribution to Bank's net income after AHP contributions. There was no shortfall in 2000 or 1999.

The 1999 Act changed these required payments in 2000 and thereafter to 20 percent of net earnings for each Bank effective January 1, 2000. The FHLBs will pay these amounts until the aggregate amounts actually paid by the FHLBs are equivalent to a $300 million annual annuity whose final maturity date is April 15, 2030. The cumulative amount to be paid to REFCORP by the Bank is not determinable at this time due to the interrelationships of all future FHLBs' earnings. The FHLBs payments during 2001 defease all future benchmark payments after the third quarter of 2023 and $51.289 million of the $75.0 million benchmark payment for the second quarter of 2023.

The Finance Board requires that all Banks holding selected MPF 100, 125 and 125 Plus assets hold retained earnings equal to 1.5% of the balance sheet value of the assets. At December 31, 2001, and 2000, the Bank's requirement was $45 million, and $11 million which was fully satisfied with over $110 million and $70 million in retained earnings.

Note 14 - Employee Retirement Plans

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

The Bank also participates in the Financial Institutions Thrift Plan (FITP), a defined contribution plan. The Bank's contribution is equal to a percentage of participants' compensation and a matching contribution equal to a percentage of voluntary employee contributions, subject to certain limitations. The Bank contributed approximately $428,000, $360,000, and $327,000 for the years ended December 31, 2001, 2000, and 1999 respectively.

Effective January 1, 1994, the Bank adopted a Benefit Equalization Plan. This plan is an unfunded, nonqualified deferred compensation plan providing benefits which are limited in the other retirement plan by laws governing such plans. The Bank's minimum obligation from this unfunded supplemental retirement plan as of December 31, 2001 was $2,220,800.

In addition to providing retirement benefits, the Bank provides health care and life insurance benefits for active and retired employees. Substantially all of the Bank's employees with at least five years of full-time employment service, become eligible for postretirement benefits at age 60 or older at retirement date. Under the Bank's current plan, eligible retiree's are entitled to full medical coverage as provided under Medicare. The Bank also provides term life insurance premium payments for eligible employees retiring after age 45.

Note 15 - Derivative Financial Instruments

In connection with its interest rate risk management program, the Bank uses various derivative financial instruments. Interest rate swap transactions involve the contractual exchange of a floating rate for a fixed or another floating rate interest payment obligation based on a notional principal amount as defined in the agreement. Forward contracts are commitments to buy or sell at a future date a financial instrument or currency at a contracted price and may be settled in cash or through delivery. Interest rate cap and floor agreements, for which either a premium is paid or received, allow the Bank to manage its exposure to unfavorable interest fluctuations over or under a specified rate. For this protection, a premium is paid. Interest rate caps and floors obligate one of the parties to the contract to make payments to the other if an interest rate index exceeds a specified upper "capped" level or if the index falls below a specified "floor" level.

The Bank enters into derivative financial instruments to hedge interest rate and embedded option risk on selected advances to members, structured Agency bonds held as investments, and structured debt. These agreements effectively convert long-term financial instruments from a fixed or an indexed rate with embedded options to a variable rate.

The Bank also enters into derivative financial instruments to hedge groups of assets and liabilities. These agreements reduce market risk associated with the change in interest rates in conjunction with the Bank's asset and liability management.

Derivative financial instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the statements of condition. The contract or notional amounts of these instruments reflect the extent of involvement the Bank has in particular classes of financial instruments; the notional amount does not represent exposure to credit loss. The amounts potentially subject to loss due to credit risks are the book value amounts of the derivatives, and not the notional amounts. Maximum credit risk is defined as the estimated cost of replacement for favorable interest rate swaps, forward agreements and purchased caps and floors in the event of counterparty default and the related collateral, if any, proved to be of no value to the Bank. This collateral has not been sold or repledged. The Bank is subject to credit risk only due to the nonperformance by counterparties to the derivatives; however, based on management's credit analysis and collateral requirements, the Bank does not anticipate any losses on these agreements.

