

# **Federal Home Loan Bank of Chicago**

**December 31, 2003**  
**Restated Annual Financial**  
**Statements and Footnotes**

# Federal Home Loan Bank of Chicago

## Restated Annual Financial Statements and Footnotes

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## Report of Independent Auditors

To the Board of Directors and Stockholders 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 (the "Bank") at December 31, 2003 and 2002 and the results of its operations and its cash flows for each of the three years in the period then ended, 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 audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 audit provides a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, the Bank has restated its financial statements at December 31, 2003 and 2002 and for each of the three years in the period ended December 31, 2003.

As discussed in Note 3 to the financial statements, the Bank 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 11, 2004, except for Notes 1, 17, 18 and 21, as to which the date is February 10, 2005  
Chicago, Illinois

# Statements of Condition

	December 31,	
	2003 (as restated)	2002 (as restated)
(In thousands)		
<b>Assets</b>		
Cash and due from banks (Note 4)	\$ 3,629	\$ 3,777
Securities purchased under agreements to resell (Note 5)	418,600	403,960
Federal funds sold	5,023,000	3,421,000
Investments:		
Held-to-maturity securities includes \$539,451,000 and \$121,080,000 pledged in 2003 and 2002 (Note 6)	5,139,067	5,628,692
Available-for-sale securities includes \$400,784,000 and \$611,225,000 pledged in 2003 and 2002 (Note 7)	605,364	1,383,242
Securities held at fair value includes \$505,510,000 and \$1,010,901,000 pledged in 2003 and 2002 (Note 8)	794,297	2,327,822
Advances (Note 9)	26,443,063	24,945,112
Mortgage loans held in portfolio, net of allowance for credit losses on mortgage loans of \$5,459,000 in 2003 and \$5,464,000 in 2002 (Note 11)	47,599,731	26,185,618
Accrued interest receivable	336,655	258,489
Bank premises and equipment, net	61,283	32,029
Derivative assets (Note 17)	454,327	422,828
Other assets	62,971	33,338
<b>Total Assets</b>	<b>\$ 86,941,987</b>	<b>\$ 65,045,907</b>
<b>Liabilities and Capital</b>		
<b>Liabilities</b>		
Deposits: (Note 12)		
Demand and overnight	\$ 1,319,093	\$ 2,374,512
Term	538,400	234,949
Deposits from other FHLBanks for mortgage loan program	27,646	69,646
Other	462,932	368,433
Total deposits	2,348,071	3,047,540
Borrowings -		
Securities sold under agreements to repurchase (Note 13)	1,200,000	1,399,000
Consolidated obligations, net: (Note 14)		
Discount notes	20,456,395	14,526,323
Bonds	57,471,055	41,243,678
Total consolidated obligations, net	77,927,450	55,770,001
Accrued interest payable	502,327	400,931
Affordable Housing Program (Note 10)	72,062	45,195
Payable to REFCORP	33,218	11,674
Derivative liabilities (Note 17)	223,540	437,068
Other liabilities	61,879	568,351
<b>Total Liabilities</b>	<b>82,368,547</b>	<b>61,679,760</b>
Commitments and contingencies (Notes 9, 10, 14, 15, 16, 17, and 20)		
Capital (Note 15)		
Capital stock (\$100 par value) issued and outstanding shares:		
41,552,177 shares in 2003 and 31,261,091 shares in 2002	4,155,218	3,126,109
Retained earnings	386,874	169,932
Accumulated other comprehensive income:		
Net unrealized gain on available-for-sale securities (Note 7)	1,500	8,174
Net unrealized gain relating to hedging activities	29,848	61,932
<b>Total Capital</b>	<b>4,573,440</b>	<b>3,366,147</b>
<b>Total Liabilities and Capital</b>	<b>\$ 86,941,987</b>	<b>\$ 65,045,907</b>

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

# Statements of Income

	For the Years Ended December 31,		
	2003 (as restated)	2002 (as restated)	2001 (as restated)
	(In thousands)		
<b>Interest Income:</b>			
Mortgage loans held for portfolio, including fees	\$ 1,849,907	\$ 1,240,179	\$ 718,367
Advances	551,242	589,590	882,873
Interest-bearing deposits	-	-	76
Securities purchased under agreements to resell	5,044	3,877	2,200
Federal funds sold	43,176	59,485	96,481
Investments:			
Held-to-maturity securities	178,643	226,069	295,398
Available-for-sale securities	31,765	5,535	-
Securities held at fair value	69,230	154,423	50,293
Loans to other FHLBanks	149	468	295
Total interest income	2,729,156	2,279,626	2,045,983
<b>Interest Expense:</b>			
Consolidated obligations	1,874,542	1,674,128	1,739,801
Deposits	35,203	46,489	79,556
Deposits from other FHLBanks for mortgage loan program	913	1,102	2,652
Securities sold under agreements to repurchase	28,620	35,545	1,107
Other borrowings	5	142	27
Total interest expense	1,939,283	1,757,406	1,823,143
<b>Net Interest Income before mortgage loan loss provision</b>	789,873	522,220	222,840
Provisions for credit losses on mortgage loans	-	2,217	1,810
<b>Net Interest Income after mortgage loan loss provision</b>	789,873	520,003	221,030
<b>Other Income:</b>			
Prepayment fees	3,953	673	824
Service fees	1,097	1,053	1,033
Net realized gain from sale of held-to-maturity securities	399	-	-
Net realized loss from sale of available-for-sale securities	(35,796)	-	-
Net (loss) gain on securities held at fair values	(56,642)	295,582	(4,872)
Net realized and unrealized (loss) gain on derivatives and hedging activities	(139,166)	(489,670)	46,910
Net realized gain (loss) from early extinguishment of debt	111,668	(1,836)	-
Other, net	5,261	9,400	2,136
Total other income	(109,226)	(184,798)	46,031
<b>Other Expense:</b>			
Salary and benefits	35,497	25,727	20,488
Other operating	38,292	23,061	17,844
Finance Board	2,113	1,600	1,269
Office of Finance	1,668	1,270	749
Mortgage loan expense	8,860	4,930	3,581
Total other expense	86,430	56,588	43,931
<b>Income before Assessments</b>	594,217	278,617	223,130
Affordable Housing Program	48,523	22,743	18,264
REFCORP (Note 2)	109,164	51,175	41,080
Total Assessments	157,687	73,918	59,344
<b>Income before cumulative effect of change in accounting principle</b>	436,530	204,699	163,786
Cumulative effect of change in accounting principle	-	-	573
<b>Net Income</b>	\$ 436,530	\$ 204,699	\$ 164,359

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 (as restated)	Accumulated Other Comprehensive (Loss) Income (as restated)	Total Capital (as restated)
	Shares	Par Value			
<b>2001</b> (as restated)					
<b>Balance, December 31, 2000</b>	16,308	\$ 1,630,805	\$ 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			164,359		164,359
Other comprehensive income:					
Net unrealized loss relating to hedging activities				\$ (5,259)	(5,259)
Comprehensive income			164,359	(5,259)	159,100
Dividends on capital stock:					
Cash			(171)		(171)
Stock	1,218	121,812	(121,812)		-
<b>2002</b> (as restated)					
<b>Balance, December 31, 2001</b>	23,943	\$ 2,394,334	\$ 112,839	\$ (5,259)	\$ 2,501,914
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			204,699		204,699
Other comprehensive income:					
Net unrealized gain on available-for-sale securities				8,174	8,174
Net unrealized gain relating to hedging activities				164,409	164,409
Reclassification adjustment for gain on hedging activities included in net income				(97,218)	(97,218)
Total other comprehensive income				75,365	75,365
Comprehensive income			204,699	75,365	280,064
Dividends on capital stock:					
Cash			(177)		(177)
Stock	1,474	147,429	(147,429)		-
<b>2003</b> (as restated)					
<b>Balance, December 31, 2002</b>	31,261	\$ 3,126,109	\$ 169,932	\$ 70,106	\$ 3,366,147
Proceeds from sale of capital stock	13,657	1,365,706			1,365,706
Redemption of capital stock	(5,560)	(556,007)			(556,007)
Comprehensive income:					
Net Income			436,530		436,530
Other comprehensive income:					
Net unrealized loss on available-for-sale securities				(49,665)	(49,665)
Net unrealized loss relating to hedging activities				(99,020)	(99,020)
Reclassification adjustment for loss on available-for-sale securities included in net income				42,991	42,991
Reclassification adjustment for loss on hedging activities included in net income				66,936	66,936
Total other comprehensive income				(38,758)	(38,758)
Comprehensive income			436,530	(38,758)	397,772
Dividends on capital stock:					
Cash			(178)		(178)
Stock	2,194	219,410	(219,410)		-
<b>Balance, December 31, 2003</b>	41,552	\$ 4,155,218	\$ 386,874	\$ 31,348	\$ 4,573,440

