

# Chicago Federal Home Loan Bank



Annual Report **2002**

# Mission Statement

The Chicago Federal Home Loan Bank's Mission is:

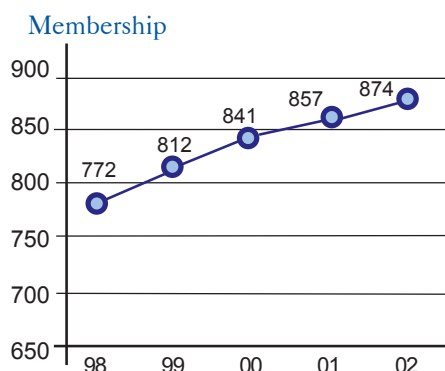
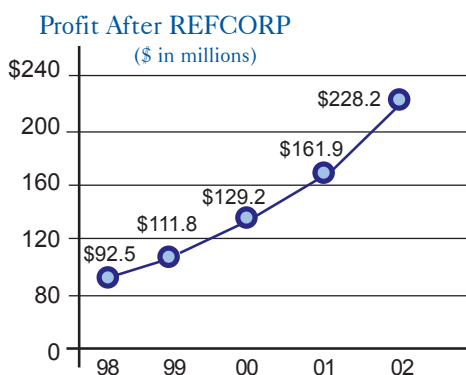
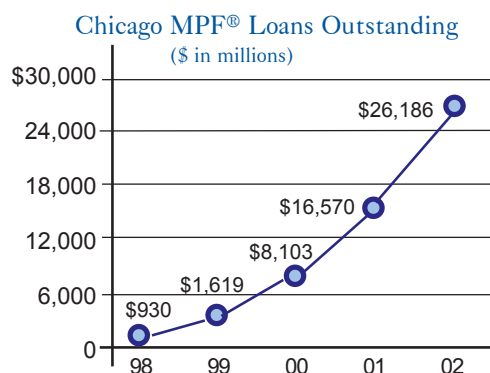
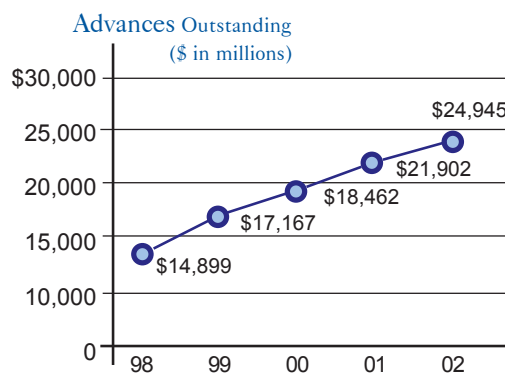
To promote housing finance, in partnership with member financial institutions which provide sound and economical home financing, throughout America and in all phases of financial and economic cycles; and

To provide liquidity, funding, and asset-liability management capability to member institutions on a secured basis with minimal credit risk to the FHLB, and to assist them to provide affordable housing and economic development in their communities.



# Financial Highlights

	<u>2002</u>	<u>2001</u>	<u>2000</u>
(\$ in thousands)			
Total Members	874	857	841
Advances Outstanding	\$24,945,112	\$21,901,609	\$ 18,462,288
MPF® Loans Outstanding	\$26,185,858	\$16,570,308	\$ 8,102,680
Total Housing Finance Related Assets	\$56,648,648	\$43,425,895	\$ 31,445,613
Total Assets	\$65,046,147	\$49,194,194	\$ 35,388,778
Total Capital	\$ 3,358,773	\$ 2,502,784	\$ 1,701,268
Net Income Before REFCORP	\$ 285,241	\$ 202,427	\$ 161,453
Net Income After REFCORP	\$ 228,192	\$ 161,949	\$ 129,154
Average Annual Dividend Rate	5.25%	6.34%	7.47%
Dividend Spread Over Average One-Year LIBOR	2.41%	0.75%	1.01%
Net Interest Income to Average Assets	0.75%	0.53%	0.66%
Operating Expenses to Average Assets	0.09%	0.10%	0.09%
Equity to Total Assets	5.16%	5.09%	4.81%



# To Our Members



*Alex J. Pollock*

We are pleased to report that 2002 was another very successful year for the Chicago Federal Home Loan Bank. Net income after REFCORP payments grew 40.9% to \$228.2 million, up from \$161.9 million last year. Net income before REFCORP was \$285.2 million, up from \$202.4 million.

Strong earnings enabled us to provide members with an attractive average dividend of 5.25%. This rate was 241 basis points over the moving average of one-year LIBOR, which exceeded our goal of 0.75% or more over this moving average. Please note that for 2003 and forward, we have changed the dividend schedule as part of our Capital Plan. Dividends will now be declared after the end of each quarter, and paid to members in February, May, August, and November.

Financial institutions throughout Illinois and Wisconsin continued to pursue membership in the Chicago FHLB, although mergers among members continued to slow growth in membership totals. In 2002, 40 financial institutions became members. Total membership at year-end stood at 874 thrifts, commercial banks, credit unions, and insurance companies, an all-time high.

Credit customers — members that have used an advance, a letter of credit, a hedging product, or funded loans through the Mortgage Partnership Finance® Program during the year — ended the year at 674 institutions, or 77% of membership. Advances outstanding

reached a record high, ending the year at \$24.9 billion, up 13.9% from \$21.9 billion in 2001.

Last June, the MPF® Program celebrated its fifth birthday. The Program has continued to grow rapidly as more member institutions recognize its benefits. At year-end, total outstanding loans for the Program nationwide were \$41.7 billion, up \$24.8 billion from 2001, producing a growth rate of 68%. Total participating financial institutions (PFIs) rose to 437 members while Chicago FHLB PFIs increased 27% to 167. With loans in all 50 states, the MPF Program has become a nationwide business.

Under the new MPF Shared Funding™ program, which closed its first transaction in March, 2003, MPF loans will become high quality securities which can be offered to members and other Federal Home Loan Banks. By creating liquid, negotiable assets, this program will allow us to better manage the assets that the MPF Program's success has generated.

The Chicago FHLB's new Capital Plan was approved by the FHFBI in June 2002. Scheduled for implementation in 2004, our Capital Plan will provide a solid base for the future, as well as allowing our members to choose what risk-return combination is best for them. The plan, structured to minimize tax and accounting issues for members, establishes two classes of stock: Class A, conditionally redeemable on six months' notice, and Class B, conditionally redeemable

# and Customers

on five years' notice. Although both classes of stock will be issued and redeemed at par of \$100, Class A has features similar to preferred stock, such as dividend and liquidation preferences, while Class B stock will be common stock, the junior position with higher return potential.

Our Community Investment and Affordable Housing Programs continued their success. Over 27% of our members participated in the Community Investment Programs in 2002. Members used over \$322.5 million in new CICA credit for housing and economic development initiatives. We awarded over \$17 million in competitive AHP grants to 99 member-sponsored projects in order to create more than 3,400 units of affordable housing, of which 1,900, or 55%, were targeted for very low income units. In addition, \$4.5 million in Downpayment Plus<sup>®</sup> funds helped families and individuals throughout Illinois and Wisconsin realize their dreams of homeownership.

Computer technology continues to play an important part in our business. eBanking, our customer-specific report website has seen rapid success. Over 85% of our members use the site to obtain information. This has allowed us to become more cost-effective and beneficial to our members. eMPF<sup>™</sup>, our transactional website for the MPF Program, continued to operate at a high level of sophistication and efficiency and will offer users the ability to price delivery commitments online.

In order to insure a mission-consistent balance sheet, we maintain a ratio of housing/mission-related assets to consolidated obligations of at least 85%. At year-end, this ratio was 101%.

Our strategic goals continue to guide the growth and development of the Chicago FHLB. They are:

1. A sustainable dividend of 0.75% or more over the moving average of one-year LIBOR.
2. Return on equity above the System average, while making strategic research and development investments.
3. Continuous flow of new products, new ideas, and new marketing and community investment programs.
4. Excellent service as perceived by customers.
5. Continued addition of new members and rapid growth in members participating in MPF.
6. Maintain high market penetration and rapid growth in MPF market penetration.
7. Truly AAA/Aaa quality.
8. Total control of every aspect of the business.
9. Continuous focus on productivity enhancement and cost effective new methods.
10. Continuous increase in skills, knowledge, and competence.
11. High energy.
12. An intellectual and managerial leader of the System.

As always, we are especially proud of our strong relationships with our members as we strive to be your strategic partner for housing finance. Thank you for the success the Chicago FHLB has enjoyed. We look forward to continuing our progress through 2003 and beyond.



Alex J. Pollock  
President and CEO

# 2002 Board of Directors



*Douglas J. Timmerman*  
Chairman



*Richard W. Graber*  
Vice Chairman

Douglas J. Timmerman, Chairman  
Chairman, President and Chief Executive Officer  
AnchorBank, F.S.B.

Richard W. Graber, Vice Chairman  
Attorney  
Reinhart Boerner Van Deuren sc

James K. Caldwell  
President and Chief Executive Officer  
The First Citizens State Bank of Whitewater

Terry W. Grosenheider  
Private Banking Relationship Manager  
U.S. Bank, N.A.

Scott K. Heitmann  
Vice Chairman  
LaSalle Bank N.A.

Leslie Ann Howard  
President and CEO  
United Way of Dane County

Allen H. Koranda  
Chairman and Chief Executive Officer  
Mid America Bank, fsb

P. David Kuhl  
Chairman and Chief Executive Officer  
Busey Bank Urbana

C. William Landefeld  
President and Chief Executive Officer  
Citizens Savings Bank

Kathleen E. Marinangel  
CEO/President and Chairman  
McHenry Savings Bank

Michael D. Meeuwsen  
President and CEO  
First Northern Savings Bank, SA

Karl S. Pnazek  
President and CEO  
CAP Services, Inc.

H. Lee Swanson  
Chairman and Chief Executive Officer  
State Bank of Cross Plains

Mindy W. Turbov  
President  
Turbov Associates

Sarah D. Vega  
Director  
Illinois Department of Financial Institutions

# MPF

## Circle of Value

The Mortgage Partnership Finance® Program celebrated its fifth anniversary in 2002. The Program continued to grow rapidly and gain market share over the year, while announcing several new initiatives. Each addition to the Program is designed to further the goal of increasing competition and efficiency in the secondary mortgage market to benefit mortgage lenders and American homebuyers.

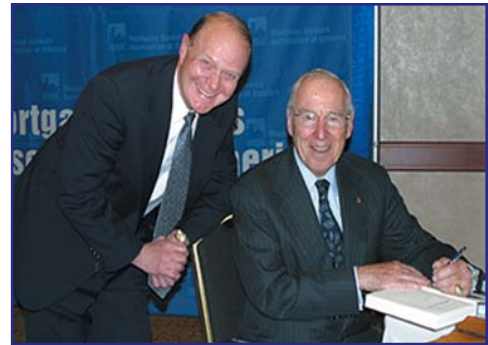
MPF® Program loans outstanding grew 68% during 2002, after growing 61% in 2001, ending the year at \$41.7 billion, up from \$24.8 billion. The Program also experienced single-day fundings of more than \$1 billion on several occasions, reflecting increasing demand.

The MPF Program creates a partnership in which lenders share the risks of the fixed-rate mortgages they originate with their regional Home Loan Bank. The credit risk and the customer relationship of the loans are managed by the Federal Home Loan Bank (FHLB) member lender while the FHLB handles the funding, interest rate, liquidity, and prepayment risks.

MPF loans have been funded in all 50 states, Washington, D.C., and Puerto Rico. Both conventional and FHA/VA-insured loans are eligible for the Program.

More than \$60 billion of mortgages have been funded through the MPF Program since its inception in 1997, helping more than 475,000 families buy a new home or lower the cost of their existing home. The Program has gained widespread acceptance in the mortgage market and has become the market of choice for many members of the Chicago FHLB.

The number of FHLB member commercial banks, thrifts, credit unions, and insurance companies participating in the Program also increased rapidly. By year-end,



*Chicago FHLB President and CEO Alex Pollock with astronaut James Lovell at the MBA Conference in November, 2002.*

437 Participating Financial Institutions (PFIs) were approved to fund MPF loans, a 55% increase from 2001. More than 130 members are in the process of joining the Program. More than 75% of PFIs have assets of less than \$500 million, as MPF has proven very popular.

“The continued growth of the MPF Program reflects the strong demand of FHLB members for a better method of funding their customers’ home loans,” said Alex J. Pollock, President and Chief Executive Officer. “With MPF, lenders are paid to manage the credit risk and customer relationships of the loans they make, while FHLB funding solves the interest rate and prepayment problem posed by fixed-rate mortgages.”

The median size of an MPF Program loan is \$117,852. The credit performance of the loans has been excellent, with only 0.10% of conventional loans more than 90 days’ delinquent, compared to the fourth quarter 2002 national average for fixed-rate conventional loans of 1.02%. The high credit quality of an MPF loan is a primary component of the Program.

# MPF Circle of Value

## Global Bond Issues

Several new developments related to the MPF Program were announced during 2002. In response to the MPF Program's rapid growth, we issued 10-year global bonds to fill a natural need for longer-term funding. Two bond issues of \$3 billion each were offered, in May and November. Both were very well received by domestic and foreign investors and have since traded better than comparable bonds.

## Alliance with the American Bankers Association

In November, a strategic marketing alliance with the American Bankers Association was announced to develop a program allowing smaller community mortgage lenders to better compete in the mortgage market. Under the program, which became available to members in March, 2003, participating community banks have improved access to the MPF Program, resulting in larger volume and wider geographic representation. The structure will permit participating banks to receive additional fee income and added value for their MPF loans. All FHLB member PFIs are eligible to participate.

"This alliance is an ideal fit for the ABA and our member banks," said Donald G. Ogilvie, ABA President and CEO. "Our mission is to enhance the profitability of our members, and this new program does just that – it gives banks an alternative that allows them to compete more effectively in the mortgage markets."

## MPF Online

eMPF® continues to grow in scope and popularity. Many PFIs around the United States now choose to send their files to Chicago via the web, thus reducing time, effort, and cost in processing. During 2003, eMPF will be offering live pricing on-line.

## MPF Shared Funding™

Another significant announcement was made in December when the Federal Housing Finance Board approved the Chicago FHLB's request to create a new risk management structure as part of the MPF Program, called the MPF Shared Funding™ program. The first transaction was completed in March 2003. This new addition to the MPF Program creates high quality mortgage securities for investment by FHLBs and their members as assets with very desirable risk characteristics.

As with all elements of the MPF Program, the Shared Funding structure is designed to retain more of the eco-



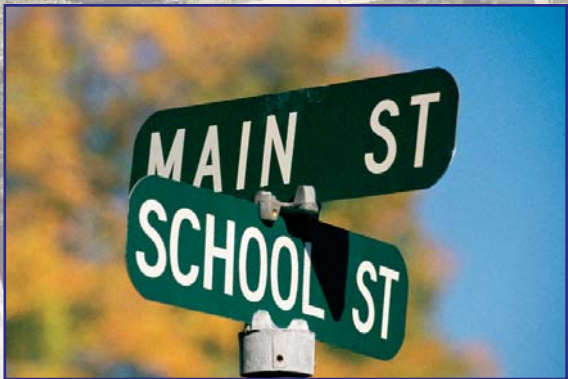
omic value of mortgage finance transactions within the FHLBs and their member financial institutions.

American homebuyers and mortgage lenders will benefit from shared funding by:

- Increased competition and member choice.

Shared Funding is a complementary risk management structure that delivers the same benefits and value of the original MPF Program to FHLBs as core mission assets, or for FHLB members, as assets with desirable risk characteristics. MPF Shared Funding, developed in response to the rapid growth and success of the

The continued growth of the MPF Program reflects the strong demand of FHLB members for a better method of funding their customers' home loans.



# MPF Circle of Value

MPF Program, maintains the principles and focus of the MPF Program and retains the maximum value of mortgage transactions within the FHLB System and its member financial institutions.

- A new alternative.

MPF Shared Funding transactions differ from mortgage-backed securities issued by the other housing GSEs in two essential ways:

1. The FHLBs do not guarantee the credit of MPF Shared Funding certificates, and new credit risk is not assumed by the FHLBs; and
2. Shared Funding certificates are not publicly offered. The FHLBs deal only with their member financial institutions and other FHLBs.

- Strengthens the financial flexibility and safety and soundness of the FHLB System.

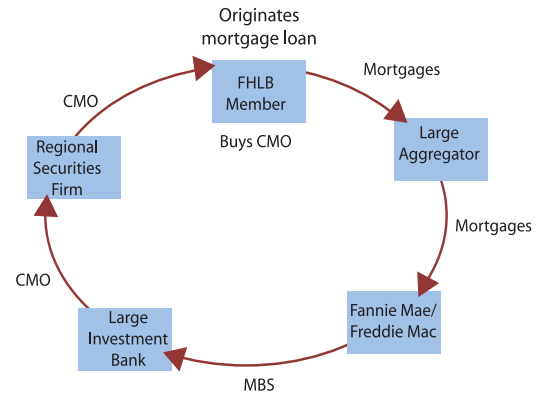
A variety of hedging techniques are currently used by the FHLBs to indirectly transfer the interest rate and prepayment risks of MPF loans to counterparties. MPF Shared Funding creates a complementary risk management tool, increasing the safety and soundness of the FHLBs.

- Increased value of FHLB membership.

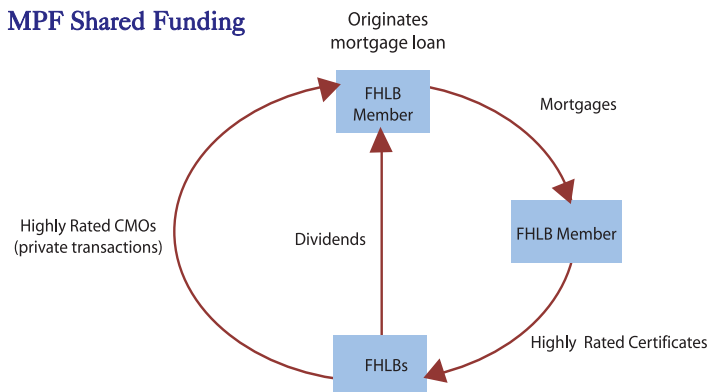
MPF Shared Funding creates a new mortgage asset product, increasing the ability of FHLB members to better serve their customers. Historically, FHLBs have offered their members only liability products, such as advances. MPF Shared Funding provides members with high-quality mortgage assets suitable for their asset-liability needs.

## Circle of Value

### Traditional Transaction



### MPF Shared Funding



- Retained Value in the FHLB System.

MPF Shared Funding retains more of the economic value of mortgage finance transactions within the FHLBs and their member institutions, creating a more efficient “circle of value.”

### What are industry experts saying?

The competition provided by the MPF Program has attracted the attention of mortgage market observers. In a September 2002 report from Wall Street investment firm Fox-Pitt, Kelton, Inc. entitled, “GSE Competition – An Update”, describes the MPF Program as having a

# Credit and Technology

noticeable impact on the secondary mortgage market. They note that it has “continued to grow in the first half of 2002, building on the momentum that began in earnest in 2001”, and that the program has “gained market share of conventional originations and conventional mortgage debt outstanding.”

## Advances at Record High

The year 2002 also saw an all-time high in advances outstanding, ending the year at \$24.9 billion, up 13.9% from 2001. Advances have increased over 67.4% over the last five years. Members have realized that the Chicago FHLB can meet an important part of their liquidity and asset/liability management needs.

Credit customers — members that have used an advance, a letter of credit, an off-balance sheet product, or funded loans through the MPF Program during the year — were 674 institutions, or 77% of average members.

## eBanking — Technology at the Forefront

The Chicago FHLB’s report-generating website, eBanking, located at [www.fhlbc.com](http://www.fhlbc.com), grew in offerings, as well as users in 2002. By year-end, over 85% of members were using the site to access their statements and reports. Currently, the following reports are available:

- Cash Management Statement (transaction details, running balances),
- Monthly Summary Statement (total advance/interest balances, stock, safekeeping and other balances),
- Demand Deposit Account Statement Monthly (checking information),
- Daily Wire Statement (incoming/outgoing wire details),

- ACH Advices (daily check clearing through the Federal Reserve Bank),
- Paid Checks Report (checking information),
- Statement of Respondents Activity (Federal Reserve Bank information),
- Safekeeping P&I Statement (principal and interest),
- Safekeeping Statement Monthly (safekeeping balances or month-end),
- Capital Stock Statement (quarterly stock and dividend balances and payments),
- Customer Profile Daily (summary of advances, letters of credit, deposits, MPF activity, stock, and more),
- Customer Profile Prior Month End (prior month-end version of the Daily Profile),
- Customer Profile Quarter End (four quarters of quarter-end Profile data),
- Customer Advances by Maturity (detailed balances), and
- Market Value Indications (market value of advances).

Many of these reports were once mailed to members at more cost and less speed. eBanking has eliminated those costs, while giving members the ability to access their reports at any time . . . free of course!

The Chicago FHLB continues to remain at the top of what technology has to offer. Great strides have been made in security and back-up systems. From improvements at the Chicago FHLB’s Business Recovery Center (located outside the city), to intense firewall and security measures, the Chicago FHLB is geared up to keep the flow of communication open between members and our information systems.

The Many  
Benefits of

# Community



The Downpayment Plus Program allows all members to provide downpayment and closing cost assistance grants when they provide mortgage financing to income-eligible first-time home buyers.

# Investment

The Chicago FHLB continues to offer members a wide variety of Community Investment programs, including advances, letters of credit, Affordable Housing grants, and downpayment assistance. Members can strengthen their community reinvestment activities by taking advantage of subsidy and grant programs, lower rate financing products, and by seeking technical assistance for community development financing, ranging from affordable housing to industrial activities. Members used over \$322.5 million in new CICA credit for housing and economic development initiatives.



The Community Investment Cash Advances offer below market rate advances to finance qualifying community lending projects. These advances are generally priced below regular Chicago FHLB advances and are available for terms ranging from one month to 10 years. Members can, in turn, lend these funds to homebuyers, for-profit, not-for-profit, or public developers of housing, economic development projects, community facilities, and infrastructure.

New to the program is the Community Economic Development Advance (CEDA) Program which provides

advances for community economic development projects, including but not limited to commercial development, industrial and/or manufacturing activities, community facilities, public infrastructure projects, Brownfield development, and small business development and/or expansion.

## The Affordable Housing Program

The Affordable Housing Program (AHP) provides grants to member institutions to assist in the creation and preservation of housing for lower income families and individuals. The Chicago FHLB contributes 10% of its net income to the AHP fund. Members have access to funds through a competitive application process conducted twice a year, in April and October.

In 2002, the Chicago FHLB awarded over \$17 million in competitive AHP grants to 99 member-sponsored projects in order to create more than 3,400 units of affordable housing, of which 1,900, or 55%, were targeted for very low income units.

Since 1996, the FHLB Chicago has dedicated up to 15% of its AHP funds for a special homeownership program, the Downpayment Plus<sup>®</sup> Program, that is not part of the competitive AHP process. The Downpayment Plus Program allows all Chicago FHLB members to provide downpayment and closing cost assistance grants when they provide first mortgage financing to income-eligible home buyers.

During 2002, \$4.5 million in Downpayment Plus funds helped families and individuals throughout Illinois and Wisconsin realize their dreams of homeownership.

Over 27% of our members participated in the Community Investment Programs in 2002.

# Case Study

## Busey Bank, Urbana, Illinois

### P. David Kuhl, Chairman of the Board and CEO

Busey Bank has been a member of the Chicago FHLB since 1992, making the institution one of the very early commercial banks to join. Since then, Busey Bank, and its President and CEO, P. David Kuhl, have been active in using advances, letters of credit, MPF®, and community investment. Busey Bank has applied, and been approved for Affordable Housing projects as well.

“Joining the Chicago FHLB has been a tremendous investment for Busey Bank,” said Mr. Kuhl. “Over the years, we have utilized most of the products the FHLB offers. Their advances have been extremely beneficial for us. We have used the community investment advances for many of projects and have found the rates to be very competitive.”

In 2000, Busey Bank became a Participating Financial Institution in the Chicago FHLB’s MPF® Program. Since then, Busey Bank has funded mortgage loans through the Program.

“The MPF Program has proven to be a well-thought out alternative for us,” commented Mr. Kuhl. “Competition is good for the industry, and the MPF Program has added a much needed shot in the arm for the mortgage business.”

Busey Bank has been a large supporter of the competitive grant program in Affordable Housing. Over the years, Busey Bank has applied and been approved for multiple projects. They are also a user of the Downpayment Plus® Program.

Mr. Kuhl is a member of the Chicago FHLB’s Board of Directors.

“Competition is good for the industry, and the MPF Program has added a much needed shot in the arm for the mortgage business.”



# Case Study

“Without the MPF Program, we would not have been able to compete the way we do today. It has been a tremendous success for us.”