At December 31, 2001 and 2000, the Bank's maximum credit risk, as defined above, was approximately $137,574,000 and $257,430,000 respectively, including $55,201,000 and $165,118,000 of net accrued interest receivable, respectively. Accrued interest receivables and payables and legal right to offset assets and liabilities by counterparty, in which amounts recognized for individual contracts may be offset against amounts recognized for other contracts, are considered in determining the maximum credit risk. The Bank held cash and securities with a market value of approximately $128,929,000 and $221,728,000 as collateral for interest rate exchange agreements as of December 31, 2001 and 2000, respectively.

A significant portion of the Bank's derivative financial instruments are transacted with financial institutions such as major banks and broker-dealers, with no single institution dominating the business. Assets pledged as collateral by the Bank to these counterparties are discussed more fully in Note 17.

Intermediation - Derivative financial instruments in which the Bank is an intermediary may arise when the Bank: (1) enters into offsetting interest rate exchange agreements with members and other counterparties to meet the needs of their member, or (2) enters into interest rate exchange agreements to offset the economic effect of other derivative financial instruments that are no longer designated to either advances, investments, or consolidated obligations.

The notional principal of derivative financial instruments in which the Bank is an intermediary is $835,911,000 and $380,000,000 at December 31, 2001 and 2000.

The following table categorizes the estimated fair value of derivative financial instruments, excluding accrued interest by product and type of hedge accounting treatment at December 31, 2001:

Total by Product	**Notional** (In Thousands)	**Estimated fair value (excludes accrued interest)** (In Thousands)
ADVANCES		
Fair Values	$15,685,078	$(483,363)
Cash Flow	1,700,000	75,743
Stand Alone	100,000	5,236
Total	17,485,078	(402,384)
INVESTMENTS		
Stand Alone	1,778,980	19,613
Total	1,778,980	19,613
MPF LOANS		
Fair Value	1,967,460	22,951
Stand Alone	5,155,000	48,417
Total	7,122,460	71,368
CO BONDS		
Fair Value	12,891,700	(55,238)
Cash Flow	1,425,000	(2,362)
Stand Alone	2,610,000	9,284
Total	16,926,700	(48,316)
DISCOUNT NOTES		
Cash Flow	1,710,000	123,550
Total	1,710,000	123,550
INTERMEDIARIES		
Stand Alone	55,911	86
Total	55,911	86
Total Notional	$45,079,129	-
Total Derivatives Excluding Accrued Interest		(236,083)
Accrued Interest at 12/31/01		55,201
Net Derivative Balance at 12/31/01		(180,882)
Net Derivative Asset Balance at 12/31/01		149,627
Net Derivative Liability Balance at 12/31/01		(330,509)
Net Derivative Balance at 12/31/01		$(180,882)

The following table categorizes the hedging activities 2001 earnings impact by product:

Earnings Impact	**Advances**	**CO Bonds**	**Investments**	**MPF Loans**	**Discount Notes**	**Total**
			(In Thousands)			
Net Margin (Amortization/Accretion)	$ 897	$(3,821)	-	-	$(1,094)	$ (4,018)
Other Income/(Expense)	23,128	9,252	$13,433	$6,102	11,081	62,996
Securities Held at Fair Value	-	-	(4,872)	-	0	(4,872)
Total	$24,025	$ 5,431	$ 8,561	$6,102	$ 9,987	$54,106

Note 16 - Segment Information

The Bank has identified two main operating segments; MPF Program and Traditional Member Finance based on its method of internal reporting. The products and services provided reflect the manner in which financial information is evaluated by management. The MPF Program income is derived primarily from the difference, or spread, between the yield on mortgage loans and the borrowing cost related to those loans. The Traditional Member Finance segment includes products such as advances, investments and consolidated obligations.

The following table sets forth the Bank's financial performance by operating segment for the years ended December 31, 2001, 2000 and 1999.