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

# Statements of Cash Flows

	For the Years Ended December 31,		
	2003 (as restated)	2002 (as restated)	2001 (as restated)
<b>Operating Activities:</b>			
<b>Net Income</b>	\$ 436,530	\$ 204,699	\$ 164,359
Cumulative effect of change in accounting principle	-	-	(573)
Income before cumulative effect of change in accounting principle	436,530	204,699	163,786
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	(132,719)	18,697	11,824
Net premiums and discounts on mortgage loans	193,665	57,848	31,629
Concessions on consolidated obligation bonds	19,870	11,421	6,190
Net deferred losses (gains) on hedges	1,465	2,029	(2,053)
Premises and equipment	10,455	7,190	5,070
Other	-	-	165
Provision for credit losses on mortgage loans held for portfolio	-	2,217	1,810
Net realized gains on sale of held-to-maturity securities	(399)	-	-
Net realized losses on sale of available-for-sale securities	35,796	-	-
Decrease (increase) on securities held at fair value, net of transfers and transition adjustments	1,302,700	(215,241)	111,592
Gain due to change in net fair value adjustment on derivative and hedging activities	(234,927)	(274,469)	(292,888)
(Gain) loss on early extinguishment of debt	(111,668)	1,836	-
Net realized loss (gain) on disposal of premises and equipment	-	1,093	(2)
(Increase) decrease in accrued interest receivable	(40,572)	(68,135)	336,331
Decrease (increase) in derivative asset-net accrued interest	22,355	8,943	(26,592)
(Decrease) increase in derivative liability-net accrued interest	(6,361)	6,350	(28,609)
Increase in other assets	(65,719)	(35,958)	(1,543)
Net increase in Affordable Housing Program (AHP) liability and discount on AHP advances	26,778	8,034	5,092
Increase (decrease) in accrued interest payable	101,396	(45,601)	(217,527)
Increase (decrease) in payable to REFCORP	21,544	(6,981)	9,959
(Decrease) increase in other liabilities	(506,475)	546,022	(48,457)
Total adjustments	637,184	25,295	(98,009)
<b>Net Cash Provided by Operating Activities</b>	<b>1,073,714</b>	<b>229,994</b>	<b>65,777</b>
<b>Investing Activities:</b>			
Net increase in securities purchased under agreements to resell	(14,640)	(354,065)	(4,210)
Net increase in Federal funds sold	(1,602,000)	(256,000)	(768,000)
Net (increase) decrease in short-term held-to-maturity securities	(94,553)	273,657	(49,454)
Proceeds from sales of long-term held-to-maturity securities	97,441	-	-
Purchase of mortgage-backed securities	(2,358,782)	(3,502,119)	(1,825,105)
Proceeds from maturities and sales of mortgage-backed securities	3,018,989	2,905,919	1,712,178
Purchases of long-term held-to-maturity securities	(143,357)	(239,763)	(1,520,423)
Proceeds from maturities of long-term held-to-maturity securities	17,205	105,271	270,684
Purchase of available-for-sale securities	(2,543,986)	(1,344,687)	-
Proceeds from sales of available-for-sale securities	3,279,518	-	-
Principal collected on advances	24,399,215	18,059,815	23,060,932
Advances made	(26,240,300)	(20,668,510)	(26,016,696)
Principal collected on mortgage loans held for portfolio	16,696,022	7,077,226	3,903,627
Mortgage loans held for portfolio originated or purchased	(38,326,192)	(16,680,743)	(12,406,251)
Recoveries on mortgage loans held for portfolio	171	45	40
Proceeds from sales of foreclosed assets	16,216	4,787	2,998
Purchase of premises and equipment	(39,709)	(20,856)	(12,286)
<b>Net Cash Used in Investing Activities</b>	<b>(23,838,742)</b>	<b>(14,640,023)</b>	<b>(13,651,966)</b>

(Continued on following page)

# Statements of Cash Flows

(Continued from following page)

	2003 (as restated)	2002 (as restated)	2001 (as restated)
	(In thousands)		
<b>Financing Activities:</b>			
Net (decrease) increase in deposits	(657,469)	1,238,488	(232,653)
Net (decrease) increase in deposits from other FHLBanks for mortgage loan programs	(42,000)	48,837	(17,265)
Net (decrease) increase in securities sold under agreement to repurchase	(199,000)	599,000	800,000
Net proceeds from issuance of consolidated obligations:			
Discount notes	357,816,650	328,044,532	377,411,969
Bonds	46,380,296	23,692,807	47,669,218
Payment for debt issuance costs	(34,879)	(19,833)	(8,888)
Payments for maturing and retiring consolidated obligations:			
Discount notes	(351,678,933)	(322,519,155)	(373,377,611)
Bonds	(29,629,306)	(17,257,138)	(39,302,222)
Proceeds from issuance of capital stock	1,365,706	1,089,076	1,063,807
Payments for redemption of capital stock	(556,007)	(504,730)	(422,090)
Cash dividends paid	(178)	(177)	(171)
Net Cash Provided by Financing Activities	<u>22,764,880</u>	<u>14,411,707</u>	<u>13,584,094</u>
Net (Decrease) Increase in Cash and Cash Equivalents	(148)	1,678	(2,095)
Cash and Cash Equivalents at Beginning of year	3,777	2,099	4,194
Cash and Cash Equivalents at End of Year	<u>\$ 3,629</u>	<u>\$ 3,777</u>	<u>\$ 2,099</u>
Supplemental Disclosures:			
Interest paid	<u>\$ 2,010,054</u>	<u>\$ 1,637,068</u>	<u>\$ 1,741,685</u>
Stock dividends issued	<u>219,410</u>	<u>147,429</u>	<u>121,812</u>

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® (MPF®) Program, under which the Bank, in partnership with its members, provides funding for home mortgage loans. In addition, the Bank also invests in Acquired Member Asset (AMA) such as MPF Shared Funding. AMA is an asset acquired from or through System members or housing associates by means of either a purchase or a funding transaction, subject to Finance Board regulations. These instruments help the Bank accomplish its 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 the FHLBs. Each FHLB has members in a specifically defined geographic district. The Bank's defined geographic membership territory is the states of Illinois and Wisconsin. 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 Bank does not have any special purpose entities or any type of off-balance sheet conduits.

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. Additional funds are provided by deposits, other borrowings and capital stock issued to members. The Bank primarily uses these funds to provide advances to members and to fund or purchase loans from members through the MPF Program. Deposits are received from both member and non-member financial institutions and federal instrumentalities. The Bank 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 2003, 2002 and 2001, were \$274,586 and \$46,441, \$250,901 and \$47,940, and \$258,914 and \$38,751, respectively.

## Note 1 - Restatement of Financial Statements

The Bank is restating its financial statements at December 31, 2003 and 2002, and for each of the three years in the period ended December 31, 2003.

The Bank uses a wide range of risk management tools, including derivatives such as caps, floors and swaptions to manage its interest rate risk. Prudent use of these instruments is central to effective management of the potential impact of interest rate movements on the Bank, and is governed by regulatory and internal limits.

The Bank determined, through a review of its hedging activities pursuant to an agreement entered into by the Bank with the Federal Housing Finance Board effective June 30, 2004, that for certain hedging transactions it applied a method of hedge accounting deemed to be inconsistent with the application of SFAS No. 133, as interpreted. As part of the restatement, management changed its accounting to conform to SFAS No. 133. These revisions consisted primarily of recording in earnings gains and losses on derivatives previously deferred in Other Comprehensive Income for a portion of the Bank's cash flow hedges and revising the timing of recognition in earnings of premiums paid on option contracts. These revisions were the result of the following factors:

- The Bank accounted for certain payer and receiver swaptions, caps and floors assuming no ineffectiveness under SFAS No. 133 Implementation Issue G20. While the stand alone payer and receiver swaptions, caps and floors economically hedge the variability of interest rate movements associated with anticipated debt issuances, the Bank determined that hedge accounting is not applicable and reclassified to earnings all related gains and losses previously deferred in Other Comprehensive Income (OCI).
- The Bank previously reclassified from OCI into earnings premiums paid on certain caps and floors using an effective yield method. As part of the restatement, the Bank corrected its method of reclassifying into earnings premiums paid on caps and floors to the caplet/floorlet methodology which is in accordance with the provisions of SFAS No. 133 Implementation Issue G20, which modifies the timing of the reclassification.
- In the course of reviewing the transactions above, a small number of derivative transaction records were identified in which recording errors required correction. Although the impact of these errors by themselves was not material, the Bank has made accounting adjustments to correct for these transactions and has established safeguards to prevent future occurrences.

The effect of the restatement through December 31, 2003 was an increase to the Bank's cumulatively reported net income after assessments of \$60.9 million. The balance at December 31, 2003 of OCI was \$88.2 million less than previously reported.

The effect of the restatement on the Statements of Income for the fiscal years ended December 31, 2003, 2002 and 2001 are set forth below:

	As Restated	As Previously Reported	Impact on Income Increase/(Decrease)
(in thousands)			
For the Year Ended December 31, 2003			
<b>Interest Income Items:</b>			
Mortgage loans held for portfolio, including fees	\$ 1,849,907	\$ 1,853,567	\$ (3,660)
Advances	551,242	560,072	(8,830)
Federal Funds Sold	43,176	45,580	(2,404)
<b>Interest Expense Items:</b>			
Consolidated Obligations	1,874,542	2,046,708	172,166
<b>Net Interest Income (after mortgage loan loss provision)</b>	<b>789,873</b>	<b>632,601</b>	<b>157,272</b>
<b>Other Income Items:</b>			
Net realized and unrealized (loss) gain on derivatives and hedging activities	(139,166)	(93,463)	(45,703)
<b>Income before Assessments</b>	<b>594,217</b>	<b>482,648</b>	<b>111,569</b>
Affordable Housing Program	48,523	39,416	(9,107)
REFCORP	109,164	88,671	(20,493)
<b>Net Income</b>	<b>\$ 436,530</b>	<b>\$ 354,561</b>	<b>\$ 81,969</b>
For the Year Ended December 31, 2002			
<b>Interest Income Items:</b>			
Mortgage loans held for portfolio, including fees	\$ 1,240,179	\$ 1,240,615	\$ (436)
Advances	589,590	619,292	(29,702)
Federal Funds Sold	59,485	51,235	8,250
<b>Interest Expense Items:</b>			
Consolidated Obligations	1,674,128	1,708,095	33,967
<b>Net Interest Income (after mortgage loan loss provision)</b>	<b>520,003</b>	<b>507,924</b>	<b>12,079</b>
<b>Other Income Items:</b>			
Net realized and unrealized (loss) gain on derivatives and hedging activities	(489,670)	(445,614)	(44,056)
<b>Income before Assessments</b>	<b>278,617</b>	<b>310,594</b>	<b>(31,977)</b>
Affordable Housing Program	22,743	25,353	2,610
REFCORP	51,175	57,049	5,874
<b>Net Income</b>	<b>\$ 204,699</b>	<b>\$ 228,192</b>	<b>\$ (23,493)</b>
For the Year Ended December 31, 2001			
<b>Interest Income Items:</b>			
Advances	\$ 882,873	\$ 882,412	\$ 461
<b>Interest Expense Items:</b>			
Consolidated Obligations	1,739,801	1,741,783	1,982
<b>Net Interest Income (after mortgage loan loss provision)</b>	<b>221,030</b>	<b>218,587</b>	<b>2,443</b>
<b>Other Income Items:</b>			
Net realized and unrealized (loss) gain on derivatives and hedging activities	46,910	46,073	837
<b>Income before Assessments</b>	<b>223,130</b>	<b>219,850</b>	<b>3,280</b>
Affordable Housing Program	18,264	17,996	(268)
REFCORP	41,080	40,478	(602)
<b>Net Income</b>	<b>\$ 164,359</b>	<b>\$ 161,949</b>	<b>\$ 2,410</b>
<b>Total three year Cumulative Effect on Net Income</b>	<b>\$ 805,588</b>	<b>\$ 744,702</b>	<b>\$ 60,886</b>