**Wisconsin State Bank, Random Lake, Wisconsin**

**Jeffrey A. Mueller, President and CEO**

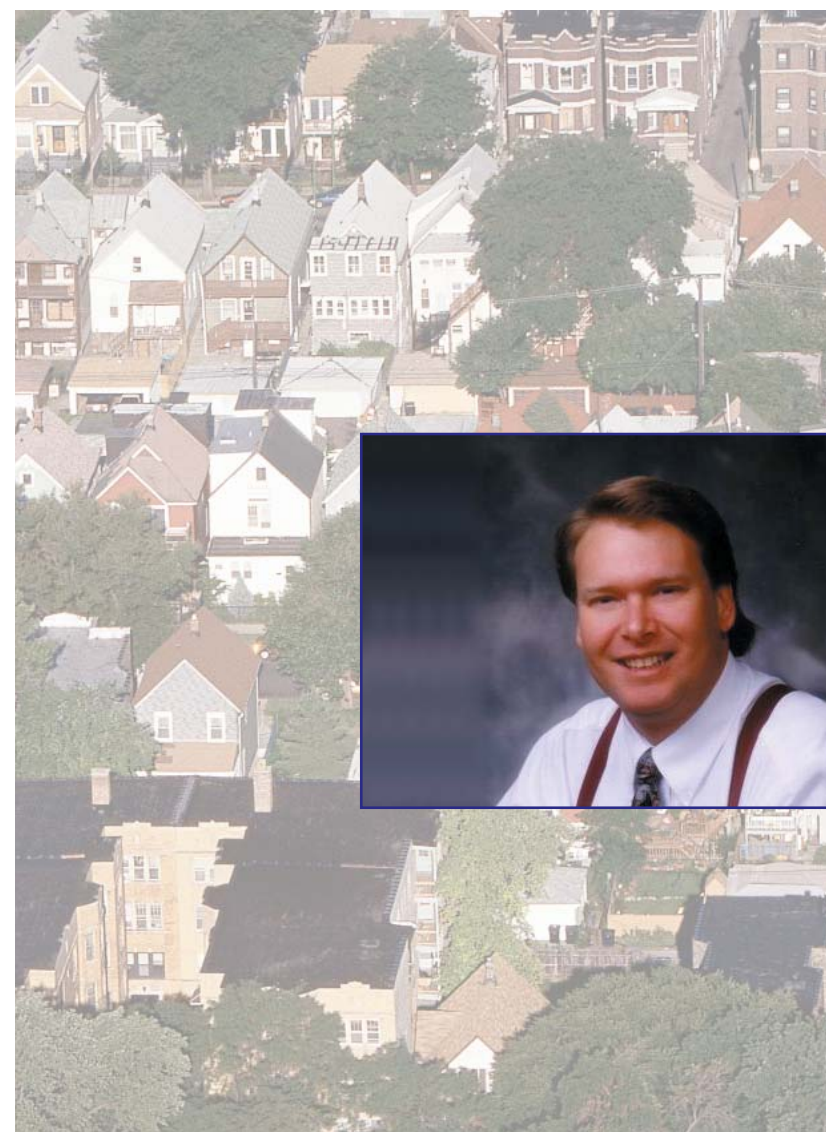
Wisconsin State Bank has been a member of the Chicago FHLB since 1995. They have been a strong user of advances ever since joining, utilizing several advance products and taking advantage of the periodic specials the Chicago FHLB offers members.

In 2001, Wisconsin State Bank became a PFI in the MPF Program. Since then, they have opened multiple master commitments and have delivered hundreds of loans.

“MPF has allowed us the opportunity to offer and retain servicing of fixed rate mortgages for our community,” said Jeffrey Mueller, President and CEO. “Even though we are located in eastern Wisconsin, we have branches over large areas of our state, and we have been able to offer mortgages throughout the southern half of Wisconsin thanks to the MPF Program.”

Mr. Mueller is quick to point out that his institution has reaped large benefits from the MPF Program. “Without the MPF Program, we would not have been able to compete the way we do today. It has been a tremendous success for us. We are originating the highest quality mortgages and now are being rewarded for our efforts. This is truly a good partnership between us and the Chicago FHLB. It gives us another great opportunity as a shareholder.”

Over the years, Mr. Mueller has also found customer service at the Chicago FHLB to be fast and efficient. “Service has been spectacular on both the advances, as well as the MPF side. Our Relationship Manager takes great care of us and our partnership has been smooth and beneficial.”



The Chicago Federal Home Loan Bank's  
 new Capital Plan is scheduled to be  
 implemented in 2004.



Change Country		US GOVT/SWAP/AGENCY COMPOSITE										13:38:44	
GOVT ASK/CHANGE	MID SWIGV	SW MIDCHG	MID AG/SW	FNMA	FHLMG	MID							
Year 1.642 -0.008	28.5 0.0	1.833 -0.12	-17.0 -1.0	1.8851	1.8690								
Year 1.949 -0.013	40.5 0.0	2.355 -0.13	-18.0 -1.0	2.1890	2.1191								
Year 2.396 -0.018	44.0 0.0	2.795 -0.18	-9.0 -1.0	2.5994	2.3747								
Year 2.759 -0.017	39.0 -0.5	3.155 -0.20	-11.0 -1.0	3.0368	2.8988								
Year 3.314 -0.029	51.0 -0.5	3.895 -0.30	-3.0 -	3.8504	3.5488								
Year 3.795 -0.025	40.5 0.0	4.205 -0.20	3.0 -1.0	4.2246	4.2857								
Year 4.758 -0.022	31.8 -0.2	5.070 -0.32	23.0 -	5.3228	5.2990								
JIA	7856.6	-32.0	S&P 500	833.58	-5.01	CCMP	1317.78	-11.22	BE600	130.32			
CASH MARKET		ACTIVE FUTURES			SWAPTION 1Y					3Y	5Y	7Y	10Y
LIBOR	1.337	5 Year	113.28	+0.1	1 Year	58.8	42.0	35.7	31.4	27.3			
LIBOR	1.340	10 Year	118.01	+0.4	2 Year	41.5	33.0	28.7	27.1	24.1			
LIBOR	1.340	Long Bond	114.15	+1.3	3 Year	32.9	28.8	26.1	24.2	21.8			
F Funds	1.260	Agency 10Y	113.10	1.2	4 Year	28.4	25.5	23.5	21.9	19.8			
N Repo	1.260	5Y Swap	112.29	0.1	5 Year	25.0	23.0	21.4	19.9	18.1			
N Repo	1.260	10Y Swap	113.12	0.8	7 Year	20.9	19.6	18.3	17.2	15.9			
Rate	Time	Indicator			Bn Survey	Actual	Prior	RM					
27	8:30	US 0	Durable Goods Orders	(JAN)	1.0%	--	-0.2%						
27	8:30	US 3	-Less Transportation	(JAN)	0.9%	--	1.1%						
27	8:30	US 3	Initial Jobless Claims	(FEB 22)	390K	--	402K						
27	8:30	US 6	Continuing Claims	(FEB 15)	3345K	--	3444K						
033	2/26	13:03	JOHN COOKE / GUESS IT'S NO SURPRISE THAT I OFTEN GET IN TR										
033	2/26	15:27	TALL PAVE / BARBARA										

# The New Capital Plan

The Chicago FHLB's new Capital Plan is scheduled to be implemented in 2004. During 2003, further information will be sent to members. The Capital Plan will be featured at the Regional Meetings as well. Prior to implementation of the plan, a full information statement will be distributed to members.

The plan directs the creation of a more permanent capital base and offers members flexibility and choice through two classes of stock. The two classes of stock are Class A, conditionally redeemable on six months' notice, and Class B, conditionally redeemable on five years' notice. The plan is



unique in that it gives members a choice over their mix of stock classes. Members can elect to hold all Class B, a mixture of A and B, or potentially all A over time. It also promotes the continued growth and success of the MPF Program.

Although both classes of stock will be issued and redeemed at par of \$100, Class A will have features similar to preferred stock, such as dividend and liquidation preferences, while Class B stock will be like common stock. Any combination of classes may be used by a member to meet its minimum stock purchase requirement. A summary of the two classes follows.

## Redemption

- **A Class:** 6-month notice subject to the bank meeting its capital requirements
- **B Class:** 5-year notice subject to the Bank meeting its capital requirements;

## Dividend Priority

- **A Class:** cumulative and senior to Class B
- **B Class:** non-cumulative and junior to Class A

## Dividend Basis

- **A Class:** stated minimum dividend at least equal to the 13-week moving average of 3-month LIBOR; to the extent Class B dividend exceeds reference index rate, 20% of the difference between reference rate and proposed Class B dividend will be added to that quarter's Class A dividend; declared by the Board of Directors.
- **B Class:** owns net income after Class A dividends and retained earnings; no Class B dividends unless Class A dividends are current; as declared by the Board of Directors.

## Dividend Forms

- **A Class:** payable in cash, as a stock dividend in shares of Class A stock or Class B stock, or any combination as determined by Board of Directors
- **B Class:** payable in cash, as a stock dividend in shares of Class A stock or Class B, stock or any combination as determined by Board of Directors

## Retained Earnings

- **A Class:** no rights to retained earnings
- **B Class:** owns retained earnings

# The New Capital Plan

## Voting Rights

- **A Class:** if voting rights of class A dividends are 6 or more quarters in arrears, Class A stockholders will be able to elect one director in each state
- **B Class:** elects all elected directors unless Class A stock dividend payments are six or more quarters in arrears

## Weighting for Membership & Activity Requirements

A member's minimum investment requirement may be fulfilled by the ownership and/or purchase of either class of stock, or any combination of the two.

- **A Class:** calculated at par. Class A is allocated towards a member's requirement after Class B.
- **B Class:** calculated at 1.25 times par. Class B is also the first allocation of a member's stock requirement.

Both classes will be issued, redeemed, and repurchased at stated par value. They will be issued in book-entry form, and they will comply with and support the Chicago FHLB's minimum capital requirements. Under the Gramm-Leach-Bliley Act, members may redeem stock only if doing so will not cause the FHLB to fail to meet any of its minimum capital requirements. The Chicago FHLB must maintain a four percent leverage ratio and a five percent minimum weighted ratio of total capital to total assets, with Class B stock and retained earnings both weighted at 1.5 times for purposes of meeting this requirement.

## Membership and Activity Investment

The plan sets required member stockownership, which is the greater of the "membership requirement" or the "activity-based requirement", as has always been the case. The membership requirement is calculated annually. For this

requirement, stock must be held equal to the greater of:

- 1% of member's mortgage assets;
- 0.10% of member total assets;
- \$10,000;
- with a maximum of 9.9% of the Chicago FHLB's previous year-end total capital stock.

The activity-based requirement is calculated each time the member borrows. It is equal to 5% multiplied by the member's outstanding advance products balance, as has always been the case.



## Conversion Process

At the conversion date, all current stock will automatically be converted to Class B. The members' tax position will remain unchanged by this conversion. Class A stock will be made available for purchase immediately afterwards.

Please refer to the Chicago FHLB's website, located at [www.fhlbc.com](http://www.fhlbc.com), for a copy of the Capital Plan and other helpful information regarding members' choices. Please call your Relationship Manager with any questions.

Members will have their choice of risk and return preference. Whether they prefer A stock, B stock, or any combination.



# Federal Home Loan Bank of Chicago

## 2002 Annual Report

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## Part I

### Business

#### 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”), comprise the Federal Home Loan Bank System (the “System”). The twelve FHLBs are government-sponsored enterprises of the United States of America and were organized under the Federal Home Loan Bank Act (“FHLB Act”) of 1932, as amended. Each FHLB has members in a specifically defined geographic district. The Bank’s defined geographic membership territory is the states of Illinois and Wisconsin. The mission of the Bank 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 sources of credit from the Bank are in the form of advances to members and investments in mortgage loans through the Mortgage Partnership Finance® (“MPF”) Program. In 1997, the Bank initiated the MPF® Program, under which the Bank, in partnership with its members, provides funding for home mortgage loans. In 2003, the Bank launched the MPF Shared Funding™ program, pursuant to which members of the Bank will issue privately-placed mortgage-backed securities, thereby providing competition in the mortgage-backed securities market. These programs help the Bank accomplish its mission of supporting housing finance throughout America. All federally-insured depository institutions and insurance companies engaged in residential housing finance and located in Illinois and Wisconsin are eligible to apply for membership in the Bank. All members are required to purchase stock in the Bank as a condition of membership and all stock is owned by the Bank’s members.

The Bank is 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. Also, the Finance Board establishes regulations governing the operations of the Bank. The Bank operates as a separate entity with its own management, employees, and board of directors. A primary source of funds for the Bank 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. The Office of Finance (“OF”) is a joint office of the FHLBs established by the Finance Board to facilitate issuing and servicing of the consolidated obligations. 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 Bank also provides members and non-members with correspondent services such as safekeeping, wire transfers, and cash management.

#### Business Segments

The Bank manages its operations by grouping its products and services within business segments. The measure of profit or loss and total assets for each segment is contained in Note 17 to the financial statements. These business segments are:

- o Traditional Funding, Liquidity and Deposit Products
- o Mortgage Partnership Finance

### Traditional Funding, Liquidity and Deposit Products

#### Advances

As a provider of low cost, short- and long-term funding, the Bank offers credit products with maturities ranging from one day to ten years at competitive rates. These products take the form of fixed and adjustable rate loans, known as “advances,” standby letters of credit, and off balance sheet instruments. Advances can be customized to meet the institution’s special funding needs using a variety of interest rate indices, maturities, amortization schedules, caps, floors, and collars. At year-end 2002, advances outstanding to members totaled \$24.9 billion.

To ensure that funds are available on demand, the Bank maintains a ready supply of liquidity available for immediate use. The Bank raises most of its funds by issuing consolidated obligation bonds and discount notes through the OF. These instruments are rated “Aaa” by Moody’s Investors Service, Inc. (“Moody’s”), and AAA by Standard and Poor’s Ratings Service (“S&P”), the Bank is able to raise funds at very attractive yields. Low overhead and administrative costs allows the Bank to pass these low rates on to members. The Bank also has received a Aaa rating on long-term deposits from Moody’s Investors Service, Inc., a AAA on letters of credit and an A-1+ counterparty rating from Standard and Poor’s Ratings Service.

As of December 31, 2002, the Bank had 30.7% of its advances outstanding to two members, Bank One, N.A. and LaSalle Bank, N.A. The loss of either of these members would have a negative impact on the Bank.

#### Investments

The Bank maintains a portfolio of investments for liquidity purposes and to provide additional earnings. To ensure the availability of funds to meet member credit needs, the Bank maintains a portfolio of short-term investments issued by highly rated institutions, including principally overnight federal funds and repurchase agreements, term federal funds, and commercial paper. The Bank enhances interest income by maintaining a long-term investment portfolio, which includes securities issued by United States government agencies and mortgage-backed securities that are issued by government sponsored mortgage agencies or that carry the highest ratings from Moody’s or S&P. The long-term investment portfolio provides the Bank with higher returns than those available in the short-term money markets.

#### Debt Financing-Consolidated Obligations

Consolidated obligations are the principal funding source for the Bank and are the joint and several obligations of the FHLBs and consist of bonds and discount notes. Consolidated obligations represent the primary source of fundings used by the Bank to acquire or originate mortgages, advances and investments. All consolidated obligations are issued through the OF. The capital markets have traditionally considered the FHLBs’ obligations as “federal agency” debt. Consequently, although the United States government does not guarantee the FHLBs’ debt, the FHLBs have had ready access to funding at relatively favorable rates. The FHLBs’ ability to access the capital markets through the sale of consolidated obligations, across the entire maturity spectrum and through a variety of debt structures, allows the FHLBs to manage their balance sheets effectively and efficiently. These instruments enjoy Agency status and are rated Aaa by Moody’s Investors Service, and AAA by Standard and Poor’s Ratings Service.

#### Deposits

The Bank offers demand, overnight, and term deposit programs to its members and to qualifying non-members. Short-term deposit programs are also offered to members. At December 31, 2002, total member deposits were \$1.8 billion, and total deposits were \$3.0 billion.

#### Mortgage Partnership Finance (“MPF”)

The MPF Program began in 1997 and has grown rapidly to over \$41.7 billion in outstanding loans at the end of 2002, of which \$26.2 billion were owned by the Bank and the remaining \$15.5 billion owned by the other FHLBs. The Program is available through nine regional

FHLBs. Over 400 FHLB member institutions - local commercial banks, thrifts, credit unions and insurance companies - have made or are approved to make MPF loans in all regions of the country. The MPF Program allows lenders to retain a portion of credit risk and customer relationship of their loans while shifting the interest rate and prepayment risks to the FHLB.

As part of MPF, the FHLBs are responsible for managing the interest rate risk, prepayment risk and liquidity risk of the fixed-rate mortgages. The FHLB provides the funding for MPF loans (the liquidity risk) and manages their interest rate and prepayment risks of the loans held in their portfolio. The credit risks of MPF loans are managed by structuring potential credit losses into certain layers. As is customary for conventional mortgage loans, private mortgage insurance ("PMI") is required for MPF loans with down payments of less than 20% of the original purchase price. Losses beyond the PMI layer are absorbed by a "first loss" account established by the FHLB. If "second losses" beyond this layer are incurred, they are absorbed through a credit enhancement provided by the participating member. The credit enhancement held by participating lenders ensures that the lender retains a credit stake in the loans it originates. For managing this risk, participating lenders receive monthly "credit enhancement fees" from the FHLB. The size of each lender's credit enhancement is calculated so that any losses in excess of the second layer are limited to those of an investor in a "AA"-rated mortgage-backed security. Management believe the FHLB has a remote probability of loss.

MPF loans generated in other FHLB districts are funded and managed through the infrastructure established by the Bank. The Bank is compensated for these services through participation interests in mortgages generated in other districts.

As of December 31, 2002, the Bank invested in MPF loans in all fifty states. The Bank does not have a dependence on any single member or small group of members with respect to the MPF Program.

### **Shared Funding Program**

In December 2002, the Finance Board approved a new business application for the MPF Shared Funding program submitted by the Bank. The MPF Shared Funding program allows mortgage loans originated through the MPF Program to be sold to a trust and pooled into securities. Under the MPF Shared Funding program, the Bank purchases the Acquired Member Assets ("AMA") eligible securities, which are rated at least AA by a Nationally Recognized Statistical Ratings Organization ("NRSRO"), from the trust sponsor. The Bank may retain or sell all or part of the securities to other FHLBs or members. The securities offered under the MPF Shared Funding program are not publicly offered and are not guaranteed by the Bank or the System. In March 2003, the first Shared Funding transaction was completed and the Bank recorded its first Shared Funding security.

## **Regulation**

### **Capital, Capitalization and Dividends**

The Gramm-Leach-Bliley Act of 1999 ("GLB Act") and the Finance Board's implementing regulation define total capital for each FHLB as the sum of the FHLB's permanent capital, plus the amounts paid-in by its members for Class A stock (which is conditionally redeemable on six months written notice); any general loss allowance, if consistent with United States Generally Accepted Accounting Principles ("GAAP") and not established for specific assets; and other amounts from sources determined by the Finance Board as available to absorb losses. The GLB Act defines permanent capital as the amount paid-in for the Class B stock (which is conditionally redeemable on five years written notice), plus the amount of an FHLB's total retained earnings, as determined in accordance with GAAP. The GLB Act requires each FHLB to maintain at all times at least a four percent capital to asset ratio as determined under GAAP and at least a five percent leverage ratio, defined as

the sum of permanent capital weighted 1.5 times and other capital weighted 1.0 times divided by total assets. A member's right to redeem is conditional on the FHLB maintaining these leverage requirements.

Until the new capital plan is implemented by the Bank, the pre-GLB Act capital rules will remain in effect. On January 30, 2001, the Finance Board published a final rule implementing a new capital structure for the FHLBs, as required by the GLB Act. The rule establishes risk-based and leverage capital requirements for the FHLBs, addresses different classes of stock that an FHLB may issue and the rights and preferences that may be associated with each class of stock, and required each FHLB to submit a capital plan to the Finance Board for approval by October 29, 2001. The capital rule provides a transition period that allows each FHLB up to three years from the effective date of its capital plan to implement its new capital structure. The Finance Board approved the Bank's capital plan on June 12, 2002. The Bank anticipates implementing the capital plan in 2004.

The members' minimum investment requirement as calculated under the prior capital rules will remain in effect with the Bank's implementation of the new capital regulations in 2004. Members will still be required to purchase capital stock equal to the greater of 1 percent of their mortgage-related assets or 5 percent of FHLBs' outstanding advances. Members could, at the FHLBs' discretion, redeem at par value any capital stock greater than their statutory requirement or sell it to other FHLB members at par value.

The GLB Act made membership voluntary for all members. Members that withdraw from membership may not reapply for membership for 5 years.

### **Risk-based Capital Requirements**

Once the Bank has implemented its capital plan under the GLB Act, the Bank becomes subject to the Finance Board's new risk-based capital regulations. This regulatory framework requires the Bank to maintain sufficient permanent capital to meet its combined credit risk, market risk and operations risk.

The Bank's credit risk capital requirement is determined by adding together the credit risk capital charges computed for assets, off-balance sheet items and derivative contracts based on, among other things, the credit risk percentages assigned to each item as required by the Finance Board.

### **Dividends**

The Bank may pay dividends from retained earnings. The Bank's Board of Directors may declare and pay dividends in either cash or capital stock. Class A Stock will carry a stated dividend that is at least equal to the average of 3-month LIBOR. Class A Stock will be cumulative. Class B Stock will be paid only when declared by the Bank's Board of Directors. Class B dividends will not be cumulative and will be payable only after minimum class A dividends, both cumulative and current, have been paid. If the Bank's Board of Directors declares a quarterly Class B Stock dividend which exceeds the moving average of 1-year LIBOR for such quarter, Class A stockholders will be entitled to receive a share of any excess dividend.

### **Oversight, Audits, and Examinations**

The Bank has an internal audit department and an audit committee; independent public accounting firm audits the annual financial statements of the Bank. The independent accounting firm conducts these audits following auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General. The Bank, the Finance Board, and the Congress all receive the audit reports. The Bank must submit annual management reports to the Congress, the President of the United States, the Office of Management and Budget, and the Comptroller General. These reports include a statement of financial condition, a statement of operations, a statement of cash flows, a statement of internal accounting and administrative control sys-

tems, and the report of the independent public accountants on the financial statements. In addition, the Finance Board conducts an annual on-site examination of the Bank and off-site reviews of its financial operations.

The Comptroller General has authority under the FHLB Act to audit or examine the Finance Board and the Bank and to decide the extent to which they fairly and effectively fulfill the purposes of the FHLB Act. Furthermore, the Government Corporations Control Act provides that the Comptroller General may review any audit of the financial statements conducted by an independent public accounting firm. If the Comptroller General conducts such a review, then he must report the results and provide his recommendations to the Congress, the Office of Management and Budget, and the FHLB in question. The Comptroller General may also conduct his own audit of any financial statements of a FHLB.

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 FHLB operates as a separate entity with its own management, employees, and board of directors. Also, the Finance Board establishes policies and regulations governing the operations of the FHLBs.

### **Affordable Housing Program (“AHP”)**

Each FHLB is required to contribute 10% of its net income after Resolution Funding Corporation (“REFCORP”) payments to its Affordable Housing Program (“AHP”) to be used to make grants or subsidized loans to members to support housing for very-low- and low-income individuals and families. In 2002, the Bank expensed \$25.4 million for the AHP.

### **REFCORP Obligation**

Each FHLB must pay 20% of its net earnings (after its AHP contribution) to REFCORP to support the payment of part of the interest on the bonds issued by REFCORP. The FHLBs must make these payments to REFCORP until the total amount of payments made is equivalent to a \$300 million annual annuity whose final maturity date is April 15, 2030. The period during which the FHLBs must make such payments to REFCORP will be adjusted depending on actual payments relative to the referenced annuity. The Finance Board, in consultation with the Secretary of the Treasury, selects the appropriate discounting factors used in this calculation. In 2002, the Bank paid \$57.0 million in REFCORP payments.

### **Multiple Membership Issue**

On October 3, 2001, the Finance Board published in the Federal Register a solicitation for comments on the implications for the FHLBs that are raised by structural changes occurring in its membership. The solicitation was prompted by the submission of several applications requesting that the Finance Board permit a single depository institution to be a member of two or more FHLBs concurrently. On January 22, 2002, the Finance Board announced that it intended to defer action on multi-district membership petitions until it decides on a course of action to address broader membership issues. In December of 2002, the Finance Board announced that an independent legal analysis concluded that the Finance Board had the authority to regulate the terms of membership in the FHLBs as part of its safety and soundness and housing-finance mission mandates and that the Finance Board would consider a proposed regulation during 2003. The Finance Board has requested additional comments from the FHLBs. Each FHLB has responded to the Finance Board’s solicitation of comments, with a number of FHLBs favoring some of the multiple membership possible changes and other FHLBs expressing reservations about the possible changes.