	MPF	Traditional Member Finance	Total
		(In thousands)	
2001			
Net interest income	$ 56,446	$ 153,898	$ 210,344
Provision for credit losses on mortgage loans	1,810	—	1,810
Other income	1,742	60,373	62,115
Other expenses	25,731	25,068	50,799
Income before assessments	30,647	189,203	219,850
Affordable Housing Program	2,502	15,494	17,996
REFCORP	5,629	34,849	40,478
Total assessments	8,131	50,343	58,474
Net income before extraordinary item	$ 22,516	$ 138,860	$ 161,376
2000			
Net interest income	$ 26,816	$ 185,413	$ 212,229
Provision for credit losses on mortgage loans	906	—	906
Other income	835	1,572	2,407
Other expenses	16,178	19,874	36,052
Income before assessments	10,567	167,111	177,678
Affordable Housing Program	863	13,492	14,355
REFCORP	1,941	30,358	32,299
Total assessments	2,804	43,850	46,654
Net income before extraordinary item	$ 7,763	$ 123,261	$ 131,024
1999			
Net interest income	$ 9,948	$ 158,587	$ 168,535
Provision for credit losses on mortgage loans	452	—	452
Other income	265	1,939	2,204
Other expenses	7,877	19,439	27,316
Income before assessments	1,884	141,087	142,971
Affordable Housing Program	—	12,464	12,464
Net income before extraordinary item	$ 1,884	$ 128,623	$ 130,507
2001			
Total mortgage loans, net	$16,570,308	$ —	$16,570,308
Average mortgage loans, net	$10,459,598	$ —	$10,459,598
2000			
Total mortgage loans, net	$ 8,102,680	$ —	$ 8,102,680
Average mortgage loans, net	$ 4,863,128	$ —	$ 4,863,128
1999			
Total mortgage loans, net	$ 1,618,768	$ —	$ 1,618,768
Average mortgage loans, net	$ 1,265,572	$ —	$ 1,265,572

Note 17 - Estimated Fair Values

Cash and Due From Banks - The estimated fair value approximates the carrying value.

Held-To-Maturity Securities - The estimated fair values of held-to-maturity securities have been determined based on quoted prices as of the last business day of the year when those prices are available. However, active markets do not exist for many types of financial instruments. Consequently, fair values for these instruments must be estimated using techniques such as discounted cash flow analysis and comparison to similar instruments. Estimates developed using these methods require judgments regarding significant matters such as the amount and timing of future cash flows and the selection of discount rates that appropriately reflect market and credit risks. Changes in these judgments often have a material effect on the fair value estimates.

Advances and Other Loans - For advances with fixed rates and more than three months to maturity, the estimated fair value has been determined by calculating the present value of expected cash flows from the advances. The discount rates used in these calculations are the replacement advance rates for advances with similar terms. Per the Finance Board regulations, advances with a maturity or repricing period greater than six months generally require a fee sufficient to make the Bank financially indifferent to the borrower's decision to prepay the advances. Therefore the estimated fair value of advances does not assume prepayment risk. For advances with floating rates and fixed rates with less than three months to maturity or repricing, the estimated fair value approximates the carrying value.

Mortgage Loans - The estimated fair values for mortgage loans have been determined based on quoted prices of similar mortgage loans available in the market. These prices, however, are highly dependent upon the prepayment assumptions that are used. Changes in the prepayment rates used often have a material effect on the fair value estimates. Since these estimates are made as of a specific point in time, they are susceptible to material near-term changes.

Accrued Interest Receivable and Payable - The estimated fair value approximates the carrying value.

Term Federal Funds Sold - The estimated fair value has been determined by calculating the present value of expected cash flows from the Federal funds. The discount rates used in these calculations are the rates for Federal funds with similar terms.

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

Term Deposits - The estimated fair value has been determined by calculating the present value of expected future cash flows from the deposits. The discount rates used in these calculations are the cost of deposits with similar terms.

Consolidated Obligations - Estimated fair value has been determined by calculating the present value of expected cash flows from the consolidated obligations. The discount rates used in these calculations are the replacement funding rates for liabilities with similar terms.