The effect of the restatement on the Statements of Condition as of December 31, 2003 and 2002 are set forth below:

	As Restated	As Previously Reported	Impact on Capital Increase/(Decrease)
(in thousands)			
As of December 31, 2003			
<b>Assets:</b>			
Mortgage loans held for portfolio, net of allowance for credit losses of \$5,459,000	\$ 47,599,731	\$ 47,603,631	\$ (3,900)
<b>Total Assets</b>	<b>86,941,987</b>	<b>86,945,887</b>	<b>(3,900)</b>
<b>Liabilities:</b>			
Borrowings - Consolidated Obligation Bonds, net	57,471,055	57,469,623	(1,432)
Payable to Affordable Housing Program	72,062	65,297	(6,765)
Payable to REFCORP	33,218	17,996	(15,222)
<b>Total Liabilities</b>	<b>82,368,547</b>	<b>82,345,128</b>	<b>(23,419)</b>
<b>Capital:</b>			
Retained Earnings	386,874	325,988	60,886
OCI - Net unrealized gain relating to hedging activities	29,848	118,053	(88,205)
<b>Total Capital</b>	<b>\$ 4,573,440</b>	<b>\$ 4,600,759</b>	<b>\$ (27,319)</b>
As of December 31, 2002			
<b>Assets:</b>			
Mortgage loans held for portfolio, net of allowance for credit losses of \$5,464,000	\$ 26,185,618	\$ 26,185,858	\$ (240)
<b>Total Assets</b>	<b>65,045,907</b>	<b>65,046,147</b>	<b>(240)</b>
<b>Liabilities:</b>			
Payable to Affordable Housing Program	45,195	47,538	2,343
Payable to REFCORP	11,674	16,945	5,271
<b>Total Liabilities</b>	<b>61,679,760</b>	<b>61,687,374</b>	<b>7,614</b>
<b>Capital:</b>			
Retained Earnings	169,932	191,015	(21,083)
OCI - Net unrealized gain relating to hedging activities	61,932	33,475	28,457
<b>Total Capital</b>	<b>\$ 3,366,147</b>	<b>\$ 3,358,773</b>	<b>\$ 7,374</b>

## Note 2 - 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.

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. Under Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, the investments would be classified (described) as trading. However, Finance Board regulation prohibits the Bank from trading investments, and the Bank does not trade investments. The Bank classifies the investments as securities held at fair value because it believes the description is more appropriate.

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.

The Bank regularly evaluates outstanding investments for impairment. If there is an other-than-temporary impairment in value of an investment, the decline in value is recognized as a loss in other expense.

**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 9 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 \$538 million or less during 2003) 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 invests in government-insured and conventional residential 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, "Second Loss Credit Enhancement," up to the amount of the credit enhancement obligation as specified in the master agreement. On one MPF product, the members assume credit losses in excess of the FLA and supplemental mortgage insurance up to the amount of the credit enhancement obligation.

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 their carrying amount, adjusted for changes in fair value due to the hedged risk.

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 estimated life of the related mortgage loans. Actual prepayment experience and estimates of future principal prepayments are used in calculating the estimated lives of the mortgage loans. The Bank aggregates the mortgage loans by similar characteristics (type, maturity, note rate, and acquisition date) in determining prepayment estimates.

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

The Bank places a conventional mortgage loan on nonaccrual status when the collection of the contractual principal or interest from the borrower 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 its 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 each member's credit enhancement obligation. 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. As a result of this analysis, the Bank has determined that an allowance for loan losses in the amount of \$5,458,622 and \$5,463,779 as of December 31, 2003 and 2002 is adequate.

**Credit Enhancement** - The credit enhancement is an obligation on the part of the participating member which provides for the retention of credit risk on loans the member originates. The amount of the credit enhancement is determined such that any losses in excess of the enhancement are limited to those required for an equivalent instrument with a long term credit rating of "AA". The participating member receives from the Bank a credit enhancement fee for holding this portion of the credit risk in the loans. These fees are paid monthly based upon the remaining unpaid principal balance. The required credit enhancement obligation amount may vary depending on the various product alternatives selected. The fixed portion of credit enhancement fees are expensed when paid. The performance portion of credit enhancement fees are expensed monthly and payable to the member based on actual performance of the mortgage loans within a particular pool. In general, performance based fees are net of cumulative unrecovered losses paid by the Bank. To the extent that losses in the current month exceed performance credit enhancement fees accrued, the remaining losses are recovered from future credit enhancement fees payable to the member.

**MPF Shared Funding Program** - The Bank participates in a "Shared Funding Program." Under this program, mortgage loans originated through the MPF Program are sold to a trust and "pooled" into securities. The Bank purchases the AMA eligible securities, which are rated at least AA, and are either retained or partially sold to other FHLBs. The investments are classified as held-to-maturity securities and are reported at amortized cost of \$621,459,398 as of December 31, 2003. These securities are not publicly traded and are not guaranteed by the Bank or the System.

**Affordable Housing Program** - As more fully discussed in Note 10, the Act requires the Bank 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. As an alternative, the Bank has the authority to make the AHP subsidy available to members as a grant.

**Prepayment Fees** - The Bank generally charges its members prepayment fees when advances are repaid prior to original maturity. The Bank evaluates whether new advances meet the criteria to qualify as a modification of an existing advance or as a new advance. If the advance qualifies as a modification, the net fee on the prepaid advance is deferred, recorded in the basis of the advance, and amortized over the life of the modified advance. This amortization is recorded in advance interest income. The net fees are recorded in other income if it is determined the advance should be treated as a new advance. 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 which approximates the interest method. 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** - Accounting for derivatives is addressed in the 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*, and SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (herein referred to as "SFAS 133"). Accordingly, all derivatives are recognized on the balance sheet at their fair value and are designated as (1) a hedge of the fair value of (a) a recognized asset or liability or (b) an unrecognized firm commitment (a "fair value" hedge); (2) a hedge of (a) a forecasted transaction or (b) the variability of cash flows that are to be received or paid in connection with either a recognized asset or liability or stream of variable cash flows (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 ("economic hedge") for asset-liability management purposes; (5) an intermediary derivative as discussed below. 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 is recorded in current-period earnings. Amounts recorded in other comprehensive income are reclassified to interest income or expense during the period in which the hedged transaction impacts earnings. Changes in the fair value and periodic settlements of a derivative designated as an economic hedge are recorded in current-period earnings in other income as "net realized and unrealized gain (loss) on derivative and hedging activities" with no fair value adjustment to an asset or liability.

The Bank may purchase 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 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 effectiveness and measuring 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.

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

When hedge accounting is discontinued due to the Bank's determination that the derivative no longer qualifies as an effective fair value hedge, the Bank will continue to carry the derivative on the balance sheet at its fair value, cease to adjust the hedged asset or liability for changes in fair value, and begin amortizing the cumulative basis adjustment on the hedged item into earnings over the remaining life of the hedged item using a method that approximates the level-yield method. When hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, the Bank will continue to carry the derivative 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 was 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 may enter into interest-rate swaps, swaptions, interest-rate cap and floor agreements, calls, puts, futures 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: by designating them as either 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 (i.e., a 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 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 fix 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, forecasted transactions or firm commitments that does not qualify for hedge accounting under the rules of SFAS 133, but is an acceptable hedging strategy under the Bank’s risk management program. These strategies also comply with Finance Board regulatory requirements. An economic hedge by definition introduces the potential for earnings variability due to the change in fair value recorded on the derivative financial instrument(s) that is not offset by corresponding changes in the value of the economically hedged assets, liabilities, forecasted transactions or firm commitments.

To meet the hedging needs of its members, the Bank acts as an intermediary between the members and other non-member counterparties by entering into offsetting interest rate exchange agreements. This intermediation allows smaller members indirect access to the swap market. The derivatives used in intermediary activities do not qualify for SFAS 133 hedge accounting treatment 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.

The Bank, consistent with Finance Board regulation, enters into derivative financial instruments to reduce the market risk exposure inherent in otherwise unhedged assets and funding positions. Bank management utilizes derivative financial instruments in the most cost efficient manner and may enter into derivative financial instruments that do not necessarily qualify for hedge accounting under SFAS 133 accounting rules. As a result, the Bank recognizes only the change in fair value of these derivative financial instruments 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.

Premiums paid to acquire options are included in the initial basis of the instrument and reported in derivative assets. With respect to interest rate caps and floors designated in a cash flow hedging relationship, the initial basis of the instrument at the inception of the hedge is allocated to the respective caplets/floorlets comprising the cap or floor. All subsequent changes in fair value in the option, to the extent deemed effective, are recognized in AOCI. The change in the allocated fair value of each respective caplet/floorlet is reclassified out of AOCI when each of the corresponding hedged forecasted transactions impacts earnings. Changes in the fair value of option contracts not designated in a hedging relationship are recognized in other income as “net realized and unrealized gain (loss) on derivative financial activities.