### **Enhanced Disclosure**

The Finance Board has initiated discussions with the staff of the Division of Corporation Finance of the SEC and the Department of

Treasury about the possible expansion of the financial disclosure reporting of the FHLBs. The OF prepares the combined quarterly and annual financial reports of the FHLBs, which under current Finance Board regulations generally must be consistent with SEC Regulations S-K and S-X, subject to certain exceptions contained in the Finance Board regulations. While the FHLBs support full financial disclosure, due to the Congressionally mandated nature of the FHLBs (e.g., the FHLBs, with cooperative ownership, are not publicly traded corporations and the member financial institutions hold all FHLB stock), changes in disclosure requirements for the FHLBs, if any, have not yet been determined. Individual FHLB’s have started to meet informally with the SEC. The Bank met with representatives of the Division of Corporation Finance in March, 2003.

### **Membership Trends**

Total membership reached an all-time high of 874 members at year-end 2002, up from 857 at year-end 2001. Of those members, 79% were commercial banks, 17% thrift institutions, 3% credit unions, and 1% insurance companies. At the end of 2002, 46% of all members had less than \$100 million in total assets, 49% had assets between \$100 million and \$1 billion, and 5% had assets in excess of \$1 billion.

Credit customers, defined as the number of members who have used advances or lines of credit at any point during the year were 674 in 2002 compared to 669 during 2001. As a percentage of total membership, credit customers accounted for 77% of members in 2002.

### **Competition**

Demand for the Bank’s advances is affected by the cost of other available sources of liquidity for its members. The Bank individually competes with other suppliers of wholesale funding, both secured and unsecured. Such other suppliers may include investment banking concerns, commercial banks and, in certain circumstances, other FHLBs. Smaller members may have access to alternative funding sources through sales of securities under agreements to repurchase, while large members may have access to all the alternatives listed. A small number of very large members may also have independent access to the national and global credit markets. The availability of alternative funding sources to members can vary as a result of a variety of factors including, among others, market conditions, members’ creditworthiness and availability of collateral, and can significantly influence the demand for the Bank’s advances.

The Bank also competes for the purchase of single-family mortgage products with the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”). The Bank competes primarily on the basis of structures, price, products, and services offered.

The Bank also competes with Fannie Mae, Freddie Mac and other government-sponsored entities as well as sovereign and supranational entities for funds raised through the issuance of unsecured debt in the national and global debt markets. Increases in the supply of competing debt products may, in the absence of increases in demand, result in higher debt costs or lesser amounts of debt issued at the same cost than otherwise would be the case. In addition, the availability and cost of funds raised through issuance of certain types of unsecured debt may be adversely affected by regulatory initiatives that tend to reduce investments by certain depository institutions in unsecured debt with greater than normal volatility or interest-rate sensitivity. Although the available supply of funds has kept pace with the funding requirements of the Bank’s members as expressed through FHLB debt issuance, there can be no assurance that this will continue to be the case indefinitely.

### **Geographic Distribution**

The Bank’s membership territory is the states of Illinois and Wisconsin. At year-end 2002 the Bank had 874 members, 67% in Illinois and 33% in Wisconsin. 74% of outstanding advances are to Illinois institutions and 26% to Wisconsin-based members. The MPF mortgage loans that the Bank has acquired or originated are across all

fifty states. No single zip code represents more than 1% of MPF loans on the Bank's balance sheet. The top five states in terms of concentration are Wisconsin, Illinois, California, Texas and Minnesota representing in total 53% of the Bank's MPF loans outstanding.

## **Employees**

The Bank's full-time equivalent employees ("FTE's") at December 31, 2002 were 223.5, compared with 194.5 at December 31, 2001 and 175.5 at December 31, 2000. Since 2000, the number of FTE's increased primarily as a result of staffing additions in the MPF area which reflect the Bank's continued investment in the national expansion of this important business. We believe that we have been successful in attracting quality employees and that our employee relations are good.

## **Taxation**

The Bank, a federally chartered corporation, is exempt from all federal, state and local taxation except for real property taxes. As part of the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA") of 1989 and the GLB Act, the Bank is required to fund an AHP as well as make payments to the REFCORP, which was established to fund the resolution of insolvent savings and loan institutions during the 1980s. These two requirements are similar in financial effect to income taxes totaling 26.5% of net income before assessments.

## **Properties**

The Bank occupies approximately 99,000 square feet of leased office space at 111 East Wacker Drive, Chicago, Illinois 60601. The Bank also maintains a leased off site back-up facility.

## **Legal Proceedings**

As of December 31, 2002, the Bank was not subject to any pending legal proceedings.

## **Submission of Matters to a Vote of Security Holders**

Under the FHLB Act, there are no matters which are submitted to shareholders for votes, hence no matters were submitted to shareholders during 2002.

## **Part II**

### **Market for our Common Stock and Related Security Holder Matters**

The members own all the stock of the Bank, the majority of the directors of the Bank are elected by and from the membership, and the Bank conducts its business in mortgages and advances almost exclusively with members. There is no established marketplace for the Bank's stock. The Bank stock is not publicly traded. It may be redeemed at par value upon request, subject to regulatory limits, and par value of all capital stock is \$100 per share. All of the shares of capital stock of the Bank are exempt from registration under the Securities Act of 1933 and the Securities Exchange Act of 1934, as amended. As of December 31, 2002, the Bank had 874 members and 31,261,091 shares of common stock outstanding.

### **Voting Rights**

Members holding capital stock at December 31 of the preceding year can participate in the annual election process for Bank directors. Their year-end minimum required stock holdings determine the voting rights of members. Eligible members may nominate and elect representatives from members in their State to serve three-year terms on the board of directors of the Bank.

The following table presents information on the 10 largest holders of the Bank's capital stock at December 31, 2002.

**Top 10 Capital Stock Holding Members in the Bank  
at December 31, 2002**

Capital Stock	City	State	Balance (In millions)	% of Total
LaSalle Bank N.A.	Chicago	IL	\$258.0	8.3%
Bank One N.A.	Chicago	IL	\$189.2	6.1%
Mid America Bank, FSB	Clarendon Hills	IL	\$169.7	5.4%
The PrivateBank and Trust Company	Chicago	IL	\$155.0	5.0%
The Northern Trust Company	Chicago	IL	\$106.5	3.4%
St. Francis, FSB	Brookfield	WI	\$91.7	2.9%
M & I Marshall and Ilsley Bank	Milwaukee	WI	\$70.6	2.3%
Associated Bank, N.A.	Green Bay	WI	\$67.0	2.1%
AnchorBank, FSB	Madison	WI	\$55.3	1.8%
First Federal Capital Bank	LaCrosse	WI	\$54.8	1.8%

\* Dollars are as of December 31, 2002 balances and do not include dividends accrued but not paid

The Bank paid quarterly cash and stock dividends, during 2002 and 2001 as outlined in the below table.

Quarter	2002		2001	
	Amount (In thousands)	Percent	Amount (In thousands)	Percent
First	\$ 30,692	5.00%	\$ 28,453	7.00%
Second	\$ 33,540	5.00%	\$ 28,540	6.50%
Third	\$ 36,410	5.00%	\$ 31,411	6.13%
Fourth	\$ 46,964	6.00%	\$ 33,579	5.75%

## Selected Financial Data

Below is a five-year summary of selected financial data

Statements of Income Data	Year Ended December 31,				
	2002	2001	2000	1999	1998
	(In thousands, except per share amounts)				
Net interest income before mortgage loan loss provision	\$ 427,183	\$ 210,344	\$ 212,229	\$ 168,535	\$ 137,769
Provision for credit losses on mortgage loans	2,217	1,810	906	452	219
Other income	(38,615)	62,115	537	2,204	4,541
Other expenses	75,757	50,799	36,052	27,316	21,067
Income before assessments (a)	310,594	219,850	175,808	142,971	121,024
Assessments	82,402	58,474	46,654	12,464	10,257
Income before cumulative effect of change in accounting principle (b)	228,192	161,376	129,154	130,507	110,767
Cumulative effect of change in accounting principle	-	573	-	-	-
Net income	228,192	161,949	129,154	130,507	110,767
Net income per share	8.16	8.33	8.50	9.55	8.95
<b>Statements of Condition Data</b>					
Assets	65,046,147	49,194,194	35,388,778	29,228,447	24,925,586
Mortgage loans held for portfolio, net allowance for credit losses on mortgage loans	26,185,858	16,570,308	8,102,680	1,618,768	930,467
Advances	24,945,112	21,901,609	18,462,288	17,167,291	14,899,069
Held-to-maturity securities	5,628,692	5,254,416	5,779,596	6,608,326	5,312,761
Federal funds sold	3,421,000	3,165,000	2,397,000	3,170,000	2,266,000
Consolidated obligations, net	55,770,001	43,276,955	30,901,848	24,202,873	18,590,473
Deposits	3,047,540	1,760,216	2,010,132	2,877,079	4,154,432
Capital	3,358,773	2,502,784	1,701,268	1,504,954	1,299,321

(a) Prior to 2000, the Bank charged its REFCORP obligations directly to retained earnings and not as an expense through the income statement. REFCORP obligations charged directly to retained earnings during 1999 and 1998 were \$18.7 million and \$18.3 million, respectively.

(b) The Bank adopted FAS 133 as of January 1, 2001 and recorded a net loss of \$4.9 million on securities held at fair value and a \$63 million net realized and unrealized gain on derivatives and hedging activities, including the transition adjustment of \$573 thousand.

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

## Introduction

The Bank is a government-sponsored enterprise whose mission is to promote housing finance, in partnership with member financial institutions which provide sound and economical home financing, throughout America; and to provide liquidity, funding, and asset liability management capability to member institutions on a secured basis with minimal credit risk to the Bank, and to assist them to provide affordable housing and economic development in their communities.

The major sources of revenue for the Bank are interest income on advances to members, and interest income on MPF loans acquired through members. The major expenses of the Bank are interest expense on consolidated obligations and AHP and REFCORP expenses.

## Affordable Housing Program

The Bank's AHP expense for 2002 was \$25.4 million, 41 percent more than the 2001 AHP expense of \$18.0 million. The AHP expense for 2001 was 25.3 percent more than the 2000 AHP expense of \$14.4 million. For years 2002, 2001 and 2000, the AHP assessment was 10 percent of net income after the required payment to REFCORP. The AHP expenses in 2002, 2001, and 2000 reflect trends of the Bank's net income. AHP helps the Bank's members meet their Community Reinvestment Act responsibilities by providing access to subsidized and other low-cost funding to create affordable rental and home ownership opportunities. Funding is also used for commercial and economic development activities that benefit low- and moderate-income neighborhoods, thus contributing to the revitalization of these neighborhoods

## REFCORP Payment

The Bank must pay 20 percent of net earnings (after its AHP obligation) to REFCORP to support the payment of part of the interest on the bonds issued by REFCORP. The FHLBs must make these payments to REFCORP until the total amount of payments actually made is equivalent to a \$300 million annual annuity whose final maturity date is April 15, 2030. The Finance Board will shorten or lengthen the period during which the FHLBs must make payments to REFCORP depending on actual payments relative to the referenced annuity. In addition, the Finance Board, in consultation with the Secretary of the Treasury, will select the appropriate discounting factors used in this calculation.

The REFCORP assessment of the Bank was \$57.0 million for the year 2002. The cash payments are made based on preliminary net income amounts due to the timing requirement of the payment. As specified in the Finance Board regulation that implements Section 607 of the GLB Act, the amount of payments by all FHLBs in excess of the \$300 million annual benchmark payment is used to simulate the purchase of zero-coupon Treasury bonds to "defease" all or a portion of the most-distant remaining quarterly benchmark payment. These benchmark payments or portions of them could be restored if the future actual REFCORP payments of the FHLBs fall short of \$300 million in a year.

The total FHLBs' cash payments to REFCORP in 2002 of \$452.4 million had the effect of shortening the period during which the FHLBs must make quarterly payments to October 15, 2021, from April 15, 2023.

## Office of Finance Expenses

The FHLBs fund the costs of the OF as a joint office that facilitates issuing and servicing the consolidated obligations of the FHLBs, preparation of the FHLBs combined quarterly and annual financial reports, and certain other functions. In 2002, the OF assessed the Bank \$1.3 million, an increase of 69.6 percent over the 2001 \$0.7 million assessment. The majority of the increase relates to new technologies being implemented to expedite the issuing and servicing of consolidated obligations and the lease expansion and build out for more office space including furniture and fixtures. The OF assessment for 2001 was an increase of \$0.2 million from the 2000 assessment of \$0.6 million.

## Finance Board Expenses

The FHLBs are assessed the costs of operating the Finance Board and have no control of these costs. In 2002, the Finance Board assessed the Bank \$1.6 million an increase of 26.1 percent over the 2001 assessment of \$1.3 million. The Finance Board assessment for 2001 was an increase of \$0.2 million from the 2000 assessment of \$1.1 million.

## Community Investment Program ("CIP")

The CIP makes advances available to members to finance their loans made for home purchase or rehabilitation to families whose incomes do not exceed 115% of the area median. CIP advances also finance members' commercial and economic development loans that benefit low- to moderate-income families and neighborhoods. The Bank provides these advances to members essentially at cost.

## Forward-Looking Information

Statements contained in this report, including statements describing the objectives, projections, estimates, or future predictions of the Finance Board, the Bank, and the OF may be "forward-looking statements." These statements may use forward-looking terminology, such as "anticipates", "believes", "expects", "could", "estimates", "may", "should", "will", or their negatives or other variations on these terms. The Bank cautions that, by their nature, forward-looking statements involve risk or uncertainty and that actual results could differ materially from those expressed or implied in these forward-looking statements or could affect the extent to which a particular objective, projection, estimate, or prediction is realized.

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

economic and market conditions;

volatility of market prices, rates, and indices that could affect the value of collateral held by the Bank as security for the obligations of FHLB members and counterparties to derivative financial instruments and similar agreements;

political events, including legislative, regulatory, judicial, or other developments that affect the FHLBs, their members, counterparties, and/or investors in the consolidated obligations of the FHLBs;

competitive forces, including without limitation, other sources of capital available to FHLB 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 Bank's business effectively;

changes in investor demand for consolidated obligations and/or the terms of derivative financial instruments and similar agreements;

timing and volume of market activity;

ability to introduce new Bank 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 FHLBs; and

inflation/deflation.

The Bank does not undertake to update any forward-looking statement in this document or that it makes from time to time.

The Bank continued to successfully fulfill its housing finance mission in 2002 in an environment of financial volatility. Interest rates in the economy continued to decline. The moving average of the one-year LIBOR index the Bank uses to benchmark its dividends dropped from 5.60% at December 31, 2001 to 2.84% at the end of the 2002. The weekly average of this index has moved from 2.46% at the end of 2001 to 1.50% at the end of 2002. In addition, the slope of the interest rate curve has steepened over the course of the year as government policy makers have reduced short-term interest rate targets. Mortgage interest rates have hovered near forty-year lows, encouraging many homeowners to refinance their home loans. As a result, both mortgage production and prepayments have risen to record levels. The Bank has strategically invested in mortgage assets through the MPF Program since 1997 and had over one-third of the Bank's earning assets in MPF mortgage loans throughout 2002. MPF mortgage production outpaced accelerated prepayments during the year, thus allowing the Bank to increase the proportion of higher-yielding mortgage assets on its balance sheet. The increased spreads earned from MPF mortgages allowed the Bank to increase earnings substantially during a year of economic instability.

## 2002 Highlights

Income before REFCORP rose 41% to \$285.2 million in 2002 from \$202.4 million in 2001. Income after REFCORP also increased 41% to \$228.2 million from \$161.9 million in 2001. The Bank's ROE before REFCORP was 9.79% in 2002, compared to 9.80% in 2001. Post-REFCORP ROE was 7.83% compared to the prior year 7.84%. At year-end, housing finance-related assets had increased 30% over 2001. Increased net profit resulted in an increase in the REFCORP charge to \$57.0 million from \$40.5 million in 2001. The Bank paid an annualized average dividend of 5.25% through December 2002, 241 basis points over the benchmark moving average of one-year LIBOR.

The Bank adopted Statement of Financial Accounting Standards No. 133, Accounting for Derivative financial instruments and Hedging Activities ("FAS 133"), incorporating FASB Statements No. 137 and 138, on January 1, 2001. FAS 133 resulted in net realized and unrealized losses in derivatives and hedging activities of \$344.6 million and net unrealized gains in securities held at fair value of \$295.6 million for a total FAS 133 loss of \$49.0 million.

A portion of the net FAS 133 loss is due to hedged anticipated debt being issued at lower than expected funding rates. The additional FAS 133 costs added to the Bank's lower debt rates combine to produce the Bank's targeted cost of funds.

Total premium/discount amortization for the year was \$57.8 million. This was substantially higher than in 2001 due to the high level of mortgage refinance activity experienced during the year as well as higher average mortgage balances.

Net income for the year ended December 31, 2002 includes an expense of \$57.0 million relating to the Bank's REFCORP payments. The GLB Act effective January 1, 2001, changed the REFCORP payment from a fixed \$300 million annual amount to 20 percent of net income. As a result of these statutory changes, the REFCORP payment is similar to a tax and is presented as an expense on the Statement of Income.

The spread between the yield on earning assets and the cost of interest-bearing liabilities in 2002 was 62 basis points, 32 basis points higher than in 2001. The yield on average assets was 4.01% in 2002, 1.26% lower than in 2001. This decline is due primarily to a declining rate environment. The return on average equity was 7.83% in 2002, compared to 7.84% in 2001.

Advances to members reached \$24.9 billion, 14% above the prior year-end. Included in this number is the mark to market adjustment, as a result of FAS 133. The Bank continued to attract new member financial institutions. Total membership stood at 874 members, an all-time high, on December 31, 2002, surpassing the prior year-end level of 857 members.

## TOP ADVANCE BORROWERS AT YEAR-END 2002

	Dollars	% of Total
	(In millions)	
Bank One, N.A.	\$ 3,715.0	15.5%
LaSalle Bank N.A.	3,651.7	15.2%
Mid America Bank, FSB	1,505.5	6.3%
The Northern Trust Company	886.0	3.7%
M & I Marshall and Ilsley Bank	869.2	3.6%
Associated Bank, N.A.	805.9	3.4%
Charter One Bank, N.A.	595.8	2.5%
First Midwest Bank	575.0	2.4%
St. Francis, FSB	535.6	2.2%
AnchorBank, FSB	530.3	2.2%

The MPF Program has been accepted by the markets as a valuable means of housing finance. MPF continued its rapid expansion to member banks and thrifts throughout the district. Nine of the 12 FHLB districts participate in MPF as of December 31, 2002. The program ended the year with \$41.7 billion in loans outstanding, up from \$24.8 billion at the end of 2001, with new loan production far outpacing accelerated prepayments.

## Results of Operations

### 2002 vs 2001

Net income before REFCORP of \$285.2 million during 2002 was \$82.8 million, or 41%, above 2001 results. Average earning assets grew 43%. Net interest income increased from \$210.3 million in 2001 to \$427.2 million in 2002, reflecting the sharply lower interest rate environment offset by strong growth in earning assets. The asset mix of the Bank's balance sheet has shifted toward higher-yielding MPF assets. At year-end, MPF loans represented 41% of the Bank's earning assets compared to 33% at the end of 2001. During 2002, MPF loans were added under a very steep interest rate curve, thus increasing the spreads on these assets. The ten-year Treasury bond is widely used in the mortgage industry as a pricing benchmark while the Bank funds the actual loans purchased using a mix of short and longer term debt including callable debt. As the spread between the various terms widens, so then does the spread on the assets earned by the Bank.

The Bank recorded a mark-to-market loss on its derivatives financial instruments and related hedged items of \$49.0 million in 2002. A portion of this loss is attributable to the cost of hedges of anticipated debt issuance which are used to effectively lock in the Bank's debt cost. The cost of these hedges is offset by lower rates on the debt issued. MPF assets grew by over \$9.6 billion as new participants were added and total fundings reflected increased demand for mortgages in the broader market. Advances increased over \$3 billion as members continued to use wholesale funding to augment their balance sheet management strategies.

Earning assets yielded 4.01% in 2002 compared to 5.27% in 2001 while costing liabilities decreased to 3.39% in 2002 from 4.97% in 2001. The net balance sheet spread was 0.62% in 2002, compared to 0.30% in 2001. The net interest margin was 0.93% in 2002, up from 0.56% in 2000, again reflecting increased spreads offsetting lower interest returns to investment of capital. Return on equity was relatively steady. The Bank's ROE before REFCORP was 9.79% in 2002, compared to 9.80% in 2001. Post-REFCORP ROE was 7.83% compared to the prior-years' 7.84% ratio.

Operating expenses rose \$10.5 million, to \$48.8 million in 2002. Operating expenses rose by 27% while total assets rose 32% during 2002, illustrating the improved efficiency of the strategic technology investments made by the Bank in the MPF Program, as well as in other important business activities. 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. Total operating expenses as a percentage of average assets were 8.7 basis points.

Total capital stock rose \$732 million to \$3.1 billion as new members purchased required stock, incremental borrowings were capitalized, stock

dividends were paid and members purchased voluntary stock for investment purposes. Retained Earnings rose to \$191 million, an \$81 million increase over 2001.

In 2002, the Bank expensed \$25.4 million, compared to \$18.0 million in 2001, to fund AHP. Since 1990, the Bank has awarded over \$100 million to help more than 25,000 families secure affordable housing.

#### **2001 vs. 2000**

Net income before REFCORP of \$202.4 million during 2001 was \$41.0 million, or 25%, above 2000 results. Net interest income declined slightly from \$212.2 million in 2000 to \$210.3 million in 2001, reflecting growth in average earning assets of 22.3% offset by the sharply lower interest rate environment. This decline in net interest income was more than compensated for by \$58.1 million in FAS 133 related gains on derivatives and hedging activities. A portion of this gain is attributable to income from hedges of anticipated debt issuance, where the debt was issued at higher than expected rates. MPF assets grew by over \$8 billion as new participants were added and total fundings reflected increased demand for mortgages in the broader market. Advances increased over \$3.4 billion as members continued to use wholesale funding to augment their balance sheet management strategies.

Earning assets yielded 5.27% in 2001 compared to 6.69% in 2000 while costing liabilities decreased to 4.97% in 2001 from 6.36% in 2000. At year-end, MPF loans represented 33% of the Bank's earning assets compared to 23% at the end of 2000. The net balance sheet spread was 0.30% in 2001, compared to 0.34% in 2000. The net interest margin was 0.56% in 2001, down from 0.65% in 2000, primarily reflecting lower interest rates. Return on equity was steady, as discussed above, due to strong asset growth and capital growth during the year. The Bank's ROE before REFCORP was 9.80% in 2001, compared to 10.65% in 2000. Post-REFCORP ROE was 7.84% compared to the prior-year's 8.52% ratio.

Operating expenses rose \$8.5 million, to \$38.3 million in 2001. The majority of the increase in non-interest operating expenses were related to MPF, due to staffing increases required for continued development of the national program, infrastructure investments, and increases in MPF volume. Total operating expenses as a percentage of average assets were 9.8 basis points.

Total capital stock rose \$764 million to \$2.4 billion as new members purchased required stock, incremental borrowings were capitalized, stock dividends were paid and members purchased voluntary stock for investment purposes. Retained Earnings rose to \$110.4 million, a \$40 million increase over 2000.

#### **Conditions in Financial Markets**

The financial markets in 2002 continued to exhibit volatility reflecting concern over the modest pace of the current economic recovery and the state of the equities market, among other factors. The U.S. stock market remained depressed in the context of continuing corporate scandals involving questionable business and accounting practices, and lower current earnings coupled with only modest growth expectations into 2003 by companies in numerous industries. Two key elements identified by the U.S. Commerce Department that have buoyed the national economy, the strong housing market and consumer spending, have recently begun to slow, reflecting, in part, consumer concerns about any sustained improvement in the economy.

In response to economic conditions, the Federal Reserve Board, through its Federal Open Market Committee, cut the federal funds rate 11 times for a total of 475 basis points during 2001. While the federal funds rate had not been further adjusted until November 6, 2002, when the Federal Open Market Committee cut the rate by 50 basis points, other interest rates continued to drop to historic lows throughout the year ended 2002. As a result of sustained lower interest rates, which reached 40+ year lows for some maturities during the year due to continued concerns about the economy and the war with Iraq, a significant

volume of redemptions of callable FHLB consolidated obligations was triggered. Those bonds were replaced by bonds with lower interest rates. In the first three quarters of 2002, the latest period for which data is available, the Bond Market Association's November 2002 "Research Quarterly" noted that new issue volume in the U.S. bond market totaled \$3.8 trillion, an increase of 19.6% from the \$3.2 trillion issued during the same period last year. The low interest rate environment continues to attract issuers, and the fixed-income markets appeal to investors looking to protect themselves against stock market volatility, despite some of the lowest bond yields in decades.

