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Introduction*Advances*

The Federal Home Loan Banks (FHLBanks) are government-sponsored enterprises with the mission to further housing finance and to foster community investment. This mission is largely accomplished by providing advances (secured loans) to members. Advances are unique to the FHLBanks. As such, this examination module does not have applicability in the examination of Fannie Mae, Freddie Mac or the Office of Finance, although the Office of Finance acts as agent for the FHLBanks in offering, issuing, and servicing consolidated obligations, which are the principal source of funding for advances. Additional information related to advances may be found in the *Credit Risk Management* module and the *Federal Home Loan Bank Membership* module.

The Federal Home Loan Bank System (System) was established in 1932 with the enactment of the Federal Home Loan Bank Act (Bank Act). In establishing the System, the United States Government sought to stimulate mortgage finance through the provision of liquidity in the form of advances by FHLBanks to their members and housing associates. Member advances are the FHLBanks' primary business. The FHLBanks provide short and long-term advances that members and housing associates use to support mortgage lending, community investment, and other operational needs of their customers. Members may use long-term advances only to support residential housing finance¹ and, in the case of community financial institution (CFI) members, to support lending for small business, small farm, small agricultural business, and community development purposes. CFI members also are allowed to pledge a broader range of collateral than other members, including secured loans made to finance small business, agriculture, or community development activities.

In the context of this module, collateral refers only to assets pledged to secure an advance or Standby Letter of Credit (SLOC). This module is not applicable to mortgages held in portfolio or to investments. FHLBank advance activity generally has low credit risk, as all advances are fully secured as required by the Bank Act and FHFA regulation. In addition, FHLBanks typically hold or can claim collateral substantially in excess of total advances outstanding of any member or non-member borrower, including access to the member's capital stock in the event of a collateral shortfall.

In accordance with 12 CFR 917.3 of the former Federal Housing Finance Board's (Finance Board) regulations, each FHLBank must have in effect at all times a risk

¹ 12 CFR 1266.3 of the FHFA regulations requires that, prior to approving an application for a long-term advance, an FHLBank shall determine that the principal amount of all long-term advances currently held by the member does not exceed the total book value of residential housing finance assets held by such member. The term "residential housing finance assets" is specifically defined by 12 CFR 1266.1 of the FHFA regulations to include, in the case of CFIs, small business, small farm, small agri-business and community development loans.

management policy that addresses the FHLBank's exposure to credit, operational, business, liquidity, and market risks. The risk management policy should identify each of the aforementioned risks as they relate to advances activities and establish standards and tolerances that can be measured and monitored. In addition, each FHLBank must perform, at least annually, a written risk assessment that identifies and evaluates all material risks that could adversely affect the achievement of the FHLBank's performance objectives and the satisfaction of compliance requirements.

12 CFR 917.4 of the Finance Board's regulations requires each FHLBank to have in effect at all times a member products policy that addresses the FHLBank's management of products offered to members and housing associates. The member products policy should address, among other matters: credit underwriting criteria; appropriate levels of collateralization; valuation and discounts of collateral; fees; pricing; the maintenance of appropriate systems, procedures, and internal controls; and appropriate operational and personnel capacity.

Standby Letters of Credit

The FHLBanks may provide SLOCs to their members and housing associates. SLOCs guarantee payment between the member and a third party. If the member fails in meeting its obligation, the FHLBank would be responsible for payment. If funded, a SLOC becomes an advance. Regulations require that an FHLBank obtain collateral at the time it issues a SLOC.² The regulation also identifies the types of collateral that a member or housing associate may pledge to secure its obligations under a SLOC.

Collateral

Members obtain liquidity by pledging mortgage-related assets and other assets as collateral for advances from FHLBanks. The Bank Act requires FHLBanks to maintain a security interest in eligible collateral, which includes mortgage loans, mortgage-backed securities (MBS) and other securities, cash, and other real estate related collateral. The member's collateral protects the FHLBank's interest should the member default or fail. For institutions whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC), a member's failure has historically resulted in the FDIC paying off FHLBank advances in order for it to obtain collateral free of any liens held by the FHLBank, as this has been the least cost resolution of the failed bank or thrift. If, however, an FHLBank's exposure to a failed member exceeds the FDIC's exposure, as measured by insured deposits, the FDIC might determine that the least cost resolution does not require the repayment of advances. Should this occur, the FHLBank would have to sell the collateral to pay off any outstanding advances to the failed institution. Adequate FHLBank collateral will protect the FHLBank should it have to enforce its security interest in the collateral following an insured depository member's failure.

² FHFA regulations addressing SLOCs are found at 12 CFR Part 1269.

FHLBanks also may make advances to housing associates, which are not members, and to members that are not insured depository institutions. For example, the Bank Act enables insurance companies to join the System although an insurance company's ability to become an FHLBank member and to grant security interests in its assets is determined by state law. Moreover, certain powers possessed by individual state insurance company commissioners and state law could limit an FHLBank's ability to enforce its security interest in collateral posted by an insurance company. Thus, extending advances to insurance companies poses different risks of loss to an FHLBank if an insurance company fails. Community Development Financial Institutions (CDFIs) also may become members and may borrow on the same terms as other types of members. CDFIs have no dedicated regulator, such as state and federal banking agencies or insurance commissioners, to oversee their operations. Liquidation of a CDFI likely would occur under the federal bankruptcy statutes. Should an insurance company, CDFI, or housing associate fail, an FHLBank may have to liquidate collateral to pay off the outstanding advance. Therefore, FHLBank collateral practices with respect to insurance companies, CDFIs, and housing associates warrant special attention.