**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 derivative financial instruments 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 derivative financial instrument 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, the 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 accounted for as a fair value hedge under SFAS 133. The swap counterparty can cancel the derivative financial instrument on the put date, and the Bank can convert the advance to 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, the Bank generally charges a prepayment fee that makes it financially indifferent to a borrower's decision to prepay an advance. When the Bank offers advances (other than short-term advances) that a member may prepay without a prepayment fee, it usually finances such advances with callable debt or otherwise hedges this option.

**Mortgage Loans** - The Bank invests in mortgage assets. The prepayment options embedded in mortgage assets can result in extensions or contractions in the expected maturities of these investments, primarily depending on changes in interest rates. Finance Board regulations limit this source of interest-rate risk by restricting the types of mortgage assets the Bank may own and by establishing limitations on duration of equity and changes in market value of equity. The Bank may manage against prepayment and duration risk by funding 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 may also use 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. Such relationships are accounted for as a fair value hedge.

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 may also purchase 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 may enter 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. Such hedge transactions are accounted for as cash flow hedges.

**Firm Commitment Strategies** - Prior to July 1, 2003, the Bank hedged the market value of firm purchase commitments on fixed-rate mortgage loans by using derivatives with similar market value characteristics. The Bank normally hedged these firm commitments by selling Mortgage-Backed Securities to be announced (TBA MBS) or other derivatives for forward settlement. When the derivative settled, the current market value of the commitments was included with the basis of the mortgage loans and amortized accordingly. This transaction was treated as a fair value hedge. Mortgage purchase commitments entered into after June 30, 2003, are considered derivatives. The Bank may designate these mortgage purchase commitments as a cash flow hedge of the anticipated purchase of mortgage loans. The change in value of the delivery commitment is recorded as a basis adjustment on the resulting loans with offsetting changes in accumulated other comprehensive income in the statement of condition. The basis adjustments on the resulting performing loans and the balance in accumulated other comprehensive income are then amortized into net interest income in offsetting amounts over the life of these loans, resulting in no impact on earnings.

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 "securities held at fair value."

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 "net unrealized gain or (loss) on available-for-sale securities".

The Bank may also manage the risk arising from changing market prices and volatility of investment securities classified as "held at fair value" by entering into derivative financial instruments (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 derivative financial instruments are included in other income in the statements of income.

**Anticipated Debt Issuance** – The Bank may enter 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 Other Comprehensive Income 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.

**Derivative Credit Risk** – 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 regulations. Based on credit analysis and collateral requirements, the management of the Bank does not anticipate any credit losses on its derivative agreements.

**Foreign Currencies** – 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.

**Bank Premises and Equipment** - The Bank recorded premises and equipment at cost, less accumulated depreciation and amortization of approximately \$24,933,000 and \$14,733,000 at December 31, 2003 and 2002, 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. Depreciation and amortization expenses were \$10,444,000, \$7,164,000 and \$5,204,000 for the years ended December 31, 2003, 2002, and 2001. Gains and losses on disposal are included in other income. The net realized (loss) gain on disposal of premises and equipment was \$0, \$(1,093,000), and \$2,000 in 2003, 2002 and 2001, respectively.

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, 2003 and 2002, the Bank had \$34,770,000 and \$13,685,000, respectively, in unamortized computer software costs included in Bank premise and equipment. Amortization of computer software costs charged to expense was \$9,401,000, \$6,056,000 and \$3,959,000 for the years ended December 31, 2003, 2002 and 2001, 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, realized 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, 2003 and 2002, the Bank had \$12,625,000 and \$7,458,000, 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 estimated 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. Unamortized concessions were \$32,137,000 and \$17,128,000 at December 31, 2003 and 2002, respectively, and are included in other assets. Amortization of such concessions are included in consolidated obligation interest expense and totaled \$19,870,000, \$11,421,000, and \$6,190,000 in 2003, 2002 and 2001, respectively. 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** - Discounts and premiums on consolidated obligation bonds are amortized to expense using the level yield method over the estimated 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 (REFCORP) 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 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 FHLBank to REFCORP will be fully satisfied. The Finance Board in consultation with the Secretary of the Treasury will select the appropriate discounting factors to be used in this annuity calculation. The cumulative amount to be paid to REFCORP by the FHLBs is not determinable at this time due to the interrelationships of all future FHLBs' earnings. The FHLBs' payments through those for 2003 defease all future benchmark payments after the 4<sup>th</sup> quarter of 2020 and \$21 million of the \$75 million benchmark payment for the 2<sup>nd</sup> quarter of 2020.

**Assessments** - The Bank is assessed for its proportionate share of the costs of operating the Finance Board and the Office of Finance, which manages the sale of consolidated obligations. Such assessments are expensed when incurred.

**Estimated Fair Values** - Some of the Bank's financial instruments lack an available trading market characterized by transactions between a willing buyer and a willing seller engaging in an exchange transaction. Therefore, the Bank uses significant estimates and present-value calculations when disclosing estimated fair values. The Bank assumes that book value approximates fair value for financial instruments with three months or less to repricing or maturity. Note 19 details the estimated fair values of the Bank's financial instruments.

**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 2002 and 2001 financial statements have been reclassified to conform to the 2003 presentation. In particular, for the years ended December 31, 2002 and 2001, the Bank has reclassified realized gains and losses (e.g., net interest payments) on standalone derivative instruments used in economic hedges. Previously, realized gains and losses on standalone derivatives used in economic hedges were classified within "net interest income after mortgage loan loss provision" while unrealized gains (losses) on these derivatives were recorded in "net realized and unrealized gain (loss) on derivatives and hedging activities" within "other income." These amounts have been reclassified and are both now included in "net realized and unrealized gain (loss) on derivatives and hedging activities" for the years ended December 31, 2002 and 2001. In addition, credit enhancement fees, previously recorded in "mortgage loan expense" have been reclassified and are now included within "net income after mortgage loan loss provision." As a result of these reclassifications and restatement, referred to in Note 1, "net interest income after mortgage loan loss provision" changed from \$424,966,000 to \$520,003,000 and from \$208,534,000 to \$221,030,000 for the years ended December 31, 2002 and 2001, respectively. In addition, "net realized and unrealized gain (loss) on derivatives and hedging activities" changed from \$(344,580,000) to \$(489,670,000) and from \$62,996,000 to \$46,910,000 for the years ended December 31, 2002 and 2001, respectively.

### Note 3 - Changes in Accounting Principle and Recently Issued Accounting Standards and Interpretations

**Adoption of SFAS 132 (revised 2003)** – FASB issued Statement of Financial Accounting Standards No. 132 (revised 2003), *“Employers’ Disclosures about Pensions and Other Postretirement Benefits”* (herein referred to as “SFAS 132 (revised 2003)”) in December 2003. The Bank will adopt the process of assessing the impact, if any, of SFAS 132 (revised 2003) on its related disclosures.

**Adoption of SFAS 145** - The Bank adopted Statement of Financial Accounting Standards No. 145, *“Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections”* (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.

**Adoption of SFAS 149** - On April 30, 2003 the Financial Accounting Standards Board (FASB) issued Statement 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (SFAS 149), which amends and clarifies financial accounting and reporting for derivative instruments and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS 149 applies to mortgage loan commitments entered into or modified after June 30, 2003. Certain of these commitments are designated as cash flow hedges of forecasted purchases with resulting changes in their fair value recorded in accumulated other comprehensive income. When the loan commitment is settled, the Bank amortizes the amount recorded in accumulated other comprehensive income in earnings along with an equal and offsetting amount from the amortization of the matching basis adjustment recorded on the loan over its life. Consequently, this amortization has no ongoing effect on earnings. Commitments that are not designated as cash flow hedges are accounted for using an economic hedge strategy and hedged by selling mortgage-backed securities to be announced or other derivatives for forward settlement. Accordingly, the Bank marks these derivatives to market through earnings. The Bank adopted SFAS 149 as of the effective date and the adoption did not have a material impact on our financial statements.

**Adoption of SFAS 150** - FASB issued Statement of Financial Accounting Standards No. 150, *“Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity”* (herein referred to as “SFAS 150”) in May 2003. The Bank adopted SFAS 150 per its provisions effective January 1, 2004. The Bank’s capital stock under certain circumstances may be considered a mandatorily redeemable financial instrument and in such instances would need to be classified as a liability. The Bank has not determined the effect that the adoption of SFAS 150 will have on its earnings or statement of condition.

**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. The initial recognition and measurement provisions apply to the Bank’s letters of credit. The resulting amounts recognized in “other liabilities” in 2003 were not material.

**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 are 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, as restated (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"	<u>(602)</u>
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, 2003, 2002 and 2001, as follows: (Dollar amounts in thousands)

Net amounts reclassified to earnings for the year ended December 31, 2001	\$ 25,968
Net change associated with hedging activities for the year ended December 31, 2001	<u>(31,227)</u>
Total cumulative effect of change in accounting principle on other comprehensive income at January 1, 2001, and net change during the year ended December 31, 2001, related to hedging activities	(5,259)
Net amounts reclassified to earnings for the year ended December 31, 2002	(97,218)
Net change associated with hedging activities for the year ended December 31, 2002	<u>164,409</u>
Accumulated comprehensive income related to hedging activities at December 31, 2002	61,932
Net amounts reclassified to earnings for the year ended December 31, 2003	66,936
Net change associated with hedging activities for the year ended December 31, 2003	<u>(99,020)</u>
Accumulated comprehensive income related to hedging activities at December 31, 2003	<u>\$ 29,848</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 years ended December 31, 2003, 2002 and 2001, the Bank recorded net (loss) gain on derivatives and hedging activities of \$(139) million, \$(490) million and \$47 million, respectively, in other income. Net (loss) gains on derivatives and hedging activities for the years ended December 31, 2003, 2002 and 2001 are as follows:

Net (Loss) Gains on Derivatives and Hedging Activities

	For the Years Ended		
	2003	2002	2001
	(In thousands)		
(Losses) gains related to fair-value hedge ineffectiveness	\$ (127,363)	\$ (34,063)	\$ 8,982
(Losses) gains on economic hedges	(47,454)	(455,607)	4,662
Gains related to cash-flow hedge ineffectiveness	35,651	-	33,266
Net (losses) gains on derivatives and hedging activities	<u>\$ (139,166)</u>	<u>\$ (489,670)</u>	<u>\$ 46,910</u>

There were no material amounts for the years ended December 31, 2003 and 2002, 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, 2003, the deferred net losses on derivative instruments accumulated in other comprehensive income expected to be reclassified into earnings during the next twelve months is \$41,215,000. 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 4 - 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, 2003 and 2002 were approximately \$584,000 and \$737,000, respectively.