The continued low level of interest rates during 2002 has had an impact on the Bank's profitability, due primarily to lower yields on short-term earning assets and the lower cost of short-term debt. The overnight Federal funds effective rate, as reported by the Board of Governors of the Federal Reserve System, is the rate at which banks sell excess reserves to one another. The overnight Federal funds average effective rate was 3.90% during 2001. During 2002, that rate averaged 1.67%, a decline from the prior year of 223 basis points.

The lower level of interest rates motivated many homeowners to take advantage of lower mortgage rates to refinance their homes. This resulted in increased prepayments on mortgages, including the MPF Program established by the Bank, and the resulting effect on income of any associated premiums or discounts. The effective yields on the mortgage assets that replaced those prepaid loans reflect the current lower overall level of interest rates.

The Bank's member institutions' overall deposit balances may impact their demand for Bank advances. For the third quarter ended September 30, 2002, the latest period for which data is available, the Federal Deposit Insurance Corporation ("FDIC") reported that total assets and deposits of all FDIC-insured institutions increased slightly compared to the third quarter of September 2001. Total assets increased 5.4%. Deposits were \$5.4 trillion for all FDIC-insured institutions, a 6.0% gain over the 2001 third quarter, while total loans increased only 4.6% compared to the third quarter of September 2001. The growth in deposits over the previous two years reversed a long period of minimal deposit growth, and this growth if continued, may lower the future demand for advances from the Bank.

#### **Critical Accounting Policies**

Various elements of the Bank's accounting policies, by their nature, are subject to estimation techniques, valuation techniques and other judgmental assessments.

#### **Accounting for Derivatives**

The Bank adopted FAS 133, as amended by Statement of Financial Accounting Standard No. 138, Accounting for Certain Derivative financial instruments and Certain Hedging Activities, on January 1, 2001. FAS 133 requires that all derivative financial instruments be recorded on the statement of condition at their fair values. 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 financial instruments that are designated as cash flow hedges and 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 instrument 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. Changes in the fair value of a non-FAS 133 hedge of an asset or liability (economic hedge) for asset-liability management will be

recorded in current-period earnings. As discussed in more detail below, the adoption of FAS 133 is likely to lead to more volatility in the statement of income because of changes in market prices and interest rates. The transition provisions of FAS 133 also provide that at the date of initial application 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”).

All derivatives are recognized on the Bank’s balance sheet at their fair value and those not used for intermediary purposes are designated as (1) 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 purpose. 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 the 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 designed as an economic hedge are recorded in current-period earnings with no fair value adjustment to an asset or liability. Hedge ineffectiveness and changes in the fair value of stand-alone derivatives are recorded in other income as “Net realized and unrealized gain (loss) on derivatives and hedging activities.”

By regulation, derivative financial instruments are only permitted to be used by an FHLB in order to mitigate identifiable risks. All of the Bank’s derivatives are positioned to offset some or all of the risk exposure inherent in its member lending, investment, and funding activities. Under FAS 133, the Bank is required to recognize unrealized losses or gains on derivative positions regardless of whether offsetting gains or losses on the underlying assets or liabilities being hedged are permitted to be recognized in a symmetrical manner. Therefore, the new accounting framework imposed by FAS 133 introduces the potential for a considerable mismatch between the timing of income and expense recognition from assets or liabilities and the income effects of hedge instruments positioned to mitigate market risk and cash-flow variability. Hence, during periods of significant changes in interest rates, the Bank’s reported GAAP earnings may exhibit considerably greater variability than had been reported in previous years. The Bank has generally continued its practice of utilizing the most cost-efficient hedging techniques available while, at the same time, reviewing the resulting accounting consequences as an important consideration.

#### Derivatives and FAS No. 133 Implications

The Bank monitors its sensitivity to changes in interest rates and uses derivative financial instruments to reduce exposure to adverse

changes in interest rates. On January 1, 2001, the Bank adopted FAS No.133. Accordingly, all derivatives are recorded in the financial statements at their respective fair value. Certain derivative financial instruments changes in fair value are reflected in current period earnings.

Presented below is the estimated earnings impact due to FAS No. 133 and the average daily historical simulation Value-at-Risk (VAR) as of December 31, 2002.

#### FAS 133 EARNINGS IMPACT AND AVERAGE DAILY VARIANCE

	2002	2001
	(In thousands)	
FAS 133 Impact	\$ -48,998	\$ +58,124
FAS 133 Average Daily VAR	\$ 3,391	2,561

#### Fair Values

At December 31, 2002, certain of the Bank’s assets and liabilities including investments classified as available-for-sale and securities held at fair value, and all derivatives are presented in the statement of condition at fair value. Under GAAP, the fair value of an asset or liability is the amount at which that asset could be bought or sold, or that liability could be incurred or settled in a current transaction between willing parties, other than in liquidation. Fair values are based on market prices when they are available. If market quotes are not available, fair values are based on discounted cash flows using market estimates of interest rates and volatility or on dealer prices and prices of similar instruments. Pricing models and their underlying assumptions are based on the Bank management’s best estimates for discount rates, pre-payments, market volatility and other factors. These assumptions may have a significant effect on the reported fair values of assets and liabilities, including derivatives, and the related income and expense. The use of different assumptions as well as changes in market conditions could result in materially different net income and retained earnings.

#### Consolidated Obligations

The Bank records a liability for consolidated obligations on its statement of condition in proportion to the proceeds it receives from the issuance of those consolidated obligations. Consolidated obligations are the joint and several obligations of the FHLBs and consist of consolidated bonds and discount notes. Accordingly, should one or more of the FHLBs be unable to repay their participation in the consolidated obligations, each of the other FHLBs could be called upon to repay all or part of such obligations, as determined or approved by the Finance Board. No liability is recorded for the joint and several obligation related to the other FHLBs’ share of the consolidated obligations. Each FHLB is rated AAA and, due to the high credit quality of each FHLB, management has concluded that the probability that a FHLB would be unable to repay its participation is remote. Since 1932, no FHLB has ever failed to make timely payments of principal and interest. Furthermore, Finance Board regulation requires all FHLBs to maintain a AAA rating.

#### Allowance for Loan Loss on Advances

The Bank has experienced no credit losses on advances since inception, nor does the Bank’s management anticipate any credit losses on advances. The Bank is required by statute to obtain sufficient collateral on advances to protect against losses, and to accept as collateral on such advances only certain United States government or government-agency securities, residential mortgage loans, deposits in the Bank, and other real estate-related and Community Financial Institutions assets. At December 31, 2002 and 2001, the Bank had right to collateral, either loans or securities, on a member-by-member basis, with an estimated fair value significantly in excess of outstanding advances.

### **Allowance for Loan Loss on MPF loans**

The Bank has an allowance for loan loss on the balances of loans acquired under the MPF loan program. The Bank bases its allowance on management's estimate of probable credit losses inherent in the Bank's mortgage loan portfolio as of the balance sheet date. The estimate is based on the Bank's loan portfolio performance history, adjusted for an analysis of current trends and conditions including the credit enhancement provided by members on MPF loans.

The Bank calculates its loan loss allowance based on an "observable event" policy. An observable event is an indication that a loss causing incident has occurred. The Bank monitors its conventional non-performing loan portfolio as the observable event and applies a loss factor to their balance to calculate the loan loss allowance.

### **Amortization/Accretion**

The Bank amortizes/accretes premiums/discounts on investments, mortgage loans, advances and consolidated obligations over the average lives of the financial instruments using a method that approximates level yield. Prepayment speeds are analyzed periodically, and all adjustments to average lives are applied on a retrospective basis.

### **Accounting for Guarantees**

In November 2002, the Financial Accounting Standards Board (FASB) issued Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34" ("FIN 45"). Commencing with financial statements for periods ending after December 15, 2002, all guarantees will need to be disclosed in notes to financial statements, including the nature and amount of a guarantee. For guarantees issued after December 31, 2002, the fair value of the obligation must be reported on the balance sheet. Existing guarantees will be grandfathered from balance sheet reporting. Starting with guarantees issued or modified after December 31, 2002, the Bank recognizes, at the inception of the guarantee, a liability for the fair value of the obligations it has undertaken in issuing the guarantee, namely the ongoing obligation to stand ready to perform over the term of the guarantee.

### **Financial Condition**

#### **Assets**

Total assets increased 32% during 2002, increasing to \$65.0 billion at December 31, 2002. Average assets rose to \$56.4 billion in 2002, up from \$39.1 billion in the prior year, a growth rate of 44.3%. Housing finance-related assets include MPF loans, advances to members, investments secured by mortgages and mortgage-backed instruments, and other mission-related investments. Total housing finance-related assets increased \$13.2 billion, or 30%, to \$56.6 billion at December 31, 2002. Total housing finance-related assets accounted for 87% of assets at December 31, 2002. Housing finance-related assets were 102% of consolidated obligations at December 31, 2002.

Advances to members, including FAS 133 basis adjustments, reached an all-time year-end high of \$24.9 billion, up 14% over the previous year-end. The MPF program posted notable growth totaling \$41.7 billion at the end of December 2002, up from \$24.8 billion the prior year-end. MPF loans on the Bank's statement of condition net of premiums, discounts and mark to market adjustments, reached \$26.2 billion or 40% of total Bank assets. 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. Nine FHLBs are approved to participate in the MPF Program.

The mortgage-backed securities ("MBS") portfolio averaged \$4.6 billion during 2002, 10.5% higher than the 2001 average portfolio. The MBS-to-equity ratio was 144% at year-end 2002 compared to 169% in 2001. MBS holdings equal to 300% of capital is the maximum allowed by Finance Board regulation. This decrease is the result of higher capital balances as well as increased purchases of MPF loans during the year.

### **Funding**

The Bank funds its assets principally through the issuance of FHLB consolidated obligations as well as through capital and deposits. The Bank issues debt jointly with the other eleven FHLBs through the OF as the System's fiscal agent. Consolidated obligations constitute the largest portion of the Bank's funding. Average consolidated obligations grew \$14 billion during 2002 to \$49 billion. Consolidated obligations financed 88% of average assets in 2002 the same as 2001. Bonds made up 74% of total consolidated obligations at year-end, the remainder being discount notes. Average deposits increased in 2002 to \$3.0 billion from \$2.1 billion in 2001. In total, deposits funded 5% of average assets in both 2001 and 2002.

As a AAA/Aaa-rated government sponsored enterprise, the Bank enjoys access to the short-term and long-term debt markets. As the Bank has grown, the level of debt has also increased proportionally using an expanding level of capital stock as a foundation. As reflected in the financing section of the statement of cash flows, comparatively fewer bonds were issued in financing during 2002 than in the two preceding years, reflecting the lower level of interest rates and the shortening of maturities of many of the Bank's assets that would be matched with this shorter funding. Cash flows from operations increased markedly from 2001 primarily due to decreases in accrued interest payable on debt and accrued interest on derivative contracts and year-end securities purchases that had not settled, thus creating increasing payable accounts.

The Bank has emphasized diversification of funding sources and channels as the need for funding from the capital markets has grown. The Bank led an effort to issue a System-first global 10-year bond to help fund and hedge the growing mortgage asset base. As the Bank's MPF Program continues its growth, the need for longer term debt also has increased. The Bank led global issues of \$3 billion in both May and November. The Bank committed to a majority of both issuances. This initiative has established an important new funding option for the FHLBs. The Bank anticipates increased demand for similar offerings in 2003.

In the normal course of managing its balance sheet, the Bank may extinguish debt obligations through repurchases of the debt. These extinguishments occur in the normal course of the Bank's business and do not create a material impact on the Bank's overall results. The Bank also uses a limited amount of repurchase agreements as a source of funding. As identified in Note 4 - "Securities Purchased Under Agreements to Resell" and Note 12 - "Borrowings", the Bank identifies these transactions as either short- or long-term borrowings as appropriate and requires the delivery of collateral should the market value of the underlying securities decrease below the market value required as collateral. As identified in Note 13 - "Consolidated Obligations", the Bank has 400 million in bonds outstanding denominated in British Pounds. These bonds mature during 2003 and are not material to the overall funding position of the Bank.

### **Capital**

Members are required to purchase capital stock in amounts based on the greater of 1% of the balance of mortgage assets held by the member institution, or 5% of their level of advances outstanding. In addition, the Bank has instituted a strategy of accepting voluntary investments in its capital stock. Voluntary stock makes up 48% of total capital stock as of year-end 2002. Member-purchased capital stock accounted for 93.5% of total equity as of December 31, 2002. Total capital includes a derivative mark-to-market adjustment to retained earnings of \$41.7 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 \$3.1 billion at the end of 2002. Retained earnings increased to \$191 million, up from \$110.4 million on December 31, 2001. Total equity increased 33% to \$3.3 billion, excluding the previously discussed OCI adjustment.

The Bank maintains a diversified membership base. The Bank's 874 members are from throughout the geographical territory of Illinois and Wisconsin. The membership of the Bank is reflective of all of the diverse

areas and economics over the region. The Bank endeavors to serve all of its membership while not becoming dependent on any member or segment of members. The top five members account for 28% of total capital stock and 116 members account for 80% of the capital stock base.

With regard to dividends paid to members during 2002, the Bank uses the 1-year LIBOR as its index and adds 75 basis points to that index to determine the benchmark dividend 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 in which the Bank hedges interest rate risk is predominantly priced using LIBOR, thus it is a relevant benchmark for the Bank's earnings and dividends. The Bank paid \$147.6 million in dividends to shareholders during 2002.

Under the Finance Board's regulations, the FHLBs may operate at a capital-to-asset ratio of 4% (25:1) provided non-core mission assets (as defined) do not exceed 11% of total assets. The Bank's non-core mission asset ratio at the end 2002 was 3.7%. The Bank is committed to maintaining its non-core mission asset ratio below this 11% threshold. The Bank's year-end regulatory capital-to-assets ratio of 5.10% was substantially greater than the required level of 4.00%. The Bank does not currently have a risk-based capital requirement though management uses a Basel-like standard to calculate a risk-based capital ratio for the Bank. Using this standard, total risk-based capital stood at 20.2% at year-end. In addition, the Bank's debt-to-capital ratio stood at 17 times total capital.

In 2004, the Bank plans to implement a new capital structure, as approved by the Bank's regulator in June, 2002. This new structure will consist of 'A' and 'B' classes of capital stock. The classes are differentiated primarily by priority, dividend formulas, and redemption periods. Class A stock will be conditionally redeemable upon six months' notice while class B stock will be conditionally redeemable upon five years' notice, as long as the Bank would continue to meet its statutory capitalization requirements after redemption. On the effective date of the capital plan,

the Bank's current capital stock will convert to class 'B' stock. Members will then be given the option to exchange class B stock for class A stock as well as to acquire class 'A' stock through direct purchase or through possible 'A' stock dividends. For a thorough explanation please refer to the Plan for the Adjustment of the Capitalization of the Bank, which is incorporated into this document by reference.

#### Capital Stock Ownership by Member Type- December 31, 2002

	(In thousands)	% of Total
Commercial Banks	\$ 1,967,618	63.0%
Thrifts	1,001,405	31.9
Credit Unions	147,125	4.7
Insurance Companies	9,961	0.3
	<u>\$ 3,126,109</u>	

#### Liquidity

The Bank is required to maintain liquidity in accordance with certain Finance Board regulations and with policies established by its board of directors. The Bank needs liquidity to satisfy member demand for short- and long-term funds, repay maturing consolidated obligations, and meet other obligations. The Bank seeks to be in a position to meet its customers' credit and liquidity needs without maintaining excessive holdings of low-yielding liquid investments or being forced to incur unnecessarily high borrowing costs. The Bank's primary sources of liquidity are short-term investments, including overnight Fed funds, resales, and commercial paper, and the issuance of new consolidated obligation bonds and discount notes. Other short-term borrowings, such as Federal Funds purchased, securities sold under agreements to repurchase, and loans from other FHLBs, also provide liquidity.

The below tables present the Bank's contractual obligations and commitments as of December 31, 2002.

Contractual Obligations	Payments Due By Period				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
			(In thousands)		
Long-term debt	\$ 42,874,655	\$ 10,224,530	\$ 11,322,560	\$ 7,117,750	\$ 14,209,815
Operating leases	35,528	3,054	6,613	7,685	18,176
Other long-term obligations	1,200,000	-	-	-	1,200,000
Total Contractual Cash Obligations	<u>\$ 44,110,183</u>	<u>\$ 10,227,584</u>	<u>\$ 11,329,173</u>	<u>\$ 7,125,435</u>	<u>\$ 15,427,991</u>

Other Commitments	Payments Due By Period				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
			(In thousands)		
Standby letters of credit	\$356,904,000	\$235,844,395	\$ 35,503,991	\$ 68,259,847	\$ 17,295,767

## Risk Management

The fundamental mission of the Bank is to provide member institutions with credit products to support housing finance. Lending and investing funds, and engaging in derivative financial instruments, have the potential for exposing the Bank to a number of risks including credit, interest rate, and operational risk. To control and manage these risks the Bank has established policies and practices to evaluate and actively manage these risk positions. The Bank's regulator, the Finance Board has established regulations governing the Bank's risk management practices. The Bank must file periodic compliance reports with the Finance Board. The Finance Board also conducts an annual on-site examination of the Bank as well as off-site analysis.

The Bank is required to maintain liquidity in accordance with certain regulations, with the Financial Management Policy, and with policies established by the Bank's board of directors. The Bank requires liquidity to satisfy member demand for short- and long-term funds, repay maturing consolidated obligations, and meet other obligations. In their asset/liability management planning, members may look to the Bank to provide standby liquidity. The Bank seeks to be in a position to meet its customers' credit and liquidity needs without being forced to incur unnecessarily high borrowing costs. The Bank's primary sources of liquidity are short-term investments and the issuance of new consolidated obligation bonds and discount notes. The Bank maintains a contingency liquidity plan designed to enable the Bank to meet its obligations and the liquidity needs of its members in the event of operational disruptions at the Bank, the OF, or the short-term capital markets.

The Bank maintains a low-risk financial profile. Interest rate risk is the primary risk faced by the Bank. The average interest-rate spread for 2002 was 62 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, 2002, defined as the cumulative difference between assets and liabilities scheduled to reprice within one year, stood at -3.3% of assets.

The Bank regularly engages in interest rate exchange agreements in order to reduce exposure to changing interest rates. As of December 31, 2002, the Bank had engaged in agreements totaling \$34.6 billion in outstanding notional principal. In addition, the Bank had notional principal of \$4.9 billion in outstanding interest rate caps, \$4.5 billion in interest rate floors, \$1.7 billion in futures and \$8.2 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 allow the bank to be indifferent as to whether the advance prepays or remains in place prior to its maturity. The bank recorded \$673 thousand in prepayment fees in 2002.

The Bank uses callable debt to mitigate interest rate risk. Excluding discount notes, 29% of the Bank's debt at December 31, 2002 was callable by the bank. Further, the Bank issues debt with coupon payment terms ("structured debt") and call features. At year-end, 38% of the Bank's issued debt was in the form of structured debt. With such debt, the Bank simultaneously enters into an interest rate exchange agreement with cash flow 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.

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

Credit risk 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. Currently, the Bank calculates its loan loss allowance based on the Bank's loan portfolio performance history, adjusted for an analysis of current trends and conditions including the credit enhancement provided by members on MPF loans. This reserve totaled \$5.5 million at the end of 2002. Charge-offs and recoveries during 2002 represented less than one basis point of the average MPF balance. At year-end 2002, 0.10% of MPF conventional loans were on non-accrual status. All MPF loan pools have credit enhancement coverage provided by one or more parties including the member, mortgage insurance companies, and the federal government through the FHA and VA loan programs.

## Conventional Mortgage Loan Delinquencies

### Chicago Bank Balances As of December 31, 2002

	% of Total Outstanding	MBA Average*
30 Days	0.75%	2.14%
60 Days	0.13%	0.44%
90+ Days	0.10%	0.38%
In Foreclosure	0.04%	0.64%

\* Data on 1-4 unit fixed-rate mortgages (not seasonally adjusted) from the Mortgage Bankers Association National Delinquency Survey.

## Quantitative and Qualitative Disclosures about Market Risk

### Market Risk Management

Market risk is the risk that market value or estimated fair value of the Bank's overall portfolio of assets, liabilities, and derivatives will decline as a result of changes in interest rates or financial market volatility, or that net earnings will be significantly reduced by interest rate changes. Market risk is managed operationally in the Bank's Treasury Group and is addressed through a selection of funding and hedging instruments supporting balance sheet assets.

The goal of market risk management is the preservation of the financial strength of the Bank at all times, including during periods of significant market volatility. The Bank's philosophy centers on protecting market value of portfolio equity, and net profit available to shareholders, across a wide range of possible interest rate changes.

Management continually monitors the Bank's sensitivity to interest rate changes. Multiple methodologies are used to calculate the Bank's potential exposure. These include measuring repricing gaps, duration, convexity, value at risk, and the market value of portfolio equity under assumed changes in the level of interest rates, shape of the yield curves, and general market volatility.

Management controls interest rate exposure through the use of appropriate funding instruments and by employing internal and external hedging strategies. Hedge positions may be executed to reduce balance sheet exposure or the risk associated with a single transaction or group of transactions. The Bank's hedge positions are evaluated continuously and adjusted as deemed necessary by management.

### Asset/Liability Management

Oversight of the management of market risk is evidenced in Asset/Liability Management Committee meetings and reports; moreover, there are regular reports by the Committee to the Board of

Directors. Reports on compliance with interest rate risk limits, applying standard shock tests to the net value of assets, liabilities, and derivatives are presented at every meeting of the Board of Directors. Market risk management policies and controls are incorporated in the Bank's Asset/Liability Management Policy.

### Types of Interest Rate Risks

Interest rate risk can come in a variety of forms, including repricing risk, yield curve risk, basis risk, and options risk. The Bank faces repricing risk when the change in the average yield of its assets or that of its liabilities is more sensitive to market changes in market interest rates. Such a change in sensitivity could reflect a number of possible mismatches in the characteristics of assets and liabilities.

Even if the yields on the Bank's assets and liabilities adjust to changes in market rates to the same extent on average, the Bank may still be exposed to yield curve risk. Yield curve risk reflects the possibility that changes in the shape of the yield curve could have different effects on the Bank's assets and liabilities.

Floating rate assets and liabilities that reprice at similar times and have base rates of similar maturity may still be involved in interest rate risk. If instruments have different base rates, the Bank will be subject to basis risk reflecting the possibility that the two base rates will diverge.

Addressing the options risk associated with mortgage-related investments is critical. Options (or prepayment) risk results from the ability of the homeowner to pay off their mortgage loans prior to maturity. For interest rate risk modeling purposes, a mortgage may be thought of as a combination of a long position in a fixed income instrument plus being short a call option.

### Measuring Types of Interest Rate Risks

Interest-rate risk is the risk that changes in interest rates may adversely affect an institution's financial condition. The goal of an interest-rate risk management strategy is not necessarily to eliminate interest-rate risk but to manage it by setting appropriate limits. The general approach of the Bank toward managing interest-rate risk is to acquire and maintain a portfolio of assets and liabilities which, together with their associated interest-rate swaps, swaptions, interest-rate cap and floor agreements, calls, puts, and futures and forward contracts (collectively, derivative financial instruments) limit the expected duration mismatch. The Bank manages interest-rate risk in several different ways as more fully discussed below.

The Bank measures interest-rate risk exposure by various methods, including the options-adjusted value and the calculation of duration of equity.

For many instruments, sophisticated mathematical models are necessary for measuring interest rate risks; for example, options-adjusted measures were developed to model embedded options and other cash flow uncertainties across a number of hypothetical interest rate environments. The options-adjusted methodology relies on the following:

- Understanding the structure of the instrument;

- Estimating a yield curve;

- Selecting the appropriate option models, prepayment functions, and stochastic processes that best describe interest rate evolution over time.

The method for computing an option adjusted value is dependent on the instrument type. Management utilizes a variety of alternative approaches, yet typically relies on the following industry standard approaches:

- Option-free instruments, such as basic interest rate swaps, require the description of the future evolution of interest rates. Once the course of interest rates has been specified and the cash flows determined, the appropriate spot rates

- are chosen to discount the future cash flows to an option adjusted value.

- Path-independent option instruments, such as interest rate caps and callable bonds, typically are evaluated by backward induction on every node of an interest rate tree capturing a large number of possible interest rate environments.

- Path-dependent option instruments, such as mortgage-related investments, are commonly evaluated by a variety of interest rate trees using Monte-Carlo simulation, where a large number of interest rate scenarios are created using random number generator techniques.