The Bank Act and Federal Housing Finance Agency (FHFA) regulations require each FHLBank, at the time it originates or renews an advance, to obtain and maintain a security interest (*i.e.*, a lien) in eligible collateral. Eligible FHLBank collateral largely falls into three categories:

- 1) Whole loans, generally secured by residential or commercial properties;
- 2) Mortgage backed securities securitizing either residential or commercial loans;
- 3) Securities issued, insured, or guaranteed by the United States Government, or any agency thereof (including mortgage-backed securities issued or guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae).

Under the Bank Act and FHFA regulations, a member's obligation to repay an advance must be evidenced by a written advances agreement. For insurance company members, the advances agreement may be documented as a funding agreement rather than or in addition to an advances agreement. The regulations also require the FHLBanks to execute a written security agreement with each member. The security agreement must thoroughly describe the eligible collateral that will be the subject of the FHLBank's security interest. Once a security interest has attached, the FHLBank can enforce the security interest on the collateral in the case of default.

An FHLBank's security interest generally attaches (*i.e.*, the security interest is created) when the FHLBank enters into the written security agreement with a member that describes the member's collateral. Although not required by statute or regulation, each of the FHLBanks utilizes security agreements that apply to all advances that the FHLBank makes to a member.

Under the Uniform Commercial Code (UCC), a security interest may be “perfected” through a number of different methods, depending on the type of collateral. Generally speaking, a “perfected” security interest will enable the FHLBank to enforce its security interest against most third parties who assert a competing interest in the collateral, including a receiver or bankruptcy trustee (such as the FDIC or a state insurance commissioner) and other creditors of the failed member. The statutory “super lien,” discussed below effectively gives the FHLBank’s security interest a priority over the claims of nearly all other claimants to the collateral.

Prior to 2001, a secured lender could perfect its security interest in mortgage loan promissory notes only by taking possession of them. Since 2001, the UCC has permitted perfection by filing a UCC-1 financing statement that describes the mortgage notes subject to the security interest. The regulations also require the FHLBanks to execute a written security agreement with each member. The security agreement must thoroughly describe the eligible collateral that will be the subject of the FHLBank’s security interest. Once a security interest has attached, the FHLBank can enforce the security interest on the collateral in the case of default.

UCC rules regarding security interests in investment securities differ depending on whether the beneficial owner holds the security directly as the owner of record on the books of the issuer or indirectly through a custodian, broker or other securities intermediary. The UCC refers to an investment security that is held directly as a “security,” which may be either “certificated” or “uncertificated.” The UCC refers to an interest in a security that is held indirectly through a securities intermediary as a “security entitlement” and to the person having the security entitlement as the “entitlement holder.” Most securities collateral pledged by FHLBank members will be in the form of “security entitlements,” rather than in the form of “certificated securities” or “uncertificated securities.”

A secured party may perfect its security interest in each of those three types of securities collateral either by filing a UCC-1 financing statement or by obtaining control of the securities collateral, but simply filing a UCC-1 statement will not give an FHLBank a first priority security interest in the collateral. In order to acquire a first priority security interest in a member’s securities collateral, an FHLBank must also obtain control of that collateral. The UCC provides different requirements for obtaining “control” of each of the three types of securities collateral described above.

Generally speaking, an FHLBank may obtain control of a security entitlement under the UCC in either of two ways. First, the FHLBank may become the entitlement holder of the security entitlement by requiring the member to transfer the collateral to the FHLBank’s account with its securities custodian. Second, an FHLBank may permit a member to keep the collateral with its own securities custodian, but enter into a three-party agreement with the member and the securities custodian under which the FHLBank is granted the authority to direct the custodian to liquidate the collateral without further consent of the member. The main risk to an FHLBank that does not obtain control of the

securities collateral is that its member may later pledge that same collateral to another creditor who does obtain control of it, in which case the FHLBank's claim to the collateral would likely be subordinate to that of the other creditor.

The UCC specifies how priority among competing secured parties in different types of collateral is determined. A security interest in mortgage loan notes that has been perfected through possession of the notes will have priority over an unperfected security interest or a security interest that has been perfected by a method other than possession. Similarly, a security interest in securities collateral (including security entitlements) that has been perfected by control will have priority over an unperfected security interest or a security interest that has been perfected by a method other than control. Generally, the priority of claims between competing creditors that have perfected their security interest in the same collateral through a method other than possession (for notes) or control (for securities), *i.e.*, both have perfected solely by filing a UCC-1 financing statement, will be determined by the order in which the entities perfected their respective security interests. Perfected security interests will always have priority over unperfected security interests, regardless of the method of perfection. Accordingly, FHLBanks that have taken the additional step of obtaining possession of pledged mortgage notes or control of pledged securities collateral should have the most senior security interest in nearly all circumstances.