In addition, the Bank maintained average collected balances with various Federal Reserve Banks and branches of approximately \$15,319,000 and \$14,383,000 for the years ended December 31, 2003 and 2002, respectively. The Bank was required to maintain minimum average daily clearing balances of \$2,000,000 for the years ended December 31, 2003 and 2002. 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 \$18,491,000 and \$9,804,000 as of December 31, 2003 and 2002, respectively. Member reserve balances are included in deposits in the statement of condition.

#### Note 5 - Securities Purchased Under Agreements To Resell

The Bank has entered into purchases of securities purchased under agreements to resell those securities. 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, 2003 and 2002, the fair value of collateral accepted by the Bank in connection with

these activities was \$418,596,000 and \$403,956,000, respectively. Of the total collateral pledged as of December 31, 2003, \$418,596,000 of collateral was permitted to be sold or repledged by the Bank.

## Note 6 - Held-To-Maturity Securities

**Major Security Types** - Held-to-maturity securities as of December 31, 2003 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
	(In thousands)			
Commercial paper	\$ 99,991	\$ -	\$ (3)	\$ 99,988
U.S. agency obligations	459,593	271	-	459,864
State or local housing agency obligations	132,388	1,439	(1,479)	132,348
SBA/SBIC Loans	572,008	2,753	-	574,761
Other	26,973	209	-	27,182
	1,290,953	4,672	(1,482)	1,294,143
Mortgage-backed securities	3,848,114	67,124	(7,998)	3,907,240
Total	\$ 5,139,067	\$ 71,796	\$ (9,480)	\$ 5,201,383

**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

**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:

	2003		2002	
	(In thousands)		(In thousands)	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 1,071,079	\$ 1,071,614	\$ 508,943	\$ 506,155
Due after one year through five years	16,658	17,035	180,198	182,215
Due after five years through ten years	71,717	74,792	88,668	104,428
Due after ten years	131,499	130,702	209,332	201,562
	1,290,953	1,294,143	987,141	994,360
Mortgage-backed securities	3,848,114	3,907,240	4,641,551	4,734,546
Total	\$ 5,139,067	\$ 5,201,383	\$ 5,628,692	\$ 5,728,906

The amortized cost of the Bank's mortgage-backed securities classified as held-to-maturity includes net premium of \$15,363,000 and \$1,855,332 at December 31, 2003 and 2002, respectively.

**Interest-Rate Payment Terms** - Interest rate payment terms for investment securities classified as held-to-maturity at December 31, 2003 and 2002 are detailed in the following table:

	2003	2002
	(In thousands)	
Amortized cost of held-to-maturity securities other than mortgage-backed securities:		
Fixed-rate	\$ 1,219,988	\$ 901,026
Variable-rate	70,965	86,115
	<u>1,290,953</u>	<u>987,141</u>
Amortized cost of held-to-maturity mortgage-backed securities:		
Pass-through securities:		
Fixed-rate	923,401	867,656
Variable-rate	106,139	171,717
Collateralized mortgage obligations:		
Fixed-rate	1,323,803	2,007,946
Variable-rate	1,494,771	1,594,232
	<u>3,848,114</u>	<u>4,641,551</u>
Total	<u>\$ 5,139,067</u>	<u>\$ 5,628,692</u>

The following table summarizes the held-to-maturity securities with unrealized losses as of December 31, 2003. The unrealized losses are aggregated by major security type and length of time that individual securities have been in a continuous unrealized loss position. The unrealized losses on these securities are considered a temporary impairment as these securities were rated AA or better at December 31, 2003.

	Less than 12 Months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Commercial Paper	\$ 99,988	\$ (3)	\$ -	\$ -	\$ 99,988	\$ (3)
State or local housing agency obligations	2,635	(110)	17,016	(1,369)	19,651	(1,479)
Mortgage-backed securities	1,058,564	(7,706)	269,973	(292)	1,328,537	(7,998)
Total Temporarily Impaired	<u>\$ 1,161,187</u>	<u>\$ (7,819)</u>	<u>\$ 286,989</u>	<u>\$ (1,661)</u>	<u>\$ 1,448,176</u>	<u>\$ (9,480)</u>

The Bank had two occurrences during 2003 in which securities classified as held-to-maturity were sold. In the first occurrence, Standard and Poor's stated they would no longer rate future issuances of this specific security. The second occurrence was precipitated due to a downgrade by Moody's from Aaa to Baa1. These events provided evidence of a significant deterioration in the issuers' creditworthiness. Upon determination of downgrades, the Bank liquidated the distressed securities.

## Note 7 - Available-for-Sale Securities

**Major Security Types** - Available-for-sale securities as of December 31, 2003, were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
	(In thousands)			
U.S. Treasury	\$ 50,207	\$ 39	\$ -	\$ 50,246
U.S. agency obligations	553,132	2,820	(834)	555,118
Total	<u>\$ 603,339</u>	<u>\$ 2,859</u>	<u>\$ (834)</u>	<u>\$ 605,364</u>

The bank has recorded \$524,135 of unrealized gains associated with hedging activities.

**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

**Redemption Terms** - The amortized cost and estimated fair value of available-for-sale securities, 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.

	2003		2002	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(In thousands)		(In thousands)	
<b>Year of Maturity</b>				
Due after one year through five years	\$ 451,827	\$ 454,647	\$ 445,365	\$ 447,242
Due after five years through ten years	151,512	150,717	921,225	936,000
Total	<u>\$ 603,339</u>	<u>\$ 605,364</u>	<u>\$ 1,366,590</u>	<u>\$ 1,383,242</u>

The amortized cost of the Bank's agency bonds classified as available-for-sale includes net premiums of \$18,517,000 and \$42,580,000 at December 31, 2003 and 2002, respectively.

**Interest Rate Payment Terms** - Interest rate payment terms for all investment securities classified as available-for-sale as of December 31, 2003 were fixed rate.

**Gains and Losses** - Gross gains of \$25,031,000, \$0 and \$0 and gross losses of \$60,827,000, \$0 and \$0 were realized on sales of available-for-sale securities during the years ended December 31, 2003, 2002 and 2001, respectively.

Gross unrealized losses, continuous for less than 12 months, were \$834,000 on securities totaling \$100,470,000 at fair value. The unrealized losses on these securities are considered a temporary impairment as these securities were rated AA or better at December 31, 2003.

## Note 8 - Securities Held at Fair Value

**Major Security Types** - Securities held at fair value as of December 31, 2003, and 2002, were as follows:

	2003	2002
	(In thousands)	
U.S. agency obligations	\$ 593,574	\$ 1,945,091
Other FHLBs' bonds	75,700	188,469
Total	669,274	2,133,560
Mortgage-backed securities	125,023	194,262
Total	<u>\$ 794,297</u>	<u>\$ 2,327,822</u>

Net (loss) gain on securities held at fair value during the year ended December 31, 2003, and 2002, included net unrealized holding (loss) gain of \$(70,090,000) and \$293,293,000, respectively. The Bank recorded gains of \$13,448,000 and \$2,289,000 on the sale of securities held at fair value for the years ended December 31, 2003 and 2002, respectively. The Bank did not sell any of these securities during 2001.

Net unrealized losses, continuous for less than 12 months, were \$2,968,000 on securities totaling \$312,140,000 at fair value. The unrealized losses on these securities are considered a temporary impairment as these securities were rated AA or better at December 31, 2003.

## Note 9 – Advances

**Redemption Terms** - At December 31, 2003 and 2002, the Bank had advances outstanding to members, including AHP advances (see Note 10), at interest rates ranging from 0.89% to 8.47% and 1.32% to 8.47%, respectively, as summarized below. AHP subsidized advances have an average interest rate of 5.66% and 4.83% as of December 31, 2003 and 2002, respectively.

Year of Maturity	2003		2002	
	Amount	Weighted Average Interest Rate	Amount	Weighted Average Interest Rate
	(In thousands)		(In thousands)	
2003	\$ -		\$ 5,380,219	3.56%
2004	7,548,016	2.92%	5,015,482	4.19%
2005	5,338,526	3.77%	3,836,712	4.75%
2006	2,733,695	2.76%	3,363,846	2.48%
2007	3,404,312	1.96%	2,175,846	2.46%
2008	2,756,531	3.83%	1,885,372	4.91%
2009	406,850	5.54%	399,761	5.58%
Thereafter	3,680,213	3.70%	1,969,818	4.98%
Total par value	25,868,143	3.20%	24,027,056	3.89%
Discount on AHP Advances	(144)		(233)	
SFAS 133 hedging adjustments	575,064		918,289	
Total with interest rate exchange agreements	<u>\$ 26,443,063</u>		<u>\$ 24,945,112</u>	

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, 2003 and 2002, the Bank had callable advances outstanding totaling \$2,348,600,000 and \$2,286,000,000, respectively.

The following table summarizes advances to member institutions at December 31, 2003 and 2002 by year of maturity or next call date for callable advances:

Year of Maturity or Next Call Date	2003	2002
	(In thousands)	
2003	\$ -	\$ 7,387,718
2004	9,881,116	5,011,482
2005	5,333,526	3,836,712
2006	1,981,095	1,360,846
2007	1,903,812	2,175,346
2008	2,681,531	1,885,372
2009	406,850	399,762
Thereafter	3,680,213	1,969,818
Total par value	<u>\$ 25,868,143</u>	<u>\$ 24,027,056</u>

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 business 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, 2003 and 2002, the Bank had convertible advances outstanding totaling \$5,150,586,000 and \$6,034,486,000, respectively.