Duration of equity shows the sensitivity of market value of equity to changes in interest rates. Higher duration numbers, whether positive or negative, indicate greater volatility of market value of portfolio equity. Under the Finance Board regulation, until the Bank has converted to its new capital plan, the duration of equity must stay within a range of +5 to -5 years assuming current interest rates. It must stay within a range of +7 to -7 years assuming an instantaneous parallel increase or decrease in interest rates of 200 basis points. The Bank reports the results of its duration of equity calculations daily to management and to the Finance Board each quarter. The Finance Board's new capital rules will require the Bank to hold permanent capital in an amount determined by a market risk model developed by the Bank.

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 reinvested into lower-yielding assets that continue to be funded by higher-cost debt. To protect against this risk, the Bank charges a prepayment fee that makes it financially indifferent to a borrower's decision to prepay an advance.

The Bank holds mortgage-related investments, including mortgage loans, mortgage-backed securities, and agency obligations. The prepayment options embedded in mortgages can result in extensions or contractions in the expected repayments of these investments, depending on changes in interest rates. The Finance Board regulation limits this source of interest-rate risk by restricting the types of mortgage-backed securities the Bank may own to those with limited average life changes under certain interest-rate shock scenarios. The Bank may hedge against contraction risk issuing consolidated obligations that have call features. In addition, the Bank may use caps, floors, and other derivative financial instruments to manage the extension and contraction variability of mortgage-related investments. The Bank may also use derivative financial instruments to transform the characteristics of investment securities other than mortgage-backed securities. 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 approximate the expected prepayment characteristics of the mortgages. 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 daily analysis of the duration and convexity of the portfolio.

### Derivatives

The Bank enters into derivative financial instruments to manage its exposure to changes in interest rates. These instruments may adjust the duration (or price elasticity) repricing frequency, or option characteristics of financial instruments to achieve risk-management objectives. Bank policy prohibits the speculative use of derivative financial instruments. The Bank uses derivatives solely for hedge purposes.

At December 31, 2002, the Bank had \$53.9 billion total notional amount of derivative financial instruments outstanding compared with

**Derivative Counterparty Credit Exposure**  
**At December 31, 2002**  
(In thousands)

Credit Rating	Notional Amount	Exposure at Fair Value	Collateral Held	After Collateral
AAA	\$ 504,400	\$ 6,570	\$ -	\$ 6,570
AA	32,517,518	201,460	183,995	17,465
A	18,850,331	176,045	176,045	-
BBB	1,760,855	-	-	-
Member Institutions(1)	268,832	-	-	-
Total Derivatives	\$ 53,901,936	\$ 384,075	\$ 360,040	\$ 24,035

**Derivative Counterparty Credit Exposure**  
**At December 31, 2001**  
(In thousands)

Credit Rating	Notional Amount	Exposure at Fair Value	Collateral Held	Exposure, Net of Collateral
AAA	\$ 635,400	\$ 2,015	\$ -	\$ 2,015
AA	35,796,438	67,480	39,936	27,545
A	8,326,815	68,079	67,758	321
BBB	102,520	-	-	-
Member Institutions(1)	217,956	105	-	105
Total Derivatives	\$ 45,079,129	\$ 137,679	\$ 107,694	\$ 29,986

(1)Collateral held with respect to derivative financial instruments with member institutions represents either collateral physically held by or on behalf of the Bank or collateral assigned to the Bank, as evidenced by a written security agreement, and held by the member institution for the benefit of the Bank.

\$45.1 billion at December 31, 2001. The notional amount serves as a factor in determining periodic interest payments or cash flows received and paid, and does not represent actual amounts exchanged or the Bank's exposure to credit and market risk.

#### Derivative Credit Risk Exposure and Counterparty Ratings

In addition to market risk, the Bank is subject to credit risk because of the risk of potential nonperformance by counterparties to the agreements as well as operational risks. The degree of counterparty risk on derivatives is reduced by the use of netting procedures that are used to mitigate the risk. At December 31, 2002, 20 counterparties represented approximately 96% of the total notional amount of outstanding derivative transactions and each had a credit rating of A or better. Four counterparties represented more than 10% of the Bank's net exposure after collateral, which was \$24.0 million, or less than 1% of our capital, at December 31, 2002. The Bank manages counterparty credit risk through credit analysis, collateral management, and other credit enhancements. The Bank requires collateral agreements on derivative financial instruments, and maximum net unsecured credit exposure amounts that may exist before collateral requirements are triggered based upon each individual counterparty's rating.

At December 31, 2002, the Bank's maximum credit risk, before considering collateral, was approximately \$384.1 million. This compares with December 31, 2001 maximum credit risk, before considering collateral, balance of \$137.7 million. In determining maximum credit risk, the Bank considers accrued interest receivables and payables, and the legal right to offset assets and liabilities by counterparty. The Bank's net exposure after collateral was approximately \$24.0 million at December 31, 2002 compared to \$29.9 million at December 31, 2001.

#### Foreign Currencies

The Bank has issued a small portion of its 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. At December 31, 2002, consolidated obligations denominated in foreign currencies represented 2.1% of consolidated obligations outstanding.

#### Managing Credit Risk

Credit risk is the risk of loss due to default. The Bank faces credit risk on advances, investments, mortgage loans and derivative financial instruments. The Bank protects against credit risk on advances through collateralization of all advances. In addition, each Bank can call for additional or substitute collateral during the life of an advance to protect its security interest. The FHLB Act limits eligible collateral to certain investment securities, residential mortgage loans, deposits with the Bank, and other real estate related assets. As a result of the GLB Act and regulatory implementation by the Finance Board, the Bank is allowed to expand eligible collateral for many of its members. Members that qualify as CFIs - defined in the GLB Act as FDIC-insured depository institutions that had average assets totaling no more than \$500 million, adjusted to \$538 million in January 2003 - can pledge secured small-business, small-farm, and small-agribusiness loans as collateral for advances. The Bank is allowed to make advances to nonmember housing associates that also have expanded collateral requirements.

While the Bank faces minimal credit risk on advances, it is subject to credit risk on some investments and on derivative financial instruments. The Bank follows guidelines established by the Finance Board and its Board of Directors on unsecured extensions of credit, whether on- or off-balance sheet. The Finance Board regulation limits the amounts and terms of unsecured credit exposure to any counterparty other than to the U.S. Government. Unsecured credit exposure to any counterparty is limited by the credit quality and capital level of the counterparty and by the capital level of the Bank.

#### Mortgage Loans Held in Portfolio

The MPF Program involves the origination/acquisition by the Bank of mortgage loans created by members. Under this program, the Bank acquires/originates mortgage assets from or through members or housing associates, and the members or housing associates continue to bear a portion of the credit risk. These assets may have more credit risk than advances, even though the member or housing associate always provides credit enhancement to protect the Bank to a AA level. At December 31, 2002, the MPF Program had an outstanding balance of \$26.2 billion in mortgage loans held in portfolio, net of allowance for credit losses, all of which were credit enhanced by members to a level equivalent to at least an investment-grade rating. Outstanding net mortgage loans held in portfolio were \$16.6 billion at December 31, 2001. The Bank has established an appropriate loan loss allowance, and the management of the Bank believes that it has the policies and procedures in place to manage appropriately this credit risk.

#### Operational Risk

Operational risk is the risk of potential loss due to human error, systems malfunctions, man-made or natural disasters, fraud, or circumvention or failure of internal controls. The Bank has established comprehensive systems of risk assessments along with financial and operating policies and procedures and appropriate insurance coverage to mitigate the likelihood of, and potential losses from, such occurrences. The Bank's policies and procedures include controls to ensure that system-generated data are reconciled to source documentation on a regular basis. In addition, the Bank has a disaster recovery plan that is designed to restore critical business processes and systems in the event of disasters.

#### Business Risk

Business risk is the risk of an adverse impact on the Bank's profitability resulting from external factors that may occur in both the short and long term. Business risk includes political, strategic, reputation and/or regulatory events that are beyond the Bank's control. The Bank's Board of Directors and management try to mitigate these risks through long-term strategic planning and through continually monitoring economic indicators and the external environment.

#### Market Value of Portfolio Equity Estimation

The market value of portfolio equity ("MVPE"), at a point in time, is defined as the discounted present value of asset cash flows minus the discounted present value of liability cash flows plus derivative cash flows. Interest rate risk analysis using MVPE involves changing interest rates used in determining the cash flows and then discounting the cash flows to their present values. The resulting percentage change in MVPE is an indication of longer-term repricing risk and options risk embedded in the balance sheet.

The MVPE measure uses implied forward rates and assumes a static balance sheet. Similar to earnings simulations, the assumptions pertaining to timing and variability of balance sheet cash flows are required in the MVPE analysis. Particularly important are the assumptions driving mortgage prepayments and market volatility.

#### PARALLEL INTEREST RATE CHANGE

	As of December 31, 2002		The 2002 data in this table has been changed as of 7/01/03 to reflect the Bank's correct market value of equity numbers.
	MVPE (In millions)	Percent Change	
Base Case	\$2,953		
Assuming a 100 basis point increase in interest rates	\$2,777	-5.9%	
Assuming a 100 basis point decrease in interest rates	\$2,935	-0.6%	
As of December 31, 2001			
	MVPE (In millions)	Percent Change	
Base Case	\$2,457		
Assuming a 100 basis point increase in interest rates	\$2,374	-3.4%	
Assuming a 100 basis point decrease in interest rates	\$2,468	+0.1%	

#### Value-at-Risk Estimation

In addition to instantaneous parallel interest rate changes, management estimates the changes in the MVPE using VAR methodology. Management primarily uses the historical simulation VAR methodology. VAR is defined as the potential 120-day dollar loss from adverse market movements, with a 99.0% confidence interval, based on historical prices and market rates. This approach is useful to establish risk tolerance limits and is commonly used in Asset/Liability management; however, it does not imply a forecast of future interest rate behavior.

Presented below is the estimated change in the MVPE across confidence intervals using the historical simulation VAR methodology as of December 31, 2002.

#### HISTORICAL SIMULATION VALUE-AT-RISK

Confidence Level of VAR	December 31, 2002	December 31, 2001
50%	2.2%	0.9%
75%	4.6%	2.8%
97%	9.2%	5.0%
99%	9.9%	5.3%

#### Duration Gap Position

On a daily basis, management reviews the portfolio duration gap of all assets, liabilities, and derivatives. The duration gap is the difference between the effective duration of total assets minus the effective duration of liabilities plus derivatives. A positive duration gap indicates that the portfolio has exposure to rising interest rates, where as a negative duration gap indicates that the portfolio has exposure to falling interest rates. The Bank actively manages the duration gap, with the goal of market risk management - the preservation of the financial strength of the Bank at all times, including during periods of significant market volatility.

Until the Bank has converted to its new capital plan, Finance Board policy requires that the Bank's duration of equity (at current interest rate levels using the consolidated obligation cost curve or an appropriate discounting methodology) be maintained within a range of +/-5 years. The Bank must maintain its duration of equity, under an assumed instantaneous +/-200 basis points parallel shift in interest rates, within a range of +/-7 years.

The table below reflects the results of the Bank's measurement of its exposure to interest-rate risk in accordance with the Finance Board policy. The table summarizes the interest-rate risk associated with all instruments entered into by the Bank.

**Duration of Equity**  
(In years)

December 31, 2002			December 31, 2001		
Up	Base	Down	Up	Base	Down
5.39	3.25	(2.93)	2.46	2.46	(3.31)

Up = +200 basis points. Down = - 200 basis points. The Finance Board regulation restricts the down rate from assuming a negative interest rate.

In calculating and measuring duration of equity, the Bank also calculates and measures its duration gap, the difference between the durations of assets and liabilities.

Presented below is the average estimated Portfolio Duration Gap.

**AVERAGE PORTFOLIO DURATION GAP**

Portfolio Duration Gap in Years	2002	2001
Portfolio Average Duration Gap	+0.00	+0.05
Portfolio Duration Gap Standard Deviation	0.05	0.08

**Operating Segments - Financial Performance**

The Bank manages its business along two major operating segments: Traditional Funding, Liquidity, and Deposit Products and MPF. Please refer to Note 17 to the Financial Statements - "Operating Segment Information" - for further information regarding the Bank's segment performance.

**Traditional Funding, Liquidity, and Deposit Products**

Net interest income was \$231 million for the year ended December 31, 2002, up 50% from \$154 for the year ended December 31, 2001. These increases in net interest income are substantially due to the increase in the volume of advances on the Bank's balance sheet, somewhat offset by the lower level of interest rates on these types of assets experienced over the course of the year.

Noninterest income was a negative \$42 million for the year ended December 31, 2002, down from \$60.4 million for the previous year end. The decreases in noninterest income were predominantly due to losses in the investment portfolio of the segment related to FAS 115.

Noninterest expense was \$30 million for the year ended December 31, 2002, up from \$25.1 million for the previous year end. The increases in noninterest expense were predominantly due to increased investments in the Bank's back office technology and infrastructure. Total assets for the segment increased by 18% over the previous year end to reach \$38 billion at December 31, 2002. This increase is primarily due to the aforementioned growth in the advance portfolio.

**Par Value of Advances by Member Type - December 31, 2002**

	Dollars	% of Total
	(In thousands)	
Commercial Banks	\$ 17,452,335	72.6%
Thriffs	\$ 6,346,067	26.4%
Insurance Companies	\$ 139,748	0.6%
Credit Unions	\$ 88,906	0.4%
	<u>\$ 24,027,056</u>	

**Mortgage Partnership Finance**

The MPF Program, which the Chicago Bank launched in June 1997, is an alternative means of funding fixed-rate mortgage loans. With MPF, 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. Since 1997 over \$60 billion worth of fixed-rate mortgage loans have been funded through MPF. MPF loans generated in other FHLB districts are funded and managed through the infrastructure established by the Bank.

The Bank is compensated for these services through fees and through participation interests in mortgages generated in other districts.

At year-end 0.10% of conventional loans that the Bank has acquired or originated were 90 days or more delinquent or in foreclosure compared to a national average of 1.02%. Increasingly credit enhancement coverage is being provided, in part, by mortgage insurance companies through supplemental mortgage insurance policies purchased by the seller, for the benefit of the Bank. The MPF Program is offered by nine FHLBs including Chicago and has funded loans in all fifty states. As of December 31, 2002, 445 institutions had been approved to participate in MPF. At year-end 2002, the MPF Program had funded over \$60 billion and had outstanding loans of \$41.7 billion system wide.

Net interest income attributable to the MPF Program was \$197 million for the year ended December 31, 2002, up 248% from \$56 million for the year ended December 31, 2001. The increase in net interest income is substantially due to significant increases in both the volume and spread for mortgage assets held on the Bank's balance sheet. However, these gains were tempered by premium write-offs and lower interest rates, as consumers took advantage of lower mortgage interest rates to refinance their loans. The Bank paid \$18 million in credit enhancement fees in 2002, up from \$6.9 million in 2001. Starting in 2003, the Bank views credit enhancement fees as an adjustment to the yield on mortgage loans and thus, a reduction of interest income. Noninterest income was \$3.4 million for the year ended December 31, 2002, up 89% from \$1.7 for the year ended December 31, 2001. For this segment, noninterest income has a negligible impact on overall profitability.

Non-interest expense was \$45.7 million for the year ended December 31, 2002, up 78% from \$25.7 in 2001. The increases in non-interest expense were predominantly due to the amortization of capitalized investments in the back office technology and infrastructure, as well as volume-related charges associated with custody and master servicing functions that the Bank has outsourced. Capital expenditures for MPF were \$8.2 million in 2002, up from \$1.5 million in 2001.

Total mortgage loans for the segment increased by 58% over the previous year end to reach \$26 billion at December 31, 2002. The increases are primarily due to the continued growth in the MPF customer base, as well as robust increases in the overall volume of MPF-eligible loans generated in the mortgage market this year. The Bank purchased or originated \$16.7 billion in MPF loans during 2002, \$5.8 of which came from the Bank's members. This represents an overall participation rate of 48%.

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, 48% of all MPF loans funded have been to households with income below the MSA median. The MPF Program also is available to borrowers who are using an AHP grant as part of their down payment.

**Management Outlook**

Mortgage origination volume will likely moderate from the record pace established in 2001 and 2002. MPF balances are anticipated to continue strong growth during the year. Competition among investors for conventional, conforming fixed-rate mortgages is expected to continue to be intense in 2003. Any decline in overall mortgage origination activity will be offset by market share gains in the nine districts that offer MPF. The Bank typically receives a participation interest in loans sold to FHLBs in MPF. This participation rate has been declining as other FHLBs have increased MPF assets on their balance sheets. Management believes the participation rate will continue to decline though increases in market share will overcome any negative effect on volumes directed to the Bank.

Shared Funding is a new business activity proposal submitted by the Bank to allow it to purchase securities formed by members using MPF loans. These securities will be created by a member and administered by

an independent trust. The securities will be rated by a NRSRO and will be available for sale to other FHLBs as well as to all FHLB members. The securities resulting from these transactions will have superior liquidity characteristics as compared to ordinary MPF loans. Management expects that this new activity will enhance the MPF Program's volume capacity by accessing capital across the entire FHLB membership base. The first transaction was completed in March, 2003.

Advance demand is expected to moderate as many members are still experiencing strong growth in retail deposits, thus reducing their wholesale funding needs. In addition, consolidation continues to cause moderation of advance demand as members are acquired by out-of-district institutions. The Finance Board has announced that they will further consider the pending question of multiple district membership during 2003. This could have a substantial impact on membership trends and product demand throughout the System.

Members continue to voluntarily invest in the Bank's capital stock. Management expects to continue to be able to pay attractive dividends as an incentive for members to continue to buy and hold the Bank's capital stock. This allows the Bank to continue growth and offers our members an attractive investment.

Management expects credit problems in the economy to persist. The Bank will continue to focus on assessing and managing credit risk in this volatile environment. Management is confident that the Bank's credit and collateral guidelines are effective and competitive. Mortgage delinquencies in the overall market have been rising since the middle of 2001. Delinquencies on acquired mortgage loans are not a primary risk to the Bank as the loans purchased include credit enhancements provided by the participating financial institution and by mortgage insurance companies. 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.

Net income is expected to rise moderately in 2003 as the Bank increases the proportion of its balance sheet dedicated to higher yielding MPF mortgage loans and related shared-funding securities. If interest rates begin to rise, the expected lives of the mortgages currently on the books will lengthen, thus reducing the amount of premium amortization that will flow as an offset to earnings. Management is expecting to be able to grow the average earning assets of the Bank beyond its current level.

## **Factors That May Affect Future Results**

### **General business and economic conditions may significantly affect our earnings.**

The Bank's business and earnings are sensitive to general business and economic conditions. These conditions include short-term and long-term interest rates, inflation, money supply, fluctuations in both debt and equity capital markets, the strength of the U.S. economy, and the local economies in which the Bank conduct business. If any of these conditions worsen, the Bank's business and earnings could be adversely affected. A prolonged economic downturn could increase the number of customers who become delinquent or default on their loans, or a rising interest rate environment could decrease the demand for loans. An increase in delinquencies or defaults could result in a higher level of charge offs and provision for loan losses, which could adversely affect the Bank's earnings.

In addition, the Bank's business and earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies. The Bank is particularly affected by the policies of the Federal Reserve Board, which regulates the supply of money and credit in the United States. The Federal Reserve Board's policies directly and indirectly influence the yield on the Bank's interest-earning assets and the cost of the Bank's interest-bearing liabilities. Changes in those policies are beyond the Bank's control and difficult to predict.

### **The Bank has significant competition**

The Bank operates in a highly competitive environment. The activities of its MPF business is subject to significant competition in purchasing conventional, conforming fixed-rate mortgage loans. The Bank faces competition in customer service, the prices paid for these assets, and in ancillary services such as automated underwriting. The most direct competition for mortgages comes from other buyers of conventional, conforming fixed-rate mortgage loans such as Fannie Mae and Freddie Mac. These investors may seek to hold conventional, conforming fixed rate mortgage loans or may aggregate loans from originators for ultimate sale. Although the Bank's competitors' activities may make it a challenge for the Bank to achieve its financial goals, it is continuously reassessing our overall competitive edge to attract more customers for the Bank's products and services.

### **The Bank is jointly and severally liable for other FHLBs consolidated obligations.**

The Bank is jointly and severally liable with the other FHLBs for the consolidated obligations issued by the other FHLBs through the OF. The Bank may not pay any dividends to members nor redeem or repurchase any shares of capital stock unless the principal and interest due on all consolidated obligations have been paid in full. If another FHLB were to default on its obligation to pay principal or interest on any consolidated obligations, the Finance Board may allocate the outstanding liability among one or more of the remaining FHLBs on a pro rata basis or on any other basis the Finance Board may determine. As a result the Bank's ability to pay dividends to its members or to redeem or repurchase shares of its capital stock could be affected not only by its own financial condition, but also by the financial condition of one or more of the other FHLBs. However, no FHLB have ever defaulted on its debt obligation since the FHLB's were established in 1932. Each FHLB is AAA-rated and any risk of default is very remote.

### **FAS 133 adjustments remain unpredictable.**

The Bank made the transition to FAS 133 in January 2001. The Bank endeavors to conduct its hedging strategies not only to reduce various financial risks on its balance sheet, but also to develop and implement hedging strategies that are efficient from a GAAP and FAS 133 perspective. Although the Bank's management believes that the FAS 133 market-to-market adjustments are manageable, there remains significant uncertainty as to the future volatility of the FAS 133 effect on current income and the magnitude of reductions to retained earnings through other comprehensive income. This is because, in overview, the FAS 133 adjustments often are unrelated to the true economics of hedged positions.

### **Reconsideration of multiple-district membership**

The Bank's regulator, the Finance Board will consider whether to allow members to maintain membership in multiple FHLB districts. While the issues are complex, it is possible that multi-district membership would result in a greater level of competition among the FHLBs. Multi-district membership would raise various operational issues including, among other things, how a single institution would comply with the stock purchase requirements of multiple FHLBs, how collateral pledged by a single institution to secure loans would be apportioned among multiple FHLBs and the extent to which a single institution should be permitted to have representation on the boards of directors of multiple FHLBs. On the other hand, if, as is currently the case, multi-district membership is not permitted, interstate mergers involving members from different FHLB districts may result in an increase in the concentration of large members in specific FHLBs and a decrease in membership and loss of business in other FHLBs.

**The Bank's regulatory and/or legislative environment could change**

The FHLBs are governed by the FHLB Act and regulations adopted thereunder by the Finance Board. The FHLBs were created to further the government policy of facilitating the flow of mortgage credit and the promotion of homeownership in the United States. From time to time, Congress has amended the Bank Act in ways that have significantly affected the rights and obligations of the FHLBs and the manner in which they carry out their housing finance mission. It is possible that legislative changes to the Bank Act in the future could adversely affect the business, operations or financial condition of the Bank. Regulations and policies of the Finance Board govern, among other things, the permissible investments and activities of the FHLBs, risk management practices, capital requirements and management and supervisory issues. It is possible that new regulations or policies adopted by the Finance Board, or changes to existing regulations or policies, also could adversely affect the business, operations or financial condition of the Bank.

## Financial Statements and Supplementary Data

The financial statements, together with the notes thereto and the report of PricewaterhouseCoopers LLP dated February 17, 2003, thereon, appear on pages 1 through 30.

Supplementary financial data for each full quarter within the two years ended December 31, 2002 are included in the below tables.