In 1987, Congress amended the Bank Act to provide that any security interest granted to an FHLBank by a member or an affiliate of a member has priority over the claims of any other party unless the claims of the other party were entitled to priority under otherwise applicable state law and are held by creditors with actual perfected security interests or bona fide purchasers for value. This provision, which was enacted as part of the Competitive Equality Banking Act of 1987 (CEBA), is sometimes referred to as the "CEBA lien" or the "superlien." In most cases, the presence of the superlien will mean that only those security interests that were perfected before the FHLBank's security interest attached will be granted priority over the FHLBank's security interest. As noted above, however, if an FHLBank has perfected its security interest only by filing a UCC-1, then other creditors that perfect their claims to the same collateral by taking possession of the notes or by obtaining control of the securities will likely have a more senior claim to that collateral than would the FHLBank.

The principal effect of the superlien is that it gives the FHLBanks the equivalent of a first priority claim to the collateral that will be senior to all but a very narrow category of competing creditors, while also relieving the FHLBanks of the administrative burden of having to take possession of the mortgage notes. The 2001 amendments to the UCC authorizing perfection of a security interest by filing a UCC-1 financing statement likewise had the effect of relieving the FHLBanks of that administrative burden, but they also allowed for the possibility that an FHLBank relying solely on a UCC-1 filing may have its security interest subordinated to the claims of a creditor in possession of the mortgage notes. In that case, the superlien likely would not help the FHLBank because of the exception noted above. An FHLBank concerned about that risk, such as when

making advances to a troubled member, could eliminate it by requiring delivery of all collateral from such members. Apart from providing priority over most claims from competing creditors of a member, the superlien remains of value against a receiver, such as the FDIC, because it provides a statutory priority over most, if not all, of the claims that FDIC could assert to the collateral.

Regulatory Environment

The primary authorities governing, or relevant to, advances of the FHLBanks are set forth below. The examiner should ensure that the application of such authorities to an FHLBank has been considered by the FHLBank and its legal counsel.

1) Federal Home Loan Bank Act

Section 7(j) of the Federal Home Loan Bank Act sets forth duties of directors of an FHLBank. Section (j) requires the board of directors to administer the affairs of the FHLBank fairly and without discriminating in favor of or against any member. With respect to advances, Section 7(j) requires that the FHLBank be prudent in exercising its discretion regarding differential pricing of advances.

2) Rules and Regulations of the Federal Housing Finance Board (Finance Board), which include the following parts and sections relevant to advances:

12 CFR Part 917 of the Finance Board regulations addresses powers and responsibilities of FHLBank boards of directors and senior management. In particular, section 917.3, Risk Management, section 917.4, Bank Member Products Policy, and section 917.6, Internal Control System, are pertinent.

12 CFR 932.4 of the Finance Board regulations requires an FHLBank to maintain capital to offset its credit risk capital charge for all assets, off-balance sheet items, and derivative contracts.

3) Rules and Regulations of the Federal Housing Finance Agency (FHFA), which include the following parts and sections relevant to advances:

12 CFR Part 1236 of FHFA regulations addresses Prudential Management and Operations Standards (“PMOS”) Standards. Specifically, PMOS Standard 6 and Standard 9 address managing asset growth and the management of credit and counterparty risk, respectively. They also require the regulated entities to have a board of director approved policy for collateral standards and collateral valuation procedures.

12 CFR Part 1266 of FHFA regulations addresses advances. Subpart A of Part 1266 is a general section dealing with definitions, authorizations, and limitations. Subpart B addresses advances to housing associates and Subpart C deals with advances to out-

of-district members and housing associates. 12 CFR 1266.7 addresses eligible collateral.

12 CFR Part 1269 of FHFA regulations addresses standby letters of credit.

4) *Advisory Bulletin of the Federal Housing Finance Agency that provide supervisory guidance relating to the topic of oversight by the board of directors and senior management is the following:*

Advisory Bulletin 2013-07, dated November 20, 2013, provides guidance for any regulated entity's model risk framework that should reflect the entity's size, complexity and extent of model use and level of risk exposure.

5) *Advisory Bulletins of the Federal Housing Finance Board that provide supervisory guidance relating to advances are:*

Advisory Bulletin 99-15, dated November 10, 1999, which offers guidance on collateral for sub-prime and high loan-to-value single-family mortgage loans.

Advisory Bulletin 00-4, dated May 26, 2000, which offers guidance on providing quantitative disclosures for putable advances to prospective borrowers.

Advisory Bulletin 01-5, dated May 1, 2001, which offers guidance on credit underwriting and collateral coverage for housing associates.

Advisory Bulletin 01-8, dated October 4, 2001, which offers guidance on establishing procedures to address the periodic review, classification and reporting of problem assets.

Advisory Bulletin 05-05, dated May 18, 2005, which provides guidance on the risk management responsibilities of the board of directors, senior management and risk management function of an FHLBank.

Advisory Bulletin 05-08, dated August 25, 2005