The following table summarizes advances to member institutions at December 31, 2003 and 2002 by year of maturity or next conversion date for convertible advances:

Year of Maturity or Next Conversion Date	2003	2002
	(In thousands)	
2003	\$ -	\$ 8,801,377
2004	10,334,448	4,736,009
2005	4,552,526	2,877,712
2006	2,620,287	3,156,733
2007	3,429,312	2,175,846
2008	1,581,036	856,877
2009	204,850	247,762
Thereafter	3,145,684	1,174,740
Total par value	<u>\$ 25,868,143</u>	<u>\$ 24,027,056</u>

**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" (CFI's) 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, 2003 and 2002, 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 possession of the 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, 2003, the Bank had advances of \$8,666,525,000 outstanding to two member institutions, and this represented 33.5 percent of total advances outstanding. The interest income from advances to these member institutions amounted to \$301,343,441 during 2003. 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, 2003 and 2002 are detailed in the following table:

	2003	2002
	(In thousands)	
Par Amount of advances:		
Fixed-rate	\$ 19,730,994	\$ 19,191,436
Variable-rate	6,137,149	4,835,620
Total Par Value	<u>\$ 25,868,143</u>	<u>\$ 24,027,056</u>

The estimated fair value of advances, as of December 31, 2003 and 2002 is disclosed in Note 19.

## Note 10 - 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 2003 or 2002. The Bank had outstanding principal in AHP-related advances of \$2,090,497 and \$4,842,571 at December 31, 2003 and 2002, respectively.

## Note 11 - Mortgage Loans Held in 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, 2003 and 2002 on mortgage loans:

	2003	2002
	(In thousands)	
Mortgages:		
Fixed medium-term* single-family mortgages	\$ 17,365,079	\$ 5,524,014
Fixed long-term single-family mortgages	29,775,492	20,416,937
Unamortized premiums, net	353,247	147,105
Plus: deferred loan cost, net	63,207	32,640
Total mortgage loans	47,557,025	26,120,696
Loan commitment basis adjustment	(11,123)	-
SFAS 133 hedging adjustments	59,288	70,386
Total with interest rate exchange agreements	<u>\$ 47,605,190</u>	<u>\$ 26,191,082</u>

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

The par value of mortgage loans outstanding at December 31, 2003 and December 31, 2002, was comprised of government-insured loans totaling \$6,607,715,000 and \$6,962,924,000 and conventional loans totaling \$40,532,856,000 and \$18,978,027,000 respectively.

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

	2003	2002	2001
	(In thousands)		
Allowance for credit losses:			
Balance, beginning of year	\$ 5,464	\$ 3,340	\$ 1,503
Chargeoffs	(176)	(138)	(13)
Recoveries	171	45	40
Net recoveries (chargeoffs)	(5)	(93)	27
Provisions for credit losses	-	2,217	1,810
Balance, end of year	<u>\$ 5,459</u>	<u>\$ 5,464</u>	<u>\$ 3,340</u>

At December 31, 2003 and 2002, the Bank had \$57,347,000 and \$25,295,000 of nonaccrual loans.

The estimated fair value of the mortgage loans held for portfolio as of December 31, 2003 and 2002 is reported in Note 19.

Mortgage loans, other than those included in large groups of smaller-balanced homogeneous loans, are considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all principal and interest amounts due according to the contractual terms of the mortgage loan agreement. At December 31, 2003 and 2002, the Bank had no recorded investments in impaired mortgage loans.

## Note 12 – 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 balance sheet.

## Note 13 – Borrowings

**Securities Sold Under Agreements to Repurchase** - The Bank has sold securities under repurchase agreements. The amounts received under these agreements represent long-term borrowings and are liabilities 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 \$1,239,388,000 and \$1,470,769,000 as of December 31, 2003 and 2002, 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, 2003, \$810,482,000 of collateral was permitted to be sold or replaced by the secured party.

## Note 14 - Consolidated Obligations

Consolidated obligations are the joint and several obligations of the FHLBs and consist of consolidated bonds and discount notes. The FHLBs issue 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 \$759.5 billion and \$680.7 billion at December 31, 2003 and 2002, 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 is 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 FHLBs' outstanding consolidated obligations and other unsecured senior liabilities above 20 times the FHLB's total capital. The Finance Board's Financial Management Policy also applied this limit on a Bank-by-Bank basis. The final rule deletes the FHLBs' overall leverage limit from the regulations, but limits each Bank's assets generally to no more than 21 times its capital. Nevertheless, any FHLB whose non-mortgage assets, after deducting deposits and capital, does 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 FHLBs' previous leverage limit of twelve times FHLBs' 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, 2003 and 2002, the FHLBs' capital stock was 4.96% and 5.17% of the par value of consolidated obligations outstanding, and the SAA balance was approximately \$24.0 million. Each Bank is required to transfer qualifying assets in the amount of its allocated share of the FHLBs' SAA balance to a trust for the benefit of the prior bondholders if its capital-to-assets ratio falls below 2%. The FHLBs' capital-to-assets ratio was greater than 2% at December 31, 2003, and 2002.

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

**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.

**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.

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

**Redemption Terms** - The following is a summary of the Bank's participation in consolidated obligation bonds at December 31, 2003 and 2002 by year of maturity.

Year of Maturity	2003		2002	
	Amount	Weighted Average Interest Rate	Amount	Weighted Average Interest Rate
	(In thousands)		(In thousands)	
2003	\$ -		\$ 10,224,530	3.53%
2004	7,664,585	2.65%	6,211,000	3.32%
2005	8,508,210	3.34%	5,111,560	4.74%
2006	9,484,200	2.79%	3,316,200	4.71%
2007	6,222,915	3.74%	3,801,550	4.69%
2008	6,200,500	3.70%	1,573,000	5.48%
2009	1,480,500	5.00%	1,235,000	5.66%
Thereafter	20,767,215	4.22%	11,401,815	4.54%
Total par value	60,328,125	3.59%	42,874,655	4.24%
Bond premiums	81,225		60,409	
Bond discounts	(2,993,465)		(2,178,065)	
SFAS 133 hedging adjustments	56,512		489,487	
Deferred net loss on terminated interest rate exchange agreements	(1,342)		(2,808)	
Total with interest rate exchange agreements	\$ 57,471,055		\$ 41,243,678	

The Bank makes significant use of fixed-rate callable debt to finance MPF Program mortgage loans, callable advances (see Note 9) 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 variable-rate advances.

The Bank's consolidated bonds outstanding includes:

	2003		2002	
	Amount	Percentage of Callable/ Non Callable Bonds to Total	Amount	Percentage of Callable/ Non Callable Bonds to Total
Par amount of consolidated bonds:				
Non-callable or non-putable	\$ 42,882,225	71.51%	\$ 30,298,655	70.67%
Callable	17,445,900	28.49%	12,576,000	29.33%
Total par value	\$ 60,328,125	100.00%	\$ 42,874,655	100.00%

The following table summarizes the Bank's participation in consolidated bonds outstanding at December 31, 2003 and 2002, by year of maturity or next call date:

Year of Maturity or Next Call Date	2003	2002
	(In thousands)	
2003	\$ -	\$ 18,747,530
2004	15,069,085	6,963,000
2005	9,511,710	4,682,560
2006	6,939,200	1,841,200
2007	4,667,915	3,876,550
2008	2,397,500	-
2009	975,500	770,000
Thereafter	20,767,215	5,993,815
Total par value	\$ 60,328,125	\$ 42,874,655

**Interest Rate Payment Terms** - Interest rate payment terms for consolidated bonds at December 31, 2003 and 2002 are detailed in the following table. Range bonds are classified as comparative-index bonds.

	2003	2002
	(In thousands)	
Par amount of consolidated bonds:		
Fixed rate	\$ 53,396,075	\$ 37,113,105
Variable rate	2,625,500	5,650,000
Inverse floating rate	50,000	50,000
Variable that converts to fixed	-	-
Comparative-index	41,550	61,550
Step-up	385,000	-
Zero coupon	3,830,000	-
Total par value	\$ 60,328,125	\$ 42,874,655

**Bonds Denominated in Foreign Currencies** - Consolidated bonds issued can be denominated in foreign currencies. Concurrent with these issuances, the Bank 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 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, 2003 and 2002 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
	2003	2002		U.S. Dollars	Interest Rate	
British Pound	-	300,000	2003	\$ 507,900	5.65%	
British Pound	-	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, 2003	\$ 20,456,395	\$ 20,500,073	1.05%
December 31, 2002	\$ 14,526,323	\$ 14,563,201	1.42%

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, 2003.

## Note 15 – Capital

The 1999 Act will result in a number of changes in the capital structure of the FHLBs. The final Finance Board capital 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 in accordance with the provisions of the 1999 Act and final capital rules. 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 plan approval. Until such time as the Bank fully implements the new capital regulations, 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 at the most recent calendar year end or 5 percent of outstanding Bank advances. However, the 1999 Act removed the provision that required a non-thrift member to purchase additional stock to borrow from the Bank if the non-thrift 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, with the Bank's approval, 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 Agreement with the Bank's regulator sets a minimum capital ratio of 5.1 percent while the Agreement is in effect.

The 1999 Act established voluntary membership for all members. All members may withdraw from membership and redeem their capital after giving notice to do so within the required timeframe. Members that withdraw from membership must wait 5 years before being readmitted to membership in the Bank.

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

## Note 16 - 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 \$2,690,000 and \$465,000 in 2003 and 2002, respectively. In 2003, the Bank contributed an additional \$5,230,000. As a result the plan is fully funded through June 30, 2005. 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 \$581,000, \$523,000, and \$428,000 for the years ended December 31, 2003, 2002, and 2001, 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 retirees 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. The Bank's minimum obligation from these plans at December 31, 2003, and 2002, was \$3,388,000 and \$2,456,000, respectively. Net periodic costs were \$603,000, \$406,000 and \$277,000 in the years ended December 31, 2003, 2002 and 2001, respectively.