	4th Quarter 2002	3rd Quarter 2002	2nd Quarter 2002	1st Quarter 2002
	(In thousands)			
Interest income	\$ 587,471	\$ 575,602	\$ 561,477	\$ 494,169
Interest expense	441,030	466,768	455,133	428,605
Net interest income	146,441	108,834	106,344	65,564
Provision for credit loss	114	394	1,230	479
Noninterest income	(29,070)	7,957	(21,382)	3,880
Noninterest expense	24,999	19,226	17,173	14,359
Assessments	24,477	25,777	17,660	14,488
Net Income	\$ 67,781	\$ 71,394	\$ 48,899	\$ 40,118

Basic earnings per common share				
Net income	\$ 2.42	\$ 2.55	\$ 1.75	\$ 1.44
Cash dividends declared per common share	1.68	1.30	1.20	1.10

	4th Quarter 2001	3rd Quarter 2001	2nd Quarter 2001	1st Quarter 2001
	(In thousands)			
Interest income	\$ 484,449	\$ 495,234	\$ 492,379	\$ 562,524
Interest expense	427,339	441,549	444,694	510,660
Net interest income	57,110	53,685	47,685	51,864
Provision for credit loss	855	578	198	179
Noninterest income	60,041	3,074	214	(1,214)
Noninterest expense	18,008	11,843	10,852	10,096
Assessments	26,076	11,764	9,772	10,862
Change effect of change in accounting principle	-	-	-	573
Net Income	\$ 72,212	\$ 32,574	\$ 27,077	\$ 30,086

Basic earnings per common share				
Net income	\$ 3.72	\$ 1.67	\$ 1.39	\$ 1.55
Dividends declared per common share	1.73	1.62	1.47	1.46

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## Average Balances/Net Interest Margin/Rates

Federal Home Loan Bank of Chicago  
as of December 31,

	2002			2001		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
(In thousands)						
Assets						
Federal funds sold and securities purchased under resale agreements	\$ 3,185,038	\$ 55,112	1.73%	\$ 2,546,943	\$ 98,681	3.87%
Other short-term investments	408,984	8,954	2.19%	542,128	26,416	4.87%
Long-term investments (1)	7,578,628	278,238	3.67%	5,259,238	303,148	5.76%
Interest-bearing deposits in banks	-	-	0.00%	-	-	0.00%
Advances	23,733,666	618,927	2.61%	19,839,326	882,358	4.45%
Mortgage loans held for portfolio (2)	20,400,463	1,257,488	6.16%	10,454,664	723,983	6.92%
Total earning assets	55,306,779	2,218,719	4.01%	38,642,299	2,034,586	5.27%
Allowance for credit losses on mortgage loans	(4,621)			(2,021)		
Other assets	1,128,400			473,467		
Total Assets	<u>\$ 56,430,558</u>			<u>\$ 39,113,745</u>		
Liabilities and Capital						
Time deposits	\$ 196,679	4,980	2.53%	\$ 132,898	7,550	5.68%
Other interest-bearing deposits	2,764,618	42,611	1.54%	1,982,913	74,658	3.77%
Short term borrowings	11,331,137	227,858	2.01%	7,508,975	299,854	3.99%
Long-term debt	37,328,355	1,480,400	3.97%	27,055,051	1,441,046	5.33%
Other borrowings	1,196,923	35,687	2.98%	26,575	1,134	4.27%
Total interest-bearing liabilities	52,817,712	1,791,536	3.39%	36,706,412	1,824,242	4.97%
Non interest-bearing deposits	3,794			-		
Other liabilities	695,338			342,785		
Total Capital	2,913,714			2,064,548		
Total Liabilities and Capital	<u>\$ 56,430,558</u>			<u>\$ 39,113,745</u>		
Net interest income and net yield on interest-earning assets		<u>\$ 427,183</u>	0.62%		<u>\$ 210,344</u>	0.30%
Average interest earning assets to interest bearing liabilities			104.71%			105.27%

### Note

(1) The amount of investment securities available-for-sale are based on their amortized costs. The yield information does not give effect to changes in fair value that are reflected as a component of stockholders' equity.

(2) Nonperforming loans are included in average balances used to determine average rate.

2000			1999			1998		
Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
(In thousands)								
\$ 2,512,232	\$ 159,101	6.33%	\$ 2,835,556	\$ 159,730	5.63%	\$ 3,797,275	\$ 209,541	5.52%
806,280	52,792	6.55%	932,979	36,009	3.86%	986,008	55,440	5.62%
5,290,846	357,177	6.75%	5,154,607	315,786	6.13%	5,145,591	321,778	6.25%
-	-	0.00%	-	-	0.00%	9,342	542	5.80%
18,119,750	1,185,628	6.54%	16,246,653	871,143	5.36%	12,329,232	704,011	5.71%
4,864,189	360,314	7.41%	1,266,025	81,985	6.48%	260,467	16,951	6.51%
<u>31,593,297</u>	<u>2,115,012</u>	6.69%	<u>26,435,820</u>	<u>1,464,653</u>	5.54%	<u>22,527,915</u>	<u>1,308,263</u>	5.81%
(1,061)			(453)			(92)		
488,890			645,209			566,250		
<u>\$ 32,081,126</u>			<u>\$ 27,080,576</u>			<u>\$23,094,073</u>		
\$ 297,654	16,995	5.71%	\$ 741,734	38,439	5.18%	\$ 590,707	32,289	5.47%
1,431,432	88,710	6.20%	2,642,536	129,743	4.91%	3,396,366	181,501	5.34%
5,373,331	331,087	6.16%	5,596,453	280,402	5.01%	4,188,460	225,337	5.38%
22,818,391	1,465,987	6.42%	16,014,319	847,346	5.29%	13,129,992	731,101	5.57%
77	4	5.19%	3,581	188	5.25%	4,964	266	5.36%
<u>29,920,885</u>	<u>1,902,783</u>	6.36%	<u>24,998,623</u>	<u>1,296,118</u>	5.18%	<u>21,310,489</u>	<u>1,170,494</u>	5.49%
-			-			-		
568,299			661,054			555,175		
1,515,516			1,420,899			1,230,414		
<u>\$ 32,004,700</u>			<u>\$ 27,080,576</u>			<u>\$ 23,096,078</u>		
	<u>\$ 212,229</u>	0.34%		<u>\$ 168,535</u>	0.36%		<u>\$ 137,769</u>	0.31%
		105.59%			105.75%			105.71%

The following table shows the approximate effect on net interest income of volume and rate changes for 2002 and 2001. For purposes of this table, changes that are not due solely to volume or rate changes are allocated to volume.

	2002 over 2001			2001 over 2000		
	Volume	Rate	Total	Volume	Rate	Total
Increase (decrease) in interest income:	(In thousands)					
Federal funds sold and securities purchased under resale agreements	\$ 24,723	\$ (68,292)	\$ (43,569)	\$ 2,198	\$ (62,618)	\$ (60,420)
Other short-term investments	(6,488)	(10,974)	(17,462)	(17,296)	(9,080)	(26,376)
Long-term investments	133,692	(158,602)	(24,910)	(2,134)	(51,895)	(54,029)
Advances	173,202	(436,633)	(263,431)	112,517	(415,787)	(303,270)
Mortgage loans held for portfolio	688,744	(155,239)	533,505	414,114	(50,445)	363,669
<b>TOTAL</b>	<b>1,013,873</b>	<b>(829,740)</b>	<b>184,133</b>	<b>509,399</b>	<b>(589,825)</b>	<b>(80,426)</b>
Increase (decrease) in interest expense:						
Time deposits	3,623	(6,193)	(2,570)	(9,407)	(38)	(9,445)
Other interest-bearing deposits	29,432	(61,479)	(32,047)	34,177	(48,229)	(14,052)
Short-term borrowings	152,629	(224,625)	(71,996)	131,591	(162,824)	(31,233)
Long-term debt	547,192	(507,838)	39,354	272,188	(297,129)	(24,941)
Other borrowings	49,941	(15,388)	34,553	1,377	(247)	1,130
<b>TOTAL</b>	<b>782,817</b>	<b>(815,523)</b>	<b>(32,706)</b>	<b>429,926</b>	<b>(508,467)</b>	<b>(78,541)</b>
Increase (decrease) in net interest income	<b>\$ 231,056</b>	<b>\$ (14,217)</b>	<b>\$ 216,839</b>	<b>\$ 79,473</b>	<b>\$ (81,358)</b>	<b>\$ (1,885)</b>

Supplementary financial data on the Bank's investment securities for the year ended December 31 are included in the below tables.

	2002	2001	2000
	(In thousands)		
Held-to-Maturity Securities			
US Government and Federal Agencies	\$ 152,070	\$ -	\$ 24,603
States and Political subdivisions	222,841	236,671	233,331
Other bonds, notes and debentures	5,253,781	5,017,745	5,518,712
<b>Total Held-to-Maturity Securities</b>	<b>\$ 5,628,692</b>	<b>\$ 5,254,416</b>	<b>\$ 5,776,646</b>

As of December 31, 2002, held-to-maturity securities had the following maturity and yield characteristics.

	Book Value	Yield
	(In thousands)	
US Government and Federal Agencies		
After one but within five years.	\$ 152,070	1.88%
States and political subdivisions		
After one but within five years	\$ 23,510	6.03%
After five but within ten years	9,850	6.00%
After ten years	189,481	4.55%
	<b>\$ 222,841</b>	<b>4.77%</b>
Other bonds, notes and debentures		
Within one year	\$ 508,943	1.85%
After one but within five years	77,887	6.65%
After five but within ten years	202,005	6.66%
After ten years	4,464,946	4.47%
	<b>\$ 5,253,781</b>	<b>4.34%</b>

	2002	2001	2000
	(In thousands)		
Available-for-Sale Securities			
US Government and Federal Agencies	\$ 1,383,242	\$ -	\$ -

As of December 31, 2002, available-for-sale securities had the following maturity and yield characteristics.

	Book Value	Yield
	(In thousands)	
US Government and Federal Agencies		
After one but within five years	\$ 447,242	2.28%
After five but within ten years	936,000	4.52%
	<u>\$ 1,383,242</u>	<u>3.83%</u>

	2002	2001	2000
	(In thousands)		
Held-at-Fair Value Securities			
US Government and Federal Agencies	\$ 1,945,091	\$ 1,542,884	\$ 1,519,820
States and Political subdivisions	-	-	-
Other bonds, notes and debentures	382,731	310,949	306,356
	<u>\$ 2,327,822</u>	<u>\$ 1,853,833</u>	<u>\$ 1,826,176</u>

As of December 31, 2002, held-at-fair value securities had the following maturity and yield characteristics.

	Book Value	Yield
	(In thousands)	
US Government and Federal Agencies		
Within one year	\$ 9,923	5.00%
After one but within five years	174,871	6.65%
After five but within ten years	1,452,387	5.35%
After ten years	307,094	5.86%
	<u>\$ 1,944,275</u>	<u>5.54%</u>
Other bonds, notes and debentures		
Within one year	\$ 110,889	8.57%
After one but within five years	74,915	7.70%
After five but within ten years	39,991	5.87%
After ten years	157,752	5.36%
	<u>\$ 383,547</u>	<u>6.76%</u>

U.S. Government agencies were the only issuers whose securities exceeded 10% of the Bank's total capital at December 31, 2002.

## Mortgage Loan Portfolio Analysis

The Bank's outstanding loans, nonperforming loans and loans 90 days or more past due and accruing interest for the years ended December 31 are as follows:

	2002	2001	2000	1999	1998
	(In thousands)				
Domestic:					
Real estate mortgages	\$ 26,191,322	\$ 16,573,648	\$ 8,104,183	\$ 1,619,455	\$ 930,702
Nonperforming real estate mortgages	\$ 25,295	\$ 4,734	\$ 1,304	\$ 393	\$ -
*Real estate mortgages past due 90 days or more and still accruing interest	\$ 118,906	\$ 99,899	\$ -	\$ -	\$ -
Interest contractually due during the year	\$ 1,688	\$ 323	\$ 85	\$ 30	\$ -
Interest actually received during the year	(858)	(165)	(41)	(11)	-
Shortfall	\$ 830	\$ 158	\$ 44	\$ 19	\$ -

The allowances for credit losses on real estate mortgage loans for the years ended December 31, are as follows:

	2002	2001	2000	1999	1998
	(In thousands)				
Domestic:					
Balance at the beginning of period	\$ 3,340	\$ 1,503	\$ 687	\$ 235	\$ 16
Charge-offs	(138)	(13)	(90)	-	-
Recoveries	45	40	-	-	-
Net (charge-offs) recoveries	(93)	27	(90)	-	-
Provisions for credit losses	2,217	1,810	906	452	219
Balance at end of period	\$ 5,464	\$ 3,340	\$ 1,503	\$ 687	\$ 235

The ratio of net (charge-offs) recoveries to average loans outstanding was less than one basis point for the years ended December 31, 2002, 2001, 2000, 1999 and 1998.

\*Only government loans (e.g., FHA, VA) continue to accrue after 90 days or more delinquent

Borrowings with original maturities of one year or less are classified as short-term. The following is a summary of short-term borrowings for each of the three years ended December 31:

	2002	2001	2000
	(In thousands)		
Federal funds purchased			
Outstanding at year-end	\$ -	\$ -	\$ -
Weighted average rate at year-end	-	-	-
Daily average outstanding for the year	\$ 1,233	\$ 822	\$ 8
Weighted average rate for the year	1.11 %	3.30 %	5.90 %
Highest outstanding at any month-end	\$ -	\$ -	\$ -
Securities under repurchase agreements			
Outstanding at year-end	\$ 1,399,000	\$ 800,000	\$ -
Weighted average rate at year-end	2.65 %	4.38 %	-
Daily average outstanding for the year	\$ 1,176,447	\$ 25,753	\$ -
Weighted average rate for the year	2.98 %	4.30 %	-
Highest outstanding at any month-end	\$ 1,399,000	\$ 800,000	\$ -
Discount notes			
Outstanding at year-end	\$ 14,526,323	\$ 8,995,376	\$ 4,948,713
Weighted average rate at year-end	1.42 %	2.13 %	6.18 %
Daily average outstanding for the year	\$ 11,331,137	\$ 7,508,975	\$ 5,373,331
Weighted average rate for the year	2.01 %	3.99 %	6.16 %
Highest outstanding at any month-end	\$ 14,526,323	\$ 9,668,458	\$ 7,130,162
Total short-term borrowings			
Outstanding at year-end	\$ 15,925,323	\$ 9,795,376	\$ 4,948,713
Weighted average rate at year-end	1.53 %	2.31 %	6.18 %
Daily average outstanding for the year	\$ 12,508,817	\$ 7,535,550	\$ 5,373,339
Weighted average rate for the year	2.10 %	3.99 %	6.16 %

At December 31, 2002, time deposits in denominations of \$100,000 or more totaled \$234,949,000. The table below presents the maturities for time deposits in denominations of \$100,000 or more:

By remaining maturity at December 31, 2002	3 months or less	Over 3 months but within 6 months	Over 6 months but within 12 months	Total
	(In thousands)			
Time certificates of deposits (\$100,000 or more)	\$ 124,174	\$ 16,625	\$ 94,150	\$ 234,949

RATIOS	2002	2001	2000
Net income to average assets	0.40%	0.41%	0.40%
Return on equity before REFCORP	9.79%	9.80%	10.65%
Return on equity after REFCORP	7.83%	7.84%	8.52%
Total average equity to average assets	5.16%	5.28%	4.72%
Dividends declared per share as a percentage of net income per share	64.71%	75.66%	87.76%

## Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

### Part III

#### Executive Officers and Directors of the Bank

##### Executive Officers

The following table sets forth certain information regarding the executive officers of the Bank.

Executive Officer	Age	Capacity in Which Served	Employee of Bank Since
Alex J. Pollock	60	President & Chief Executive Officer	1991
Kenneth L. Gould	58	Executive Vice President, Mortgage Partnership Finance	1992
Charles A. Huston	55	Executive Vice President, Banking	1991
Michael W. Moore	49	Executive Vice President, Treasury	1992
Eldridge Edgecombe	54	Senior Vice President, Community Investment	2001
Peter E. Gutzmer	49	Senior Vice President, General Counsel & Corporate Secretary	1985
Roger D. Lundstrom	42	Senior Vice President, Financial Information	1984
Thomas D. Sheehan	57	Senior Vice President, Corporate Operations	1997

Prior to joining the Bank, Mr. Edgecombe was a Vice President and the Chief Operating Officer for the Federal Home Loan Bank of Cincinnati's Housing and Community Investment Department.

Unless otherwise noted, during the five fiscal years ended December 31, 2002, all of the Bank's above-named executive officers have continuously held senior-level positions with the Bank.

## Directors

The following table sets forth information regarding each of the Bank's directors. Except as otherwise indicated, each director has been engaged in the principal occupation described below for at least five years.

Name	Age	Company Director Since	Expiration of Term as Director
James K. Caldwell	59	1998	12-31-2003
Gerardo H. Gonzalez	40	2003	12-31-2005
Richard W. Graber	46	2002	12-31-2004
Terry W. Grosenheider	46	2002	12-31-2003
Scott K. Heitmann	54	2000	12-31-2005
Allen H. Koranda	56	1997	12-31-2005
P. David Kuhl	53	2000	12-31-2004
C. William Landefeld	63	1999	12-31-2003
Kathleen E. Marinangel	57	2002	12-31-2004
Richard K. McCord	59	2003	12-31-2005
William H. Ross	60	2003	12-31-2005
Jack C. Rusch	56	2003	12-31-2005
H. Lee Swanson	64	1999	12-31-2004
Douglas J. Timmerman	62	1996	12-31-2003
Mindy W. Turbov	46	1998	12-31-2003
Sarah D. Vega	39	2002	12-31-2004

Mr. Caldwell has been President and Chief Executive Officer of The First Citizens State Bank of Whitewater since 1979. He also serves as a director of Weiler & Co., the Fairhaven Corporation and Recreational Properties, Inc.

Mr. Gonzalez has served as Managing Partner of Gonzalez, Saggio & Harlan, L.L.P., a Milwaukee law firm, since 1995.

Mr. Graber is a partner at the law firm of Reinhart, Boerner and Van Duren, sc since 1981. He also serves as a director of the Medical College of Wisconsin.

Mr. Grosenheider has been a private banking relationship manager with U.S. Bank, N.A. since 2002. Previously, He served as the Deputy Secretary of the Wisconsin Department of Financial Institutions from 2000 to 2002. He also held several positions within the Wisconsin Department of Commerce, including Administrator of the Division of Community Development, Administrator of the Division of Economic Development and the Administrator of Marketing, Advocacy and Technology Development, from 1992 until his 2000 appointment as Deputy Secretary.

Mr. Heitmann is Vice Chairman and director of LaSalle Bank N.A., Chicago, Illinois, and Vice Chairman of ABN AMRO North America, Inc., its holding company. Mr. Heitmann also serves as Chairman, President and Chief Executive Officer of Standard Federal Bank N.A., Troy, Michigan, a wholly-owned subsidiary of ABN AMRO North American, Inc.

Mr. Koranda has served as Chairman and CEO of Mid America Bank, fsb, since 1984 and as Chairman and Chief Executive Officer of MAF Bancorp, the holding Company for the bank, since 1990. He currently serves as director of American Community Bankers and the Illinois League of Financial Institutions.

Mr. Kuhl has served as Chairman and CEO of Busey Bank in Urbana, Illinois since 2003. He has been with the Busey Corporation since 1979, serving previously as President and CEO. Mr. Kuhl also serves as a director of 1st Busey Corp, Busey Bank, 1st Busey Securities Inc and 1st Busey Trust. The 1st Busey Corp. is the holding company for Busey Bank, 1st Busey Securities and 1st Busey Trust.

Mr. Landefeld has been President and Chief Executive Officer of Citizens Savings Bank in Bloomington, Illinois, since 1987. He serves as a director of the Illinois League of Financial Institutions, Citizens First Financial Corp., and Citizens Savings Bank.

Ms. Marinangel serves as the CEO, President and Chairman of the Board of McHenry Savings Bank since 1991. She serves as a director of the Illinois League of Financial Institutions and the Illinois Board of Savings Institutions.

Mr. McCord has served as the President and Chief Executive Officer and a director of Illinois National Bank in Springfield and of Illinois National Bancorp, Inc. since 1999. Prior to re-establishing Illinois National Bank in 1999, Mr. McCord was named in 1995 as President and Chief Operating Officer and a director for First of America Bank-Illinois, N.A. He retired from National City Bank, the successor to First of America Bank in 1998, and launched the second generation of Illinois National Bank in 1999. Mr. McCord serves as a director of the Community Bank Council of the Federal Reserve of Chicago.

Mr. Ross serves as President and Treasurer of Ross Carbide & Supply Company, Inc. which he and his wife founded in 1966. He also serves as a director of the Badger Power Marketing Authority, a wholesale supplier of energy and electric transmission.

Mr. Rusch has served as the President and CEO of First Federal Savings Bank, LaCrosse, Wisconsin, since January of 2001. Prior to that, he served as President from August 2000 to January 2001 and other positions of increasing responsibility since joining the Bank in 1985.

Mr. Swanson has served as Chairman, CEO of the State Bank of Cross Plains in Cross Plains, Wisconsin, since 2000. He previously served as President and CEO. Mr. Swanson also serves as a director of Madison Gas and Electric Co.

Mr. Timmerman is the Chairman, President and Chief Executive Officer of AnchorBank and its holding company, Anchor Bancorp Wisconsin Inc., of Madison, Wisconsin since 1985. He also serves as a director of the Wisconsin Savings & Loan Review Board.

Ms. Turbov is the President of Turbov Associates, a consulting firm, since 1997. Ms. Turbov is a director of the National Housing Conference, the McAuley Institute and the Metropolitan Planning Council of Chicago Resource Board.

Mrs. Vega is currently a lawyer living in Chicago, IL. She served from 1999-2003 as Director of the Illinois Department of Financial Institutions. Prior to her appointment as Director, Ms. Vega served as the Supervisor of the Department of Financial Institution's Credit Union Division for eight years.

## Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

None

## Certain Relationships and Related Transactions

Since the Bank is a cooperative, capital stock ownership is a prerequisite to transacting any business with the Bank. The majority of the Bank's Board of Directors are elected by the membership. As such, all members and most directors would be classified as related parties, as defined by securities law and SEC regulations. The following table represents the volume of business transacted with members of the Bank.

	2002	2001
	(In thousands)	
Advance Volume	\$ 9,622,205	\$ 12,097,827
MPF Loans Purchased	\$ 5,823,967	\$ 3,406,073
Deposits Outstanding to Members	\$ 1,830,945	\$ 1,207,434

## Part IV

### Exhibits and Financial Statement Schedules

(a) Financial Statements

See Index to 2002 Financial Statements on page 1.

(b) Financial Statement Schedules

All financial statement schedules are omitted because they are not applicable or not required, or because the required information is included in the 2002 Annual Report financial statements or the Notes thereto.