Borrowings - The estimated fair value has been determined by calculating the present value of expected future cash flows from the borrowings and reducing this amount for accrued interest payable. The discount rates used in these calculations are the cost of borrowings with similar terms.

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

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

Financial Instrument	Carrying Value	Net Unrecognized Gain or (Loss)	Estimated Fair Value
		(In thousands)	
Financial Assets			
Cash and due from banks	$ 2,099	$ —	$ 2,099
Securities purchased under agreements to resell	49,895	(1)	49,894
Federal funds sold	3,165,000	(73)	3,164,927
Held-to-maturity securities	5,254,416	28,691	5,283,107
Securities held at fair value	1,826,176	—	1,826,176
Advances to members	21,901,609	34,795	21,936,404
Mortgage loans, net	16,570,308	179,165	16,749,473
Accrued interest receivable	242,021	—	242,021
Derivative assets	149,627	—	149,627
Total financial assets	$ 49,161,151	$ 242,577	$ 49,403,728
Financial Liabilities			
Deposits	(1,760,216)	(541)	(1,760,757)
Securities sold under agreements to repurchase	(800,000)	6,015	(793,985)
Consolidated obligations:			
Discount notes	(8,995,376)	(4,327)	(8,999,703)
Bonds	(34,273,282)	(529,017)	(34,802,299)
Accrued interest payable	(446,532)	—	(446,532)
Derivative liabilities	(330,509)	—	(330,509)
Commitments to extend credit	—	(13,878)	(13,878)
Total financial liabilities	$ (46,605,915)	$ (541,748)	$(47,147,663)

With the adaption of SFAS 133 in 2001, the Bank has reflected fair value changes of financial assets and liabilities associated with effective hedge relationships in earnings during the year and has adjusted the 2001 carrying values of the financial assets and liabilities accordingly. As a result of the implementation of SFAS 133, the 2001 and 2000 fair value tables are not comparable.

The carrying value and estimated fair values of the Bank's financial instruments at December 31, 2000 were as follows:

Financial Instrument	Carrying Value	Net Unrealized Gain or (Loss)	Estimated Fair Value
		(In thousands)	
Financial Assets			
Cash and due from banks	$ 4,194	$ —	$ 4,194
Securities purchased under agreements to resell	45,685	(6)	45,679
Federal funds sold	2,397,000	(309)	2,396,691
Held-to-maturity securities	5,776,876	(23,027)	5,753,849
Derivative financial instruments associated with held-to-maturity securities	2,720	3,866	6,586
Held-to-maturity securities, net	5,779,596	(19,161)	5,760,435
Advances to members	18,462,230	109,101	18,571,331
Derivative financial instruments associated with advances to members	58	(100,218)	(100,160)
Advances to members	18,462,288	8,883	18,471,171
Mortgage loans	8,103,851	96,419	8,200,270
Allowance for credit losses	(1,503)	1,503	—
Hedges on mortgage loans	332	(8,292)	(7,960)
Mortgage loans, net	8,102,680	89,630	8,192,310
Accrued interest receivable	578,352	—	578,352
Total financial assets	$ 35,369,795	$ 79,037	$ 35,448,832
Financial Liabilities			
Deposits	(2,010,132)	(524)	(2,010,656)
Consolidated obligations:			
Discount notes	(4,948,713)	1,110	(4,947,603)
Bonds	(25,949,504)	(244,062)	(26,193,566)
Derivative financial instruments associated with consolidated obligation bonds	(3,631)	(441)	(4,072)
Consolidated obligations, net	(30,901,848)	(243,393)	(31,145,241)
Accrued interest payable	(664,059)	—	(664,059)
Derivative financial instruments in which the Bank is an intermediary, net	(47)	294	247
Commitments to extend credit	—	80	80
Hedges of commitments to extend credit	—	(113)	(113)
Total financial liabilities	$ (33,576,086)	$ (243,656)	$(33,819,742)