## Note 17 - 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, mandatory delivery contracts for mortgage loans executed after June 30, 2003, 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, 2003 and 2002, the Bank's maximum credit risk, as defined above, was approximately \$454,327,000 and \$450,421,280 respectively, including \$23,913,867 and \$39,907,750 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 \$446,115,000 and \$439,817,977 as collateral for interest rate exchange agreements as of December 31, 2003 and 2002, respectively. Additionally, collateral with respect to interest-rate exchange agreements with member institutions includes collateral assigned to the Bank, as evidenced by written security agreement.

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 20.

**Intermediation** - Derivative financial instruments in which the Bank is an intermediary may arise when the Bank: (1) enters into interest-rate exchange agreements with members and offsetting interest rate exchange agreements with other counterparties to meet the needs of its 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 was an intermediary is \$552,240,773 and \$937,664,000 at December 31, 2003 and 2002, respectively.

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, 2003:

Total by Product	Notional (as restated)	Estimated fair value (excludes accrued interest) (In thousands) (as restated)
ADVANCES		
Fair Values	\$ 14,088,011	\$ (547,987)
Cash Flow	1,490,000	93,033
Stand Alone	300,000	2,512
Total	15,878,011	(452,442)
INVESTMENTS		
Stand Alone	1,070,044	(29,276)
MPF LOANS		
Fair Value	15,007,296	118,408
Cash Flow	233,836	863
Stand Alone	600,000	4,431
Total	15,841,132	123,702
CO BONDS		
Fair Value	11,915,550	59,285
Cash Flow	500,000	-
Stand Alone	300,000	5,724
Total	12,715,550	65,009
DISCOUNT NOTES		
Cash Flow	2,700,000	223,501
Stand Alone	3,160,000	215,080
	5,860,000	438,581
DEPOSITS		
Stand Alone	1,750,000	60,858
INTERMEDIARIES		
Stand Alone	552,241	441
Total	\$ 53,666,978	\$ 206,873
Total Derivatives Excluding Accrued Interest		206,873
Accrued Interest at 12/31/03		23,914
Net Derivative Balance at 12/31/03		230,787
Net Derivative Asset Balance at 12/31/03		454,327
Net Derivative Liability Balance at 12/31/03		(223,540)
Net Derivative Balance at 12/31/03		\$ 230,787

The following table categorizes the hedging activities 2003 earnings impact by product:

Earnings Impact	Net Margin (Amortization / Accretion) (as restated)	Other Income/(Expense) (as restated)	Securities Held at Fair Value (as restated)	Total (as restated)
(In thousands)				
Advances	\$ (32,812)	\$ (8,766)	\$ -	\$ (41,578)
CO Bonds	(7,491)	(12,695)	\$ -	(20,186)
Investments	29	58,855	(58,748)	136
MPF Loans	(43,451)	(112,353)	-	(155,804)
Discount Notes	9,611	(37,819)	-	(28,208)
Deposits	(10,715)	-	-	(10,715)
Balance Sheet	-	(26,505)	-	(26,505)
Intermediaries	-	116	-	116
Total	\$ (84,829)	\$ (139,167)	\$ (58,748)	\$ (282,744)

## Note 18 - Segment Information

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

The following table sets forth the Bank's financial performance by operating segment for the years ended December 31, 2003, 2002 and 2001.

	MPF <u>(as restated)</u>	Traditional Member Finance <u>(In thousands)</u>	Total <u>(as restated)</u>
2003			
Net interest income	\$ 642,018	\$ 147,855	\$ 789,873
Provision for credit losses on mortgage loans	-	-	-
Other income	(120,769)	11,543	(109,226)
Other expenses	51,103	35,327	86,430
Income before assessments	470,146	124,071	594,217
Affordable Housing Program	37,613	10,910	48,523
REFCORP	84,188	24,976	109,164
Total assessments	121,801	35,886	157,687
Net income before cumulative effect of change in accounting principle	<u>\$ 348,345</u>	<u>\$ 88,185</u>	<u>\$ 436,530</u>
2002			
Net interest income	\$ 189,323	\$ 332,897	\$ 522,220
Provision for credit losses on mortgage loans	2,217	-	2,217
Other income	(39,437)	(145,361)	(184,798)
Other expenses	27,670	28,918	56,588
Income before assessments	119,999	158,618	278,617
Affordable Housing Program	9,796	12,947	22,743
REFCORP	22,040	29,135	51,175
Total assessments	31,836	42,082	73,918
Net income before cumulative effect of change in accounting principle	<u>\$ 88,163</u>	<u>\$ 116,536</u>	<u>\$ 204,699</u>
2001			
Net interest income	\$ 53,273	\$ 169,567	\$ 222,840
Provision for credit losses on mortgage loans	1,810	-	1,810
Other income	1,325	44,706	46,031
Other expenses	18,861	25,070	43,931
Income before assessments	33,927	189,203	223,130
Affordable Housing Program	2,770	15,494	18,264
REFCORP	6,231	34,849	41,080
Total assessments	9,001	50,343	59,344
Net income before cumulative effect of change in accounting principle	<u>\$ 24,926</u>	<u>\$ 138,860</u>	<u>\$ 163,786</u>
2003			
Total mortgage loans, net	\$ 47,599,575	\$ 156	\$ 47,599,731
Average mortgage loans, net	\$ 38,004,715	\$ 10	\$ 38,004,725
Total assets	\$ 49,392,492	\$ 37,549,495	\$ 86,941,987
2002			
Total mortgage loans, net	\$ 26,185,618	\$ -	\$ 26,185,618
Average mortgage loans, net	\$ 20,395,842	\$ -	\$ 20,395,842
Total assets	\$ 27,080,375	\$ 37,965,532	\$ 65,045,907
2001			
Total mortgage loans, net	\$ 16,570,308	\$ -	\$ 16,570,308
Average mortgage loans, net	\$ 10,452,643	\$ -	\$ 10,452,643
Total assets	\$ 16,884,057	\$ 32,310,137	\$ 49,194,194

## Note 19 - Estimated Fair Values

The following estimated fair value amounts have been determined by the Bank using available market information and the Bank's best judgment of appropriate valuation methods. These estimates are based on pertinent information available to the Bank as of December 31, 2003 and 2002. Although the Bank uses its best judgment in estimating the fair value of these financial instruments, there are inherent limitations in any estimation technique or valuation methodology. For example, because an active secondary market does not exist for a portion of the Bank's financial instruments, in certain cases, fair values are not subject to precise quantification or verification and may change as economic and market factors and evaluation of those factors change. Therefore, these estimated fair values are not necessarily indicative of the amounts that would be realized in current market transactions. The Fair Value Summary Tables do not represent an estimate of overall market value of the Bank as a going concern, which would take into account future business opportunities.

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

**Securities Purchased Under Agreements to Resell** - The estimated fair value approximates the recorded book balance.

**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 excluding the 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 are determined based on quoted market prices of similar mortgage loans available in the market. These prices, however, are highly dependent upon the underlying prepayment assumptions. 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 on available market prices including accrued interest receivable and payable. However, active markets do not exist for many types of financial instruments. Consequently, fair values for these instruments must be estimated using techniques such as discounted cash flow analysis and comparisons to similar instruments. Estimates developed using these methods are highly subjective and require judgments regarding significant matters such as the amount and timing of future cash flows and the selection of discount rates that appropriately reflect market and credit risks. Changes in these judgments often have a material effect on the fair value estimates. Since these estimates are made as of a specific point in time, they are susceptible to material near term changes. The fair values are netted by counterparty where such legal right exists. If these netted amounts are positive, they are classified as an asset and if negative, a liability.

**Deposits** - The 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 estimated 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 estimated fair value of standby letters of credit is based on the present value of 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, 2003 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	\$ 3,629	\$ -	\$ 3,629
Securities purchased under agreements to resell	418,600	(4)	418,596
Federal funds sold	5,023,000	(43)	5,022,957
Held-to-maturity securities	5,139,067	62,316	5,201,383
Securities available for sale	605,364	-	605,364
Securities held at fair value	794,297	-	794,297
Advances to members	26,443,063	(26,259)	26,416,804
Mortgage loans held for portfolio, net	47,599,731	304,929	47,904,660
Accrued interest receivable	336,655	-	336,655
Derivative assets	454,327	-	454,327
Total financial assets	<u>\$ 86,817,733</u>	<u>\$ 340,939</u>	<u>\$ 87,158,672</u>
<u>Financial Liabilities</u>			
Deposits	(2,348,071)	2	(2,348,069)
Securities sold under agreements to repurchase	(1,200,000)	(41,920)	(1,241,920)
Consolidated obligations:			
Discount notes	(20,456,395)	(5,621)	(20,462,016)
Bonds	(57,471,055)	(674,006)	(58,145,061)
Accrued interest payable	(502,327)	-	(502,327)
Derivative liabilities	(223,540)	-	(223,540)
Loan commitments	-	727	727
Standby letters of credit	(136)	-	(136)
Total financial liabilities	<u>\$ (82,201,524)</u>	<u>\$ (720,818)</u>	<u>\$ (82,922,342)</u>

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) (In thousands)	Estimated Fair Value
<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 held for portfolio, net	26,185,618	652,472	26,838,090
Accrued interest receivable	258,489	-	258,489
Derivative assets	422,828	-	422,828
Total financial assets	<u>\$ 64,980,540</u>	<u>\$ 926,417</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>

## Note 20 - Commitments and Contingencies

Commitments which legally bind and unconditionally obligate the Bank for additional advances totaled \$105,000 and \$2,555,000 at December 31, 2003 and 2002, 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 financial arrangement between the Bank and its member under which the Bank ensures payment to a third party on the member's behalf. If the Bank is required to make payment for a beneficiary's draw, these amounts may be converted into a collateralized advance to the member. Outstanding standby letters of credit were approximately \$395,759,000 and \$356,904,000 at December 31, 2003 and 2002, respectively, and had original terms of one to 10 years with final expiration in 2011. Unearned fees for transactions prior to 2003 as well as the value of the guarantees related to standby letters of credit entered into after 2002 are recorded in other liabilities and amount to \$136,000 at December 31, 2003. 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 funding and issuance, respectively, in a manner consistent with advances to members (Note 9). The estimated fair value of commitments and letters of credit as of December 31, 2003 and 2002 is reported in Note 19.