# Federal Home Loan Bank of Chicago

## 2002 Financial Statements

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# Statements of Condition

December 31,

	2002	2001
	(In thousands)	
<b>Assets</b>		
Cash and due from banks (Note 3)	\$ 3,777	\$ 2,099
Securities purchased under agreements to resell (Note 4)	403,960	49,895
Federal funds sold	3,421,000	3,165,000
<b>Investments:</b>		
Held-to-maturity securities includes \$121,079,833 and \$187,895,320 pledged in 2002 and 2001 (Note 5)	5,628,692	5,254,416
Available-for-sale securities includes \$611,225,031 and \$0 pledged in 2002 and 2001 (Note 6)	1,383,242	—
Securities held at fair value includes \$1,010,901,405 and \$0 pledged in 2002 and 2001 (Note 7)	2,327,822	1,853,833
Advances (Note 8)	24,945,112	21,901,609
Mortgage loans held for portfolio, net of allowance for credit losses on mortgage loans of \$5,463,779 in 2002 and \$3,339,520 in 2001 (Note 10)	26,185,858	16,570,308
Accrued interest receivable	258,489	214,364
Bank premises and equipment, net	32,029	19,455
Derivative assets (Note 16)	422,828	149,627
Other assets	33,338	13,588
<b>Total Assets</b>	<b>\$ 65,046,147</b>	<b>\$ 49,194,194</b>
<b>Liabilities and Capital</b>		
<b>Liabilities</b>		
Deposits: (Note 11)		
Demand and overnight	\$ 2,374,512	\$ 1,506,903
Term	234,949	109,702
Deposits from other FHLBanks for mortgage loan program	69,646	20,809
Other	368,433	122,802
Total deposits	3,047,540	1,760,216
Borrowings -		
Securities sold under agreements to repurchase (Note 12)	1,399,000	800,000
Consolidated obligations, net: (Note 13)		
Discount notes	14,526,323	8,995,376
Bonds	41,243,678	34,281,579
Total consolidated obligations, net	55,770,001	43,276,955
Accrued interest payable	400,931	446,532
Affordable Housing Program (Note 9)	47,538	36,816
Payable to REFCORP	16,945	18,053
Derivative liabilities (Note 16)	437,068	330,509
Other liabilities	568,351	22,329
<b>Total Liabilities</b>	<b>61,687,374</b>	<b>46,691,410</b>
Commitments and contingencies (Notes 8, 9, 13, 14, 15, 16, and 19)		
<b>Capital (Note 14)</b>		
Capital stock (\$100 par value) issued and outstanding shares: 31,261,091 shares in 2002 and 23,943,341 shares in 2001	3,126,109	2,394,334
Retained earnings	191,015	110,429
Accumulated other comprehensive income:		
Net unrealized gain on available-for-sale securities (Note 6)	8,174	—
Net unrealized gain (loss) relating to hedging activities	33,475	(1,979)
<b>Total Capital</b>	<b>3,358,773</b>	<b>2,502,784</b>
<b>Total Liabilities and Capital</b>	<b>\$ 65,046,147</b>	<b>\$ 49,194,194</b>

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

# Statements of Income

	For the Years Ended December 31,		
	2002	2001	2000
	(In thousands)		
<b>Interest Income:</b>			
Mortgage loans held for portfolio, including fees	\$ 1,257,488	\$ 723,983	\$ 360,314
Advances	618,927	882,358	1,185,628
Interest-bearing deposits	—	76	—
Securities purchased under agreements to resell	3,877	2,200	3,775
Federal funds sold	51,235	96,481	155,326
Investments:			
Held-to-maturity securities	125,140	278,900	409,428
Available-for-sale securities	5,535	—	—
Securities held at fair value	156,049	50,293	—
Loans to other FHLBanks	468	295	541
<b>Total interest income</b>	<b>2,218,719</b>	<b>2,034,586</b>	<b>2,115,012</b>
<b>Interest Expense:</b>			
Consolidated obligations	1,708,258	1,740,900	1,797,074
Deposits	46,489	79,556	103,838
Deposits from other FHLBanks for mortgage loan program	1,102	2,652	1,867
Borrowings from other FHLBanks	—	—	4
Securities sold under agreements to repurchase	35,545	1,107	—
Other borrowings	142	27	—
<b>Total interest expense</b>	<b>1,791,536</b>	<b>1,824,242</b>	<b>1,902,783</b>
<b>Net Interest Income before mortgage loan loss provision</b>	<b>427,183</b>	<b>210,344</b>	<b>212,229</b>
Provisions for credit losses on mortgage loans	2,217	1,810	906
<b>Net Interest Income after mortgage loan loss provision</b>	<b>424,966</b>	<b>208,534</b>	<b>211,323</b>
<b>Other Income:</b>			
Prepayment fees	673	824	14
Service fees	1,053	1,033	1,067
Net gain (loss) on securities held at fair values	295,582	(4,872)	—
Net realized and unrealized (loss) gain on derivatives and hedging activities	(344,580)	62,996	—
Other, net	8,657	2,134	(544)
<b>Total other income</b>	<b>(38,615)</b>	<b>62,115</b>	<b>537</b>
<b>Other Expenses:</b>			
Salary and benefits	25,727	20,488	17,038
Other operating	23,061	17,844	12,806
Finance Board	1,600	1,269	1,073
Office of Finance	1,270	749	568
Mortgage loan expense	24,099	10,449	4,567
<b>Total other expenses</b>	<b>75,757</b>	<b>50,799</b>	<b>36,052</b>
<b>Income before Assessments</b>	<b>310,594</b>	<b>219,850</b>	<b>175,808</b>
Affordable Housing Program	25,353	17,996	14,355
REFCORP (Note 1)	57,049	40,478	32,299
<b>Total Assessments</b>	<b>82,402</b>	<b>58,474</b>	<b>46,654</b>
<b>Income before cumulative effect of change in accounting principle</b>	<b>228,192</b>	<b>161,376</b>	<b>129,154</b>
Cumulative effect of change in accounting principle	—	573	—
<b>Net Income</b>	<b>\$ 228,192</b>	<b>\$ 161,949</b>	<b>\$ 129,154</b>

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

# Statements of Capital

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

	Capital Stock		Retained Earnings (Subject to Restrictions)		Accumulated		
	Shares	Par Value	Restricted	Unrestricted	Total Retained Earnings	Other Comprehensive (Loss) Income	Total Capital
<b>2000</b>							
<b>Balance, December 31, 1999</b>	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)
Comprehensive income:							
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)		—
<b>2001</b>							
<b>Balance, December 31, 2000</b>	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 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)		—
<b>2002</b>							
<b>Balance, December 31, 2001</b>	23,943	2,394,334	—	110,429	110,429	(1,979)	2,502,784
Proceeds from sale of capital stock	10,891	1,089,076					1,089,076
Redemption of capital stock	(5,047)	(504,730)					(504,730)
Comprehensive income:							
Net income				228,192	228,192		228,192
Other comprehensive income:							
Net unrealized gain on available-for-sale securities						8,174	8,174
Net unrealized gain relating to hedging activities						35,454	35,454
Total other comprehensive income						43,628	43,628
Comprehensive income				228,192	228,192	43,628	271,820
Dividends on capital stock:							
Cash				(177)	(177)		(177)
Stock	1,474	147,429		(147,429)	(147,429)		—
<b>Balance, December 31, 2002</b>	<b>31,261</b>	<b>\$3,126,109</b>	<b>\$ —</b>	<b>\$191,015</b>	<b>\$191,015</b>	<b>\$41,649</b>	<b>\$3,358,773</b>

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

# Statements of Cash Flows

	For the Years Ended December 31,		
	2002	2001	2000
	(In thousands)		
<b>Operating Activities:</b>			
<b>Net income</b>	\$ 228,192	\$ 161,949	\$ 129,154
Cumulative effect of change in accounting principle	—	573	—
Income before cumulative effect of change in accounting principle	228,192	162,522	129,154
Adjustments to reconcile income before cumulative effect of change in accounting principle to net cash provided by operating activities:			
Depreciation and amortization:			
Net premiums and discounts on consolidated obligations, investments, and deferred costs and fees received on interest-rate exchange agreements	18,697	11,824	(49,672)
Net premiums and discounts on mortgage loans	57,848	31,629	4,117
Concessions on consolidated obligation bonds	11,421	6,190	6,502
Other comprehensive income	65,481	(4,018)	—
Net deferred losses (gains) on hedges	2,029	(2,053)	1,030
Premises and equipment	7,190	5,070	2,485
Other	—	165	(1,467)
Provision for credit losses on mortgage loans held for portfolio	2,217	1,810	906
(Increase) decrease on securities held at fair value, net of transfers and transition adjustments	(215,241)	111,592	—
Gain due to change in net fair value adjustment on derivative and hedging activities	(371,927)	(286,736)	—
Loss on early extinguishment of debt	1,836	—	1,870
Net realized gain (loss) on disposal of premises and equipment	1,093	(2)	(6)
(Increase) decrease in accrued interest receivable	(68,135)	336,331	(17,151)
Decrease (increase) in derivative asset-net accrued interest	8,943	(26,592)	—
Increase (decrease) in derivative liability-net accrued interest	6,350	(28,609)	—
Increase in other assets	(35,958)	(1,543)	(3,169)
Net increase in Affordable Housing Program (AHP) liability and discount on AHP advances	10,645	4,824	5,008
(Decrease) increase in accrued interest payable	(45,601)	(217,527)	90,330
(Decrease) increase in payable to REFCORP	(1,108)	9,357	3,875
Increase (decrease) in other liabilities	546,022	(48,457)	60,092
Total adjustments	(1,802)	(96,745)	104,750
<b>Net Cash Provided (Used) by Operating Activities</b>	<b>229,994</b>	<b>65,777</b>	<b>233,904</b>
<b>Investing Activities:</b>			
Net (increase) decrease in securities purchased under agreements to resell	(354,065)	(4,210)	4,705
Net (increase) decrease in Federal funds sold	(256,000)	(768,000)	773,000
Net decrease (increase) in short-term held-to-maturity securities	273,657	(49,454)	472,787
Purchase of mortgage-backed securities	(3,502,119)	(1,825,105)	(614,000)
Proceeds from maturities and sale of mortgage-backed securities	2,905,919	1,712,178	832,541
Purchases of long-term held-to-maturity securities	(239,763)	(1,520,423)	(44,261)
Proceeds from maturities of long-term held-to-maturity securities	105,271	270,684	184,877
Purchase of available-for-sale securities	(1,344,687)	—	—
Principal collected on advances	18,059,815	23,060,932	31,172,159
Advances made	(20,668,510)	(26,016,696)	(32,467,157)
Principal collected on mortgage loans held for portfolio	7,077,226	3,903,627	252,699
Mortgage loans held for portfolio originated or purchased	(16,680,743)	(12,406,251)	(6,741,634)
Recoveries on mortgage loans held for portfolio	45	40	—
Proceeds from sales of foreclosed assets	4,787	2,998	—
Purchase of premises and equipment	(20,856)	(12,286)	(7,261)
<b>Net Cash Used in Investing Activities</b>	<b>(14,640,023)</b>	<b>(13,651,966)</b>	<b>(6,181,545)</b>

<b>Financing Activities:</b>			
Net increase (decrease) in deposits	1,238,487	(232,651)	(902,061)
Net increase (decrease) in deposits from other FHLBanks for mortgage loan programs	48,837	(17,265)	35,114
Net increase in securities sold under agreement to repurchase	599,000	800,000	—
Net proceeds from issuance of consolidated obligations:			
Discount notes	328,044,532	377,411,969	350,489,157
Bonds	23,692,807	47,669,218	36,708,776
Payment of debt issuance costs	(19,833)	(8,888)	(11,392)
Payments for maturing and retiring consolidated obligations:			
Discount notes	(322,519,155)	(373,377,611)	(352,050,198)
Bonds	(17,257,138)	(39,302,222)	(28,398,881)
Proceeds from issuance of capital stock	1,089,077	1,063,807	474,025
Payments for redemption of capital stock	(504,730)	(422,090)	(406,643)
Cash dividends paid	(177)	(173)	(27,497)
<b>Net Cash Provided by Financing Activities</b>	<b>14,411,707</b>	<b>13,584,094</b>	<b>5,910,400</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>1,678</b>	<b>(2,095)</b>	<b>(37,241)</b>
<b>Cash and Cash Equivalents at Beginning of year</b>	<b>2,099</b>	<b>4,194</b>	<b>41,435</b>
<b>Cash and Cash Equivalents at End of Year</b>	<b>\$ 3,777</b>	<b>\$ 2,099</b>	<b>\$ 4,194</b>
<b>Supplemental Disclosures:</b>			
Interest paid	\$ 1,637,068	\$ 1,741,685	\$ 1,489,660
Stock dividends issued	\$ 147,429	\$ 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 sources of credit from the Bank is in the form of advances to members and the Mortgage Partnership Finance<sup>®</sup> (MPF) Program, under which the Bank, in partnership with its members, provides funding for home mortgage loans. In addition, the FHLBs also invest in other mortgage related investments such as mortgage-backed securities. 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 and the Office of Finance 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. The FHLBs do not have any special purpose entities or any type of off-balance sheet conduits.

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 capital stock issued to members. 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 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 2002, 2001 and 2000, were \$250,901 and \$47,940, \$258,914 and \$38,751, and \$250,535 and \$45,789, 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** - 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, over the estimated life of the investment. 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 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").

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

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

**Advances** - Advances to members are net of discounts on advances for the Affordable Housing Program, as discussed below. In addition, prior to implementing SFAS 133 in 2001, the carrying value of advances is adjusted for the unamortized cost of, and deferred gains and losses from, associated derivative financial instruments. 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 collateral on advances to protect it from losses. As Note 8 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 credit 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 credit losses on advances is deemed necessary by management.

**Mortgage Loans Held in Portfolio** - 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 mortgage loans as held for investment and, accordingly, 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 mortgage 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 mortgage loan. Actual prepayment experience and estimates of future principal prepayments are used in calculating the average lives of the mortgage loans. The Bank aggregates the mortgage loans by similar characteristics (type, 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 conventional mortgage loan on nonaccrual status when the collection of the contractual principal or interest is 90 days or more past due. When a mortgage loan is placed on nonaccrual status, accrued but uncollected interest and amortization of agent fees, premiums and discounts are reversed against interest income. The Bank records cash payments received on nonaccrual mortgage loans as interest income and a reduction of principal.

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

**Affordable Housing Program** - As more fully discussed in Note 9, 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 other income when received. The Bank nets gains and losses on derivative financial instruments associated with prepaid advances with prepayment fees in net realized and unrealized (loss) gain on derivatives and hedging activities.

**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** - All derivatives are recognized on the balance sheet at their fair value and those not used for intermediary purposes 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 purpose. 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 designed as an economic hedge are recorded in current-period earnings with no fair value adjustment to an asset or liability. Hedge ineffectiveness and changes in the fair value of stand-alone derivatives are recorded in other income as "Net realized and unrealized 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 pursuant to an economic hedge. 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 and its method of assessing ineffectiveness. 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, using the level-yield method, 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.

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

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

All options acquired by the Bank are intended to be held for the duration of the hedge relationship. Premiums paid to acquire options in a fair value hedge relationship are accounted for at the derivative's value at inception and reported in other assets. Premiums paid to acquire options in an economic hedge are accounted for at the derivative's value at settlement and reported in other assets. In a highly effective hedge relationship, the premiums paid are reported in other assets and considered the fair value at inception of the option. Premiums paid are amortized over the life of the hedge relationship.

**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 FHLBs, one or more FHLBs may individually serve as counterparties to derivative financial instruments associated with specific debt issues.

For instance, 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 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. The Bank may hedge a convertible advance by entering into a cancelable interest-rate exchange agreement where the Bank pays fixed and receives variable. This type of hedge is treated as a fair value hedge under SFAS 133. The swap counterparty can cancel the interest-rate exchange agreement on 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 and establishing limitations on duration of equity and changes to market value of equity. 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.

A combination of swaps and options, including futures, may be used as a portfolio of derivatives linked to a portfolio of mortgage loans. The portfolio of mortgage loans consists of one or more pools of similar assets, as designated by factors such as product type and coupon. As the portfolio of loans changes due to new loans, liquidations and payments, the derivatives portfolio is modified accordingly to hedge the interest-rate and prepayment risks effectively. A new hedging relationship is created with each change to the loan portfolio.

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.

**Anticipated Streams of Future Cash Flows** - The Bank enters into an option to hedge a specified future variable cash stream as a result of rolling over short-term fixed-rate financial instruments such as LIBOR advances and discount notes. The option will effectively cap the variable cash stream at a predetermined target rate.

**Firm Commitment Strategies** - The Bank hedges the market value of purchase commitments on fixed rate mortgage loans by using derivatives that would have similar market value characteristics. The Bank normally hedges these firm commitments by selling a Mortgage-Backed Securities to be announced (TBA MBS) or other derivatives for forward settlement. When the derivative settles, the current market value of the commitments is included with the basis of the mortgage loans and amortized accordingly. This transaction would be treated as a fair value hedge.

The Bank may also hedge a firm commitment for a forward starting advance through the use of an interest-rate swap. In this case, the swap will function as the hedging instrument for both the firm commitment and the subsequent advance. The basis movement associated with the firm commitment will be rolled into the basis of the advance at the time the commitment is terminated and the advance is issued. The basis adjustment will then be amortized into interest income over the life of the advance.

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

Prior to the implementation of SFAS 133, the Bank adjusted the carrying value of these investments for the fair value of derivative financial instruments that are associated with them. Beginning in 2001, for available-for-sale securities that have been hedged and qualify as a fair value hedge, the Bank records the portion of the change in value related to the risk being hedged in other income as "Net realized and unrealized gain (loss) on derivatives and hedging activities" together with the related change in the fair value of the derivative financial instruments, and the remainder of the change in other comprehensive income as an "net unrealized gain or (loss) on available-for-sale securities". For available-for-sale securities that have been hedged and qualify as a cash flow hedge, the Bank records the effective portion of the change in value of the derivative related to the risk being hedged in other comprehensive income as a "net unrealized gain loss on hedging activities". The ineffective portion is recorded in other income.

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

**Anticipated 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 derivative 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 foreign 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, 2002, consolidated obligations denominated in foreign currencies represented less than 1 percent of consolidated obligations outstanding. The Bank is not exposed to material amounts of foreign currency risk.

To meet the 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** - The Bank recorded premises and equipment at cost less accumulated depreciation and amortization of approximately \$14,733,000 and \$11,358,000 at December 31, 2002 and 2001 respectively. Depreciation is recognized on a straight-line basis. Computer hardware and software are depreciated over 3 years and equipment over 5 years. Leasehold improvements are amortized on a straight-line basis over 10 years 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.

Cost of computer software developed or obtained for internal use is accounted for in accordance with Statement of Position No. 98-1, “Accounting for the Costs of Computer Software Developed or Obtained for Internal Use” (SOP 98-1). SOP 98-1 requires the cost of purchased software and certain costs incurred in developing computer software for internal use to be capitalized and amortized over future periods. As of December 31, 2002 and 2001, the Bank had \$13,685,000 and \$2,679,000, respectively, in unamortized computer software costs included in Bank premise and equipment. Amortization of computer software costs charged to expense was \$6,056,000, \$3,959,000 and \$1,485,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

**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. Fair value is defined as the amount that a willing seller could expect from a willing buyer in an arm’s-length transaction. 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. As of December 31, 2002 and 2001, the Bank had \$7,458,000 and \$1,977,000, respectively, in real estate owned, which is reported in the MPF Program operating segment.

**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 nature 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 nature.

**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. The Finance Board in consultation with the Secretary of the Treasury will select the appropriate discounting factors to be used in this annuity calculation. The cumulative amount to be paid to REFCORP by the FHLBanks is not determinable at this time due to the interrelationships of all future FHLBanks’ earnings. The FHLBanks’ payments for 2002 defease all future benchmark payments after the 1st quarter of 2022 and \$71 million of the \$75 million benchmark payment for the 4th quarter of 2021.

**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 18.

**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 and due from banks as cash and cash equivalents.  
**Reclassifications** - Certain amounts in the 2001 and 2000 financial statements have been reclassified to conform with the 2002 presentation.

## Note 2 - Changes in Accounting Principle and Recently Issued Accounting Standards and Interpretations

**Adoption of SFAS 145** - The FHLBank adopted Statement of Financial Accounting Standards No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" (herein referred to as "SFAS 145") on June 30, 2002. SFAS 145 rescinds both SFAS 4, "Reporting Gains and Losses from the Extinguishment of Debt" and the amendment to SFAS 4, SFAS 64, "Extinguishment of Debt made to Satisfy Sinking-Fund Requirements," and eliminates the requirement that gains and losses from the extinguishment of debt (except for those considered unusual or infrequent in nature) be aggregated and, if material, classified as an extraordinary item, net of the related income tax effect. In accordance with the transition provisions of SFAS 145, previously reported gains and losses on early retirement of debt have been reclassified into other income under "other, net". The amounts reclassified were not material.

**Adoption of FIN 45** - FASB issued Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34" ("FIN 45") on November 25, 2002. FIN 45 expands existing disclosure requirements at December 31, 2002 for guarantees and provides initial recognition and measurement provisions to be applied on a prospective basis for guarantees issued or modified after December 31, 2002.

**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 are recognized in current period earnings. Changes in the fair value of a non-SFAS 133 hedge of an asset or liability (economic hedge) for asset/liability management are recorded each period in current earnings.

For a derivative designated as a fair-value hedge, the transition adjustment for the derivative was reported as a cumulative effect adjustment of net income. Concurrently, any fair value gain or loss on the hedged item was recognized as an adjustment of the hedged item's carrying amount, but only to the extent of the offsetting transition adjustment of the derivative, and was also reported as a cumulative effect adjustment of net income. The transition provisions of SFAS 133 also provide that at the date of initial implementation an entity may transfer any security classified as "held-to-maturity" to "available-for-sale" or "trading" (herein referred to as securities held at fair value), and any security classified as "available-for-sale" to "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	<u>\$ 573</u>

The Bank also recorded cumulative-effect adjustments in other comprehensive income as of January 1, 2001, and recorded changes in other comprehensive income for the years ended December 31, 2002 and 2001, as follows: (Dollar amounts in thousands):

Net amounts reclassified to earnings for the year ended December 31, 2001	\$ 29,248
Net change associated with hedging activities for the year ended December 31, 2001	<u>(31,227)</u>
Total cumulative effect of change in accounting change principle on other comprehensive income at January 1, 2001, and net change during the year ended December 31, 2001, related to hedging activities	(1,979)
Net amounts reclassified as to earnings for the year ended December 31, 2002	(65,997)
Net change associated with hedging activities for the year ended December 31, 2002	<u>101,451</u>
Accumulated comprehensive income related to hedging activities at December 31, 2002	<u><u>33,475</u></u>

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, 2002 and 2001, the FHLBank recorded net (losses) gains on derivatives and hedging activities of \$(345) million and \$63 million, respectively, in other income. Net (losses) gains on derivatives and hedging activities for the years ended December 31, 2002 and 2001 are as follows:

Net (Losses) Gains on Derivatives and Hedging Activities

	For the Year Ended	
	2002	2001
	(In thousands)	
(Losses) gains related to fair-value hedge ineffectiveness	\$ (34,063)	\$ 8,982
(Losses) gains on economic hedges	(310,517)	20,748
Gains related to cash-flow hedge ineffectiveness	—	33,266
Net (losses) gains on derivatives and hedging activities	\$(344,580)	\$62,996

There were no material amounts for the years ended December 31, 2002 and 2001, that were reclassified into earnings as a result of the discontinuance of cash flow hedges because it became probable that the original forecasted transactions would not occur by the end of the originally specified time period or within a two month period thereafter. Amounts recorded in other comprehensive income are subsequently reclassified into earnings during the same period in which the underlying hedged item affects earnings. As of December 31, 2002, the deferred net losses on derivative instruments accumulated in other comprehensive income expected to be reclassified as to earnings during the next twelve months is \$105,511,000. The maximum length of time over which the FHLBank is hedging its 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.

### 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, 2002 and 2001 were approximately \$737,000 and \$515,000, 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, 2002 and 2001. The Bank was required to maintain minimum average daily clearing balances of \$2,000,000 for the years ended December 31, 2002 and 2001. 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. The amount shown as cash and due from banks includes pass-through reserves deposited with Federal Reserve Banks of approximately \$9,804,000 and \$11,113,000 as of December 31, 2002 and 2001, 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. At December 31, 2002 and 2001, the fair value of collateral accepted by the Bank in connection with these activities was \$403,960,000 and \$49,895,000, respectively. Of the total collateral pledged as of December 31, 2002, \$403,960,000 of collateral were permitted to be sold or repledged by the Bank.

## Note 5 - Held-To-Maturity Securities

Major Security Types - Held-to-maturity securities as of December 31, 2002 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
(In thousands)				
Commercial paper	\$ 49,918	\$ —	\$ (3)	\$ 49,915
U.S. agency obligations	152,070	528	—	152,598
State or local housing agency obligations	222,841	3,889	(1,455)	225,275
SBA/SBIC Loans	548,516	15,378	(11,100)	552,794
Other	13,796	98	(116)	13,778
	987,141	19,893	(12,674)	994,360
Mortgage-backed securities	4,641,551	96,892	(3,897)	4,734,546
Total	\$ 5,628,692	\$ 116,785	\$ (16,571)	\$ 5,728,906

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

**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:

	2002		2001	
	(In thousands)		(In thousands)	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 508,943	\$ 506,155	\$ 782,600	\$ 782,804
Due after one year through five years	180,198	182,215	35,632	36,408
Due after five years through ten years	88,668	104,428	99,447	101,400
Due after ten years	209,332	201,562	209,302	196,669
	987,141	994,360	1,126,981	1,117,281
Mortgage-backed securities	4,641,551	4,734,546	4,127,435	4,165,826
Total	\$ 5,628,692	\$ 5,728,906	\$ 5,254,416	\$ 5,283,107

The amortized cost of the Bank's mortgage-backed securities classifications held-to-maturity includes net of premium (discounts) of \$1,855,332 and (\$1,529,042) at December 31, 2002 and 2001, respectively.

**Interest-Rate Payment Terms** - Interest rate payment terms for investment securities classified as held-to-maturity at December 31, 2002 and 2001 are detailed in the following table:

	2002	2001
	(In thousands)	
Amortized cost of held-to-maturity securities other than mortgage-backed securities:		
Fixed-rate	\$ 901,026	\$ 1,067,824
Variable-rate	86,115	59,157
	987,141	1,126,981
Amortized cost of held-to-maturity mortgage-backed securities:		
Pass-through securities:		
Fixed-rate	867,656	96,333
Variable-rate	171,717	330,270
Collateralized mortgage obligations:		
Fixed-rate	2,007,946	2,343,795
Variable-rate	1,594,232	1,357,037
	4,641,551	4,127,435
Total	\$ 5,628,692	\$ 5,254,416

## Note 6 - Available-for-Sale Securities

**Major Security Types** - Available-for-sale securities as of December 31, 2002, were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
	(In thousands)			
U.S. agency obligations	\$ 1,366,590	\$ 16,652	\$ —	\$ 1,383,242

The Bank has recorded \$8,479,000 of unrealized gains on available-for-sale securities associated with hedging activities.

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

	Amortized Cost	2002 Estimated Fair Value
	(In thousands)	
<b>Year of Maturity</b>		
Due after one year through five years	\$ 445,365	\$ 447,242
Due after five years through ten years	921,225	936,000
Total	\$ 1,366,590	\$ 1,383,242

The amortized cost of the FHLBank's mortgage-backed securities classified as available-for-sale includes net premiums of \$42,580,000 at December 31, 2002.

**Interest Rate Payment Terms** - Interest rate payment terms for all investment securities classified as available-for-sale at December 31, 2002 were fixed rate.