The following table categorizes derivative financial instruments as non-cancelable, cancelable by counterparty, and cancelable by the Bank at December 31, 2000:

Total by Class Type of Interest Rate Exchange Agreements	Notional Amount	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
			(In thousands)		
Interest rate swaps:					
Non-cancelable:					
Bank pays fixed, receives variable	$ 9,330,781	$ 513	$ 14,053	$ (65,115)	$ (50,549)
Bank pays variable, receives fixed	14,561,328	(3,837)	143,278	(135,833)	3,608
Bank pays variable, receives variable	408,259	5,617	18,903	(7,415)	17,105
Cancelable by counterparty					
Bank pays fixed, receives variable	4,844,728	(3,428)	11,349	(62,545)	(54,624)
Bank pays variable, receives fixed	2,107,000	(664)	7,764	(25,880)	(18,780)
Bank pays variable, receives variable	180,000	—	—	(2,431)	(2,431)
	31,432,096	(1,799)	195,347	(299,219)	(105,671)
Interest rate caps purchased	940,000	2,506	—	(2,089)	417
Interest rate floors purchased	240,000	2	72	—	74
Interest rate caps sold	125,000	(1,607)	1,233	—	(374)
Forward and futures contracts	2,820,000	332	57	(304)	85
Total	$35,557,096	$ (566)	$ 196,709	$ (301,612)	$ (105,469)

Note 18 - Commitments and Contingencies

Commitments which legally bind and unconditionally obligate the Bank for additional advances totaled $5,000,000 at December 31, 2000. There were no advance commitments at December 31, 2001. Commitments generally are for periods up to 12 months. Outstanding standby letters of credit were approximately $374,000,000 and $463,000,000 at December 31, 2001 and 2000, respectively. Letters of credit are fully collateralized at the time of issuance, in a manner consistent with advances to members (Note 7).

Commitments which unconditionally obligate the Bank to fund/purchase mortgage loans totaled approximately $979,494,000 and $148,145,000 at December 31, 2001 and 2000 respectively. Commitments are generally for periods not to exceed forty-five business days.

The Bank generally executes interest rate exchange agreements with those counterparties with a rating of single-A or better by either Standard & Poor's or Moody's and generally enters into bilateral collateral agreements. As of December 31, 2001 and 2000, the Bank had pledged as collateral securities with a fair value of $187,895,000 and $181,025,000, respectively, to counterparties who have market risk exposure from the Bank related to interest rate exchange agreements.

Net rental costs for premises and equipment were approximately $3,000,000, $3,029,000, and $2,518,000 for the years ended December 31, 2001, 2000 and 1999, respectively. Future minimum rentals are as follows:

Year	Premises	Services and Equipment	Total
		(In thousands)	
2002	$ 2,126	$ 194	$ 2,320
2003	2,652	172	2,824
2004	2,778	147	2,925
2005	2,910	89	2,999
2006	3,116	25	3,141
Thereafter	16,689	—	16,689
Total	$ 30,271	$ 627	$ 30,898

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

As described in Note 12, all FHLBs have joint and several liability for the consolidated obligations issued by each Bank. Accordingly, should one or more of the FHLBs be unable to repay their participation in the consolidated obligations, the other FHLBs could be called upon to repay a portion of such obligations. The Bank has a contingent liability for consolidated obligations of other FHLBs of $593,865,545,000 and $583,235,798,000 and for the years ended December 31, 2001 and 2000, respectively.

As of December 31, 2001, the Bank was not subject to any pending legal proceedings arising in the normal course of business.