Commitments which unconditionally obligate the Bank to fund/purchase mortgage loans totaled approximately \$288,942,000 and \$1,408,222,000 at December 31, 2003 and 2002, respectively. Commitments are generally for periods not to exceed forty-five business days. In accordance with SFAS 149, such commitments entered into after June 30, 2003, were recorded as derivatives at their fair value.

The Bank has entered into standby bond purchase agreements with state housing authorities within its district whereby the Bank, for a fee, agrees to purchase and hold the authorities' bonds until the designated marketing agent can find a suitable investor or the housing authority repurchases the bond according to a schedule established by the standby agreement. Each standby agreement dictates the specific terms that would require the Bank to purchase the bond. The bond purchase commitments entered into by the Bank expire within ten years, no later than 2013 though some are renewable at the option of the Bank. Total commitments for bond purchases were \$248,656,000 and \$148,836,000 at December 31, 2003, and 2002, with the Wisconsin Housing and Economic Development Authority, respectively. During 2003, the Bank was not required to purchase any bonds under these agreements.

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, 2003 and 2002, the Bank had pledged as collateral securities with a book value of \$245,746,000 and \$272,437,000, 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 \$2,992,000, \$2,482,000, and \$2,088,000 for the years ended December 31, 2003, 2002 and 2001, respectively. Future minimum rentals are as follows:

Year	Premises	Services and Equipment	Total
		(In thousands)	
2004	\$ 2,752	\$ 281	\$ 3,033
2005	2,930	144	3,074
2006	3,188	45	3,233
2007	3,486	-	3,486
2008	3,705	-	3,705
Thereafter	11,798	-	11,798
Total	\$ 27,859	\$ 470	\$ 28,329

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 14, 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 very highly rated and any future possible loss on these obligations is considered remote. The amount of the other FHLB's consolidated obligations were \$678,681,550,000 and \$623,257,144,000 for the years ended December 31, 2003 and 2002, respectively.

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

## Note 21 – Subsequent Events

### Regulatory Agreement with the Finance Board

On June 30, 2004, the Bank entered into a Written Agreement with the Finance Board. Pursuant to the Written Agreement, the Bank will maintain a regulatory capital level of no less than of 5.1% and restrict the annual on-balance sheet growth of its acquired member assets program (MPF<sup>®</sup>) to 10%. The Bank was also required to engage independent outside consultants to review and report on the Bank's (i) management and board oversight, (ii) risk management policies and practices, (iii) internal audit functions, and (iv) accounting, recordkeeping and reporting practices and controls. These reviews are completed as of the date of this report and actions plans arising out of the consultant recommendations are being implemented.

In accordance with the Written Agreement, the Bank has adopted a Business and Capital Management Plan for 2005 – 2007 acceptable to the Finance Board. The plan sets forth commitments made by the Bank for the management of its operations, including the following:

1. The Bank will continue complying with the terms of the Written Agreement until it is terminated.
2. The Bank will manage a reduction of its voluntary stock measured as a percent of regulatory capital (total capital stock plus retained earnings) to the following minimum targets:
  - December 31, 2005 53%
  - December 31, 2006 48%
  - December 31, 2007 43%
3. The Bank will delay implementation of a new capital structure until December 31, 2006, or until a time mutually agreed upon with the Finance Board. Also, the Bank will reevaluate the structure of the Bank's capital plan, originally approved by the Finance Board on June 12, 2002, and may propose amendments for approval by the Finance Board based on the review.
4. As part of the continued development and evolution of the Mortgage Partnership Finance<sup>®</sup> Program, the Bank will explore alternative methods of capitalizing and funding MPF<sup>®</sup> assets including techniques to liquefy MPF<sup>®</sup> assets, creating additional capacity for the Bank and other FHLBs.
5. The Bank will adopt a new dividend policy requiring its dividend payout ratio in a given quarter not to exceed 90% of adjusted core net income for that quarter. For these purposes, adjusted core net income means the Bank's GAAP net income, excluding gains or losses arising from significant non-recurring events, such as advance prepayment fees and gains or losses on debt transfer transactions and associated derivative contracts and other hedge instruments. While the Written Agreement remains in effect, quarterly dividends of greater than 5.5%, on an annualized basis, will require regulatory approval.

### **Recent Rating Agency Actions**

On July 1, 2004, Standard and Poor's Rating Services ("S&P") lowered its long-term counterparty credit rating on the Bank to AA+ from AAA and kept its outlook at negative in response to the announced agreement with the Finance Board. At the same time, S&P affirmed the Bank's A-1+ short-term counterparty credit rating. The S&P rating for the consolidated obligations of the FHLBs is not affected by ratings actions pertaining to individual FHLBs and remains at AAA/A-1+.

On November 18, 2004, Moody's Investor Service affirmed its Aaa long-term deposit rating and Prime-1 short-term deposit rating on the Chicago FHLB and is maintaining a stable outlook. The consolidated debt credit ratings are unaffected by this action, and remain at Aaa/Prime-1.

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

On June 23, 2004, the Finance Board unanimously adopted a rule requiring each of the FHLBs to voluntarily register a class of securities with the Securities and Exchange Commission ("SEC") under section 12(g) of the Securities and Exchange Act of 1934. The Finance Board decision requires initial filing by each FHLB of a registration statement by June 30, 2005, and for each FHLB to ensure that the SEC declares the registration statement effective by August 29, 2005, subject to the possibility of a Finance Board order extending the deadline. Once registered, the Bank will be required to file quarterly, annual and other periodic reports with the SEC.

### **GSE Regulatory Reform Legislation**

Congress is expected to consider legislation in 2005 to reform the regulatory structure for the three U.S. housing government sponsored enterprises – the Federal Home Loan Banks, Fannie Mae and Freddie Mac. A bill creating a new independent GSE regulatory agency was passed by the Senate Banking Committee in April of 2004, but did not progress further. Among other things, the legislation would have abolished publicly-appointed directors at the GSEs, required the GSEs to register their stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934, and

replaced the FHLB's Office of Finance with a new jointly-owned corporation. While new legislation is expected to contain many of the same provisions as last year's bill, it is impossible to predict with certainty the exact provisions of such a bill, whether such legislation ultimately will be enacted into law, or if enacted, what effect such legislation would have on the Chicago FHLB.

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

The Federal Reserve Board in September announced, through Docket No.OP-1182, that it has revised its Policy Statement on Payments System Risk (PSR policy) concerning interest and redemption payments on securities issued by government-sponsored enterprises (GSEs) and certain international organizations. The Reserve Banks are currently processing and posting these payments to depository institutions' Federal Reserve accounts by 9:15 a.m. Eastern Time, the same posting time as for U.S. Treasury securities' interest and redemption payments, even if the issuer has not fully funded its payments. The revised policy requires that, beginning July 20, 2006, Reserve Banks will release these interest and redemption payments as directed by the issuer provided the issuer's Federal Reserve account contains sufficient funds to cover them. While the issuer will determine the timing of these payments during the day, each issuer will be required to fund its interest and redemption payments by 4 p.m. Eastern Time in order for the payments to be processed that day. Also beginning July 20, 2006, the revised policy will align the treatment of the general corporate account activity of GSEs and certain international organizations with the treatment of activity of other account holders that do not have regular access to the discount window and thus are not eligible for intraday credit. Such treatment will include applying a penalty fee to daylight overdrafts resulting from these entities' general corporate payment activity. The Bank is evaluating the impact of this proposed change on its operations. These changes will impact the Bank. However, it is not possible to predict what, if any, changes will be made and what effect the changes would have on the Bank.

### **Management Change**

Effective August 30, 2004, J. Mikesell Thomas was named President and Chief Executive Officer of the Bank. Mr. Thomas replaces Charles A. Huston, Acting President since July 1, 2004, following the resignation of Alex J. Pollock.

## Audit Committee Report

March 15, 2005

The Audit Committee of the Board of Directors of the Federal Home Loan Bank of Chicago for 2004 was composed of six outside Directors. The members of the Audit Committee at March 15, 2005 were P. David Kuhl, James F. McKenna, Terry W. Grosenheider, Gerald J. Levy, William H. Ross and Allen H. Koranda.

This report is submitted by the 2005 Audit Committee. The 2005 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 2005 in compliance with the charter. The Audit Committee has reviewed and discussed the audited 2003 Restated Annual Financial Statements and Notes with management. The Audit 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 Audit 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 2003 Restated Annual Financial Statements and Notes.

P. David Kuhl, Chairman  
James F. McKenna, Vice Chairman  
Terry W. Grosenheider  
Gerald J. Levy  
William H. Ross  
Allen H. Koranda

## 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 2003 Restated Annual Financial Statements and Footnotes 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 judgments.

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. The Bank determined, through a review of its hedging activities pursuant to an agreement entered into by the Bank with the Federal Housing Finance Board effective June 30, 2004, that for certain hedging transactions it applied a method of hedge accounting deemed to be inconsistent with the interpreted application of SFAS No. 133. As part of the restatement, management changed its hedge accounting to conform to SFAS No. 133. These revisions consisted of recording in earnings gains and losses previously deferred in Other Comprehensive Income for a portion of the Bank's cash flow hedges and revising the timing of recognition in earnings of premiums paid on option transactions. The Bank has implemented additional controls in the area of derivatives accounting to prevent or detect future errors and has strengthened its Accounting Policy and SEC Reporting function. Management believes that as of December 31, 2004 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.



J. Mikesell Thomas  
President and Chief Executive Officer



Roger D. Lundstrom  
Executive Vice President