## Note 7 - Securities Held at Fair Value

**Major Security Types** - Securities held at fair value as of December 31, 2002, and 2001, were as follows:

	2002	2001
	(In thousands)	
U.S. agency obligations	\$1,945,091	\$1,542,884
Other FHLBs' bonds	188,469	204,249
Total	2,133,560	1,747,133
Mortgage-backed securities	194,262	106,700
Total	\$2,327,822	\$1,853,833

Net gain (loss) on securities held at fair value during the year ended December 31, 2002, and 2001, included a change in net unrealized holding gain (loss) of \$295,582,000 and \$(4,872,000), respectively. The Bank recorded a gain of \$2,289,000 on the sale of securities held at fair value for the year ended December 31, 2002. The Bank did not sell any securities during 2001 and 2000.

## Note 8 - Advances

**Redemption Terms** - At December 31, 2002 and 2001, the Bank had advances outstanding to members, including AHP advances (see Note 9), at interest rates ranging from 1.32% to 8.47% and 1.74% to 8.47%, respectively, as summarized below. AHP subsidized advances have an average interest rate of 4.83% and 5.13% as of December 31, 2002 and 2001 respectively.

Year of Maturity	2002		2001	
	Amount (In thousands)	Weighted Average Interest Rate	Amount (In thousands)	Weighted Average Interest Rate
2002	—	—	\$ 6,849,625	4.38%
2003	\$ 5,380,219	3.56%	3,452,028	4.88
2004	5,015,482	4.19	2,343,147	5.27
2005	3,836,712	4.75	1,644,721	5.86
2006	3,363,846	2.48	3,188,769	2.81
2007	2,175,846	2.46	155,337	6.50
Thereafter	4,254,951	5.00	3,784,735	5.12
Total par value	24,027,056	3.89%	21,418,362	4.59%
Discount on AHP advances	(233)		(309)	
SFAS 133 hedging adjustments	918,289		483,556	
Total with interest rate exchange agreements	\$ 24,945,112		\$ 21,901,609	

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, 2002 and 2001 the Bank had Callable Advances outstanding totaling \$100,100,000 and \$75,100,000 respectively.

The following table summarizes advances to member institutions at December 31, 2002 and 2001 by year of maturity or next call date for Callable Advances:

Year of Maturity or Next Call Date	2002	2001
	(In thousands)	
2002	—	\$ 6,924,724
2003	\$ 5,480,319	3,452,028
2004	5,015,482	2,343,147
2005	3,836,712	1,644,721
2006	3,363,846	3,163,770
2007	2,175,846	155,337
Thereafter	4,154,851	3,734,635
Total par value	\$ 24,027,056	\$ 21,418,362

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, 2002 and 2001, the Bank had Convertible Advances outstanding totalling \$6,034,486,000 and \$6,015,086,000, respectively.

The following table summarizes advances to member institutions at December 31, 2002 and 2001 by year of maturity or next conversion date for Convertible Advances:

Year of Maturity or Next Conversion Date	2002	2001
	(In thousands)	
2002	—	\$ 10,641,505
2003	\$ 9,828,650	4,153,678
2004	4,972,684	2,254,349
2005	2,874,712	737,722
2006	3,237,263	3,037,586
2007	2,200,846	155,337
Thereafter	912,901	438,185
Total par value	\$ 24,027,056	\$ 21,418,362

**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" (CFIs) are subject to expanded 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, 2002 and 2001, 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 two exceptions are claims that would be entitled to priority under otherwise applicable law or perfected security interest.

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

The Bank's potential credit risk from advances is concentrated in commercial banks and savings institutions. As of December 31, 2002, the Bank had advances (in thousands) of \$7,366,677 outstanding to two member institutions, and this represented 31 percent of total advances outstanding. The income from advances to these member institutions amounted to \$190,027,092 during 2002. The Bank held sufficient collateral to cover the advances to these institutions, 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 at December 31, 2002 and 2001 are detailed in the following table:

	2002	2001
	(In thousands)	
Par amount of advances:		
Fixed-rate	\$ 19,191,436	\$ 17,617,766
Variable-rate	4,835,620	3,800,596
Total par value	<u>\$ 24,027,056</u>	<u>\$ 21,418,362</u>

The estimated fair value of advances, as of December 31, 2002 and 2001 is disclosed in Note 18.

## Note 9 - 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. 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 for all 12 FHLBs, 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 2002 or 2001. The Bank had outstanding principal in AHP-related advances of \$4,842,571 and \$5,297,958 at December 31, 2002 and 2001, respectively.

## Note 10 - Mortgage Loans Held for Portfolio

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, 2002 and 2001 on mortgage loans:

	2002	2001
	(In thousands)	
Mortgages:		
Fixed medium-term* single-family mortgages	\$ 5,524,014	\$ 2,088,350
Fixed long-term single-family mortgages	20,416,937	14,430,880
Unamortized premiums, net	147,105	44,494
Plus: deferred loan costs, net	32,640	11,442
Total mortgage loans	<u>26,120,696</u>	<u>16,575,166</u>
SFAS 133 hedging adjustments	70,626	(1,518)
Total with interest rate exchange agreements	<u>\$ 26,191,322</u>	<u>\$ 16,573,648</u>

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

The par value of mortgage loans outstanding at December 31, 2002 and December 31, 2001, was comprised of government guaranteed loans totaling \$6,962,924,000 and \$5,747,293,000 and conventional loans totaling \$18,978,027,000 and \$10,771,937,000 respectively. The allowances for credit losses on MPF Program loans was as follows:

	2002	2001	2000
	(In thousands)		
Allowance for credit losses:			
Balance, beginning of year	\$ 3,340	\$ 1,503	\$ 687
Chargeoffs	(138)	(13)	(90)
Recoveries	45	40	—
Net recoveries (chargeoffs)	(93)	27	(90)
Provisions for credit losses	2,217	1,810	906
Balance, end of year	\$ 5,464	\$ 3,340	\$ 1,503

The estimated fair value of the mortgage loans held for portfolio as of December 31, 2002 and 2001 is reported in Note 18.

## Note 11 - 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 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.

## Note 12 - 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. Assets having a book value of \$1,470,769,000 and \$830,420,000 as of December 31, 2002 and 2001, respectively, were pledged as collateral for repurchase agreements. The assets pledged generally were comprised of investment securities. Of the total collateral pledged as of December 31, 2002, \$1,344,043,000 of collateral were permitted to be sold or replaced by the secured party.

## Note 13 - Consolidated Obligations

Consolidated obligations are the joint and several obligations of the FHLBs and consist of consolidated bonds and discount notes. Through December 31, 2000, the Finance Board issued consolidated obligations through the Office of Finance. Effective January 1, 2001, and in accordance with final rules adopted by the Finance Board, the Finance Board discontinued issuing consolidated obligations and the FHLBs began issuing consolidated obligations through the Office of Finance as their agent. Consolidated bonds are issued primarily to raise intermediate and long-term funds for the 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 \$680.7 billion and \$637.3 billion at December 31, 2002 and 2001, 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 has been based on a ratio of assets to capital, rather than a ratio of liabilities to capital. The Finance Board's former regulations prohibited the issuance of consolidated obligations if such issuance would bring the 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, a 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, 2002 and 2001, the Bank's capital stock was 5.17% and 5.22% of consolidated obligations outstanding and the SAA balance was approximately \$24.0 million and \$28.3 million. 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, 2002, and 2001.

**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 Index (COFI), and others. In addition, to meet the specific needs of certain investors in consolidated obligations, both 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, 2002 and 2001 by year of maturity.

Year of Maturity	2002		2001	
	Amount (In thousands)	Weighted Average Interest Rate	Amount (In thousands)	Weighted Average Interest Rate
2002	—		\$ 7,373,950	5.94%
2003	\$ 10,224,530	3.53%	8,254,530	4.17
2004	6,211,000	3.32	3,131,000	4.71
2005	5,111,560	4.74	2,806,560	6.51
2006	3,316,200	4.71	3,558,200	5.16
2007	3,801,550	4.69	1,795,050	6.48
Thereafter	14,209,815	4.74	7,531,315	6.13
Total par value	42,874,655	4.24%	34,450,605	5.44%
Bond premiums	60,409		77,310	
Bond discounts	(2,178,065)		(195,295)	
SFAS 133 hedging adjustments	489,487		(46,205)	
Deferred net loss on terminated interest rate exchange agreements	(2,808)		(4,836)	
Total with interest rate exchange agreements	\$ 41,243,678		\$ 34,281,579	

The Bank makes significant use of fixed-rate callable debt to finance MPF Program mortgage loans, Callable Advances (see Note 8) 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:

	2002		2001	
	Amount (In thousands)	Percentage of Callable/ Non Callable Bonds To Total	Amount (In thousands)	Percentage of Callable Non Callable Bonds To Total
Par amount of consolidated bonds:				
Non-callable or non-putable	\$ 30,298,655	70.67%	\$ 23,046,605	66.90%
Callable	12,576,000	29.33	11,404,000	33.10
Total par value	<u>\$ 42,874,655</u>	<u>100.00%</u>	<u>\$ 34,450,605</u>	<u>100.00%</u>

The following table summarizes the Bank's participation in consolidated bonds outstanding at December 31, 2002 and 2001, by year of maturity or next call date:

Year of Maturity or Next Call Date	2002	2001
	(In thousands)	
2002	—	\$ 13,704,950
2003	\$ 18,747,530	11,549,530
2004	6,963,000	3,038,000
2005	4,682,560	2,106,560
2006	1,841,200	1,138,200
2007	3,876,550	805,050
Thereafter	6,763,815	2,108,315
Total par value	<u>\$ 42,874,655</u>	<u>\$ 34,450,605</u>

**Interest Rate Payment Terms** - Interest rate payment terms for consolidated bonds at December 31, 2002 and 2001 are detailed in the following table. Range bonds are classified as comparative-index bonds.

	2002	2001
	(In thousands)	
Par amount of consolidated bonds:		
Fixed rate	\$ 37,113,105	\$ 30,873,555
Variable rate	5,650,000	3,400,000
Inverse floating rate	50,000	50,000
Variable that converts to fixed	—	30,000
Comparative-index	61,550	97,050
Total par value	<u>\$ 42,874,655</u>	<u>\$ 34,450,605</u>

**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, 2002 and 2001 respectively, and included 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, 2002 and 2001 was as follows:

Foreign Currency Description	Amount Denominated in Foreign Currency (In thousands)		Year of Maturity	Effective Terms of Bonds Combined with Exchange Contracts (In thousands) Par Amount in U.S. Dollars		Interest Rate
	2002	2001		U.S. Dollars	Interest Rate	
British Pound	—	300,000	2002	\$ 488,700	6.88%	
British Pound	300,000	300,000	2003	507,900	5.65%	
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, 2002	\$ 14,526,323	\$14,563,201	1.42%
December 31, 2001	8,995,376	\$ 9,015,850	2.13%

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

## Note 14 - 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 Finance Board approved the Bank's capital plan on June 12, 2002. 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 Bank fully implements the new capital regulations, anticipated in 2004, 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 plan has been implemented, 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 minimum 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.

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.

## Note 15 - 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 through June 30, 2002. Contributions to the Plan resumed on July 1, 2002. Funding and administrative costs of FIRF charged to other operating expenses were \$464,608 in 2002. 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 \$523,000, \$428,000, and \$360,000 for the years ended December 31, 2002, 2001, and 2000, respectively.

In addition, the Bank maintains a deferred compensation plan, available to all employees, which is, in substance, an unfunded supplemental retirement plan. The plan's liability consists of the accumulated compensation deferrals and accrued earnings on the deferrals. The Bank's minimum obligation from these plans at December 31, 2002, and 2001, was \$2,456,249 and \$2,220,800, respectively.

Effective January 1, 1994, the Bank adopted a Benefit Equalization Plan. This plan is an unfunded nonqualified deferred compensation plan providing benefits limited in the other retirement plans by laws governing such plans.

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 16 - 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, mortgage loans, 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, 2002 and 2001, the Bank's maximum credit risk, as defined above, was approximately \$450,421,280 and \$137,574,000 respectively, including \$39,907,750 and \$55,201,000 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 \$439,817,977 and \$128,929,000 as collateral for interest rate exchange agreements as of December 31, 2002 and 2001, 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 19.

**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 \$937,664,000 and \$835,911,000 at December 31, 2002 and 2001.

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, 2002:

Total by Product	Notional	Estimated fair value (excludes accrued interest)
	(In thousands)	
<b>ADVANCES</b>		
Fair Values	\$16,772,364	\$(903,014)
Cash Flow	4,075,000	301,563
Total	20,847,364	(601,451)
<b>INVESTMENTS</b>		
Fair Value	600,000	(44,196)
Cash Flow	400,000	31,600
Stand Alone	1,960,402	(193,812)
Total	2,960,402	(206,408)
<b>MPF LOANS</b>		
Fair Value	2,643,255	(2,022)
Stand Alone	3,145,000	24,483
Total	5,788,255	22,461
<b>CO BONDS</b>		
Fair Value	14,363,250	439,599
Cash Flow	1,500,000	1,515
Stand Alone	225,000	5,212
Total	16,088,250	446,326
<b>DISCOUNT NOTES</b>		
Cash Flow	3,530,000	175,726
<b>DEPOSITS</b>		
Cash Flow	3,750,000	108,868
<b>INTERMEDIARIES</b>		
Stand Alone	937,664	328
Total	\$53,901,935	(54,150)
Total Derivatives Excluding Accrued Interest		(54,150)
Accrued Interest at 12/31/02		39,910
Net Derivative Balance at 12/31/02		(14,240)
Net Derivative Asset Balance at 12/31/02		422,828
Net Derivative Liability Balance at 12/31/02		437,068
Net Derivative Balance at 12/31/02		\$ (14,240)

The following table categorizes the hedging activities 2002 earnings impact by product:

Earnings Impact	Advances	CO Bonds	Investments	MPF Loans	Discount Notes	Total
	(In thousands)					
Net Margin						
(Amortization/Accretion)	\$(26,575)	\$(3,082)	\$ 1,162	\$ (3,063)	\$(25,693)	\$( 57,251)
Other Income/(Expense)	8,075	(1,622)	(317,745)	(38,009)	-	(349,301)
Securities Held at Fair Value	-	-	294,827	-	-	294,827
Total	\$(18,500)	\$(4,704)	\$(21,756)	\$(41,072)	\$(25,693)	\$(111,725)

## Note 17 - Segment Information

The Bank has identified two main operating segments; MPF<sup>®</sup> 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 deposits.

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

	MPF	Traditional Member Finance	Total
	(In thousands)		
2002			
Net interest income	\$ 196,523	\$ 230,660	\$ 427,183
Provision for credit losses on mortgage loans	2,217	—	2,217
Other income	3,416	(42,031)	(38,615)
Other expenses	45,746	30,011	75,757
Income before assessments	151,976	158,618	310,594
Affordable Housing Program	12,406	12,947	25,353
REFCORP	27,914	29,135	57,049
Total assessments	40,320	42,082	82,402
Net income before extraordinary item	\$ 111,656	\$ 116,536	\$ 228,192
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	186	351	537
Other expenses	16,178	19,874	36,052
Income before assessments	9,918	165,890	175,808
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	\$ 7,114	\$ 122,040	\$ 129,154
2002			
Total mortgage loans, net	\$26,185,858	\$ —	\$26,185,858
Average mortgage loans, net	\$24,818,945	\$ —	\$24,818,945
Total assets	\$27,080,615	\$37,965,532	\$65,046,147
2001			
Total mortgage loans, net	\$16,570,308	\$ —	\$16,570,308
Average mortgage loans, net	\$10,459,598	\$ —	\$10,459,598
Total assets	\$16,884,057	\$32,310,137	\$49,194,194
2000			
Total mortgage loans, net	\$8,102,680	\$ —	\$ 8,102,680
Average mortgage loans, net	\$4,863,128	\$ —	\$ 4,863,128
Total assets	\$8,155,802	\$27,232,976	\$35,388,778

## Note 18 - Estimated Fair Values

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

**Federal Funds Sold** - The estimated fair value has been determined by calculating the present value of the expected future cash flows for instruments with more than three months to maturity. The discount rates used in these calculations are the rates for Federal funds with similar terms. The estimated fair value approximates the recorded book balance for federal funds with three months or less to maturity.

**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 future cash flows from the advances and reducing this amount for accrued interest receivable. The discount rates used in these calculations are the replacement advance rates for advances with similar terms. 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 Held for Portfolio** - 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.

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

**Consolidated Obligations** - 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 of borrowings with fixed rates and more than three months to maturity 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. For borrowings with floating rates and fixed rates with three months or less to maturity or repricing, the estimated fair value approximates the recorded book balance.

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

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

Financial Instrument	Carrying Value	Net	
		Unrecognized Gain or (Loss)	Estimated Fair Value
(In thousands)			
<u>Financial Assets</u>			
Cash and due from banks	\$ 3,777	\$ —	\$ 3,777
Securities purchased under agreements to resell	403,960	(4)	403,956
Federal funds sold	3,421,000	(33)	3,420,967
Held-to-maturity securities	5,628,692	100,214	5,728,906
Securities available for sale	1,383,242	—	1,383,242
Securities held at fair value	2,327,822	—	2,327,822
Advances to members	24,945,112	173,768	25,118,880
Mortgage loans, net	26,185,858	652,232	26,838,090
Accrued interest receivable	258,489	—	258,489
Derivative assets	422,828	—	422,828
Total financial assets	<u>\$ 64,980,780</u>	<u>\$ 926,177</u>	<u>\$ 65,906,957</u>
<u>Financial Liabilities</u>			
Deposits	(3,047,540)	(369)	(3,047,909)
Securities sold under agreements to repurchase	(1,399,000)	(44,433)	(1,443,433)
Consolidated obligations:			
Discount notes	(14,526,323)	(6,252)	(14,532,575)
Bonds	(41,243,678)	(1,289,943)	(42,533,621)
Accrued interest payable	(400,931)	—	(400,931)
Derivative liabilities	(437,068)	—	(437,068)
Loan Commitments	—	27,921	27,921
Standby letters of credit	—	78	78
Total financial liabilities	<u>\$ (61,054,540)</u>	<u>\$ (1,312,998)</u>	<u>\$ (62,367,538)</u>

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

Financial Instrument	Carrying Value	Net	
		Unrealized Gain or (Loss)	Estimated Fair Value
(In thousands)			
<u>Financial Assets</u>			
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	1,853,833	—	1,853,833
Advances to members	21,901,609	34,795	21,936,404
Mortgage loans held for portfolio, net	16,570,308	179,165	16,749,473
Accrued interest receivable	214,364	—	214,364
Derivative assets	149,627	—	149,627
Total financial assets	<u>\$ 49,161,151</u>	<u>\$ 242,577</u>	<u>\$ 49,403,728</u>
<u>Financial Liabilities</u>			
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	(34,281,579)	(522,720)	(34,804,299)
Accrued interest payable	(446,532)	—	(446,532)
Derivative liabilities	(330,509)	—	(330,509)
Commitments to extend credit	—	(13,878)	(13,878)
Total financial liabilities	<u>\$ (46,614,212)</u>	<u>\$ (533,451)</u>	<u>\$ (47,149,663)</u>

## Note 19 - Commitments and Contingencies

Commitments which legally bind and unconditionally obligate the Bank for additional advances totaled \$2,555,000 and \$0 at December 31, 2002 and 2001, respectively. Commitments generally are for periods up to 12 months. Standby Letters of credit are executed for members for a fee. A standby letter of credit is a short-term financing arrangement between the Bank and its member. If the Bank is required to make payment for a beneficiary's draw, these amounts are converted into collateralized advance to the member. Outstanding standby letters of credit were approximately \$356,904,000 and \$374,000,000 at December 31, 2002 and 2001, respectively, and had original terms of one to 12 years with final expiration in 2012. Based on management's credit analysis and collateral requirements, the Bank does not deem it necessary to have any provision for credit losses on these commitments and letters of credit. Commitments and letters of credit are fully collateralized at the time of issuance, in a manner consistent with advances to members (Note 8). The estimated fair value of commitments and letters of credit as of December 31, 2002 and 2001 is reported in Note 18.

Commitments which unconditionally obligate the Bank to fund/purchase mortgage loans totaled approximately \$1,408,222,000 and \$979,494,000 at December 31, 2002 and 2001, 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, 2002 and 2001, the Bank had pledged as collateral securities with a fair value of \$1,112,471,000 and \$187,895,000, 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 \$2,482,000, \$2,088,000, and \$2,216,000 for the years ended December 31, 2002, 2001 and 2000, respectively. Future minimum rentals are as follows:

Year	Premises	Services and Equipment	Total
		(In thousands)	
2003	\$ 2,752	\$ 302	\$ 3,054
2004	2,986	257	3,243
2005	3,250	120	3,370
2006	3,615	22	3,637
2007	4,048	—	4,048
Thereafter	18,176	—	18,176
Total	\$ 34,827	\$ 701	\$ 35,528

The Bank's lease agreement expires on July 31, 2011. Rent payments consist of a base rent, tax share rent (which is not capped) and operating cost share rent. The operating cost share rent is equal to the lower of either the Bank's proportionate share or 108% of the proportionate share for the prior year. 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 13, 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, as determined or approved by the Finance Board. The Bank does not recognize a liability for its joint and several obligation since each FHLB is rated triple-A and any future possible loss on these obligations is extremely remote. The amount of the other FHLBank's consolidated obligations were \$623,257,144,000 and \$593,865,545,000 for the years ended December 31, 2002 and 2001 respectively.

As of December 31, 2002, 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, 2002 and 2001, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the 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 of America. 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 discussed in Note 2, the FHLBank adopted Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by Statement of Financial Accounting Standards No. 138, on January 1, 2001.



February 17, 2003  
Chicago, Illinois

## Management Report of Responsibility for Financial Reporting

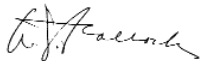
The management of the Federal Home Loan Bank of Chicago (the Bank) prepared the financial statements contained in the Annual Report in accordance with generally accepted accounting principles. Management has primary responsibility for the integrity and objectivity of the financial statements, which include 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, 2002 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 six 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 17, 2003

The Audit Committee of the Board of Directors of the Federal Home Loan Bank of Chicago for 2002 was composed of six Directors. The members of the Audit Committee at December 31, 2002 were: Michael D. Meeuwsen, Karl S. Pnazek, Kathleen E. Marinangel, H. Lee Swanson, Douglas J. Timmerman, and Sarah D. Vega.

This report is submitted by the 2003 Audit Committee, whose members are listed below. Both the 2002 and 2003 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 reviews 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 2002 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.

P. David Kuhl, Chairman  
Jack C. Rusch, Vice Chairman  
H. Lee Swanson  
Douglas J. Timmerman  
Sarah D. Vega

# 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 and significant accounting, and reporting issues.
- \* 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 preparing the Bank's financial statements. 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 three 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 analysis 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 quorum 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  
December, 2002

# Chicago FHLB Officers

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## **Executive Vice Presidents**

Kenneth L. Gould, Mortgage Partnership Finance

Charles A. Huston, Banking

Michael W. Moore, Treasury

## **Senior Vice Presidents**

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Gnanesh Coomaraswamy, Portfolio Management

Eldridge Edgecombe, Community Investment

Peter E. Gutzmer, General Counsel & Corporate Secretary

Roger D. Lundstrom, Financial Information

Michael E. McFerrin, Capital Markets

Gerald L. McKinney, Information Systems

William D. Miller, Structured Finance

Thomas D. Sheehan, Corporate Operations

Mark R. Szczepaniak, Controller

Frank D. Whelan, Mortgage Partnership Finance

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Benedicto B. Barin, Information Systems

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James L. Barrett, FHLB Relationships

Joseph Bliujus, Banking Operations

Steve B. Commare Jr., Mortgage Partnership Finance

Sandra C. Damholt, Law

Michael N. Dattels, Banking

Jonathan C. Ekman, Banking

David M. Feldhaus, External Affairs

Martin F. Grill, Information Systems

Timothy J. Haas, Banking

Jeffrey M. Haux, Mortgage Partnership Finance

Diane M. Houser, Banking

Jeffrey A. Lazar, Human Resources

Thomas C. Maag, Mortgage Partnership Finance

Sybil C. Malinowski, Law

Timothy J. Maloney, FHLB Relationships

James R. O'Brien, FHLB Relationships

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Carl B. Ritzel, Credit

Eric S. Schambow, Mortgage Partnership Finance

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Scott A. Stewart, Banking

Dennis E. Thomas, Internal Audit

Barbara Bidell Watkins, Law

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Charles M. Childs

Grace R. Cruz

Dianne L. Eggers

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Denise L. Gans

Jaronda L. Hall

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James F. Scalise

David S. Schaefer

Daniel E. Schwartz

Kimberly S. Small

Betty J. Southwick

Gregory Tankson

Stephen Thomas

Michael L. Waddy

Julie A. Walker

Judy A. Wall

Ann Wasoff



## Chicago

### Federal Home Loan Bank

111 East Wacker Drive, Chicago, IL 60601

[www.fhlbc.com](http://www.fhlbc.com)

(312) 565-5700