Report of Independent Accountants

To the Board of Directors and Shareholders of
the Federal Home Loan Bank of Chicago

In our opinion, the accompanying statements of condition and the related statements of income, capital and of cash flows present fairly, in all material respects, the financial position of the Federal Home Loan Bank of Chicago at December 31, 2001 and 2000, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Bank's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Also, in accordance with those standards and as part of our audit of the Bank's financial statements, we issued a separate report on compliance and on internal control over financial reporting. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As explained in Note 1, the Federal Home Loan Bank of Chicago changed their method of accounting for REFCORP payments during the year ended December 31, 2000. For the years ended December 31, 2001 and 2000, the REFCORP payments have been recorded as an expense in the statements of income. During the year ended December 31, 1999 REFCORP payments were recorded as deductions from capital. As discussed in Note 1, the Federal Home Loan Bank of Chicago adopted Statement of Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended by Statement of Accounting Standards No. 138, on January 1, 2001.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental disclosure appearing below the statement of income is presented for purposes of additional analysis and is not a required part of the basic financial statements.

February 12, 2002
Chicago, Illinois

Management Report of Responsibility for Financial Reporting

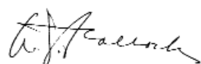
The management of the Federal Home Loan Bank of Chicago (the Bank) prepared the financial statements contained in the Annual Report in accordance with generally accepted accounting principles. Management has primary responsibility for the integrity and objectivity of the financial statements, which include amounts that are based on management's best estimates and judgements. Other information in the Annual Report is consistent with that contained in the financial statements.

The Bank's financial statements have been audited by PricewaterhouseCoopers LLP. Management has made available to PricewaterhouseCoopers LLP all the Bank's financial records and related data, as well as the minutes of Directors' meetings. The report of the independent accountants expresses an opinion as to the fair presentation of the financial position, results of operations, and cash flows of the Bank based on their audit conducted in accordance with generally accepted auditing standards.

Management of the Bank has established and maintains an internal control structure designed to provide reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use or disposition, and the prevention and detection of fraudulent financial reporting. The internal control structure provides for appropriate division of responsibility and is documented by written policies and procedures that are communicated to employees. Management monitors the internal control structure for compliance, adequacy, and cost effectiveness. Management believes that as of December 31, 2001 the Bank's internal control structure is adequate to accomplish these objectives.

The Bank maintains an internal auditing program that independently assesses the internal control structure and recommends possible improvements to it. The Audit Committee of the Board of Directors is composed of five directors and oversees the Bank's financial reporting and internal control structure. The Audit Committee of the Board meets periodically with management, internal auditors and independent public accountants to review matters relating to financial accounting and reporting policies and control procedures. Both PricewaterhouseCoopers LLP and Internal Audit have full access, with or without management present, to the Audit Committee.

Management's objective is to foster a strong ethical climate so that the Bank's affairs are conducted according to the highest standards of personal and corporate conduct.



Alex J. Pollock
President and Chief Executive Officer

Roger D. Lundstrom
Senior Vice President

Audit Committee Report

February 19, 2002

The Audit Committee of the Board of Directors of the Federal Home Loan Bank of Chicago for 2001 was composed of six outside Directors. The members of the Audit Committee at December 31, 2001 were: Raymond S. Stolarczyk, Michael D. Meeuwsen, Karl S. Pnazek, H. Lee Swanson Douglas J. Timmerman, and Timothy W. Wright.

This report is submitted by the 2002 Audit Committee, whose members are listed below. Both the 2001 and 2002 Audit Committee members are independent, as defined by the Federal Housing Finance Board.

The Audit Committee oversees the Bank's financial reporting process; oversees Internal Audit's review of compliance with laws, regulations, policies and procedures; and oversees Internal Audit's evaluation of the adequacy of administrative, operating, and internal accounting controls. The Audit Committee has adopted and is governed by a written charter, and satisfied its responsibilities during 2001 in compliance with the charter. The Audit Committee has reviewed and discussed the audited financial statements with management. The Committee has discussed with the independent auditors the matters required to be discussed by SAS No. 61 and SAS No. 90, Audit Committee Communications. The Committee has also received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1, and has discussed with the auditors the auditor's independence.

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

Michael D. Meeuwsen, Chairman
Karl S. Pnazek, Vice Chairman
Kathleen E. Marinangel
H. Lee Swanson
Douglas J. Timmerman

Charter for the Audit Committee of the Board of Directors

1.0 OBJECTIVE

The objective of the Audit Committee is to assist the Board of Directors in fulfilling its fiduciary responsibilities regarding the financial statements and reports of the Bank, internal controls, and compliance with laws, regulations and policy.

2.0 RESPONSIBILITIES AND SPECIFIC DUTIES

2.1 The Audit Committee is responsible for:

- Facilitating communication between the Board of Directors and the Bank's internal auditors, external auditors and Federal Housing Finance Board examiners.
- Reviewing and approving annual audit plans of the internal and external auditors.
- Monitoring the accomplishment of audit plans.
- Reviewing and approving audited Bank financial statements and financial statement disclosures.
- Determining that no restrictions are imposed upon audit scope.
- Reviewing key accounting policies.
- Reviewing security for computer systems, facilities, and back-up systems.
- Reviewing management's response to audit findings and reports.
- Reviewing implementation by management of corrective actions.
- Overseeing any investigation of conflicts of interest and unethical conduct.
- Overseeing the selection, compensation, and performance evaluation of the Director of Internal Audit.
- Reviewing and approving the Charters of the Audit Committee, the Internal Audit Department and the Director of Internal Audit at least annually.

2.2 The above responsibilities of the Audit Committee will be discharged through discussions with the internal and external auditors and Bank management and review of audit reports.

2.3 The responsibility of the Audit Committee is limited to matters upon which the Board of Directors has the authority to make a final determination.

2.4 The Committee may retain independent outside counsel upon determination that such action is necessary to properly discharge its responsibilities and duties.

2.5 The Committee's duties do not include planning or conducting audits or determining that the Bank's financial statements are complete and accurate and are in accordance with generally accepted accounting principles. These are the responsibilities of the Director of Internal Audit and management, respectively. Nor is it the duty of the Committee to conduct investigations, to resolve disagreements, if any, between management and the Director of Internal Audit or to assure compliance with laws, regulations or the Bank's Code of Ethics, although the Committee may provide policy oversight of such matters.

3.0 MEMBERS, OFFICERS AND TERMS

3.1 Chairman. A Chairman and a Vice-Chairman of the Committee shall be designated by the Board from time to time, but at least annually. In the event of the absence of the Chairman of the Committee, the Vice-Chairman of the Committee shall act as Chairman.

3.2 Members and Terms. The Committee shall be composed of no less than five Board members. The other members of the Committee (i) shall be chosen from among the remaining directors of the Board, (ii) shall include elective and appointive directors and (iii) shall serve such terms as may, from time to time, be set by the Board. In determining membership of the Committee, the Board will provide for continuity of service.

3.3 Staff. The Director of Internal Audit shall serve as staff to the Committee, and shall conduct such studies, and analyses and make such presentations as the Committee needs to carry out its responsibilities.

4.0 MEETINGS

4.1 Meetings. The Committee shall establish its own procedures and shall meet in accordance with such procedures.

4.2 Required Meetings. The Committee shall meet at least twice annually with the Director of Internal Audit and the external auditors. The Committee shall meet in executive session at its discretion with such participants as it may determine, as often as it desires.

4.3 Telephone Meeting. A Committee meeting may be conducted by conference telephone.

4.4 Special Meeting. The chairman of the Committee or the President & Chief Executive Officer may call a special meeting of the Committee upon not less than one day's notice to the members of the Committee.

4.5 Quorum. At any meeting of the Committee, a majority of the Committee shall constitute a quo rum and the affirmative vote of a majority of that quorum shall be necessary to pass any resolution.

4.6 Minutes. Minutes of all meetings of the Committee will be submitted to the Board of Directors and be signed by the chairman of the Committee. The minutes of the meetings shall contain a record of the persons present, significant matters discussed, and resolutions adopted. Minutes of meetings of the Committee shall be preserved by the Bank in minute books in the custody of the Bank's Corporate Secretary. A copy of all minutes shall be forwarded to the Federal Housing Finance Board.

Approved by the Board of
Directors this 20th day
of March, 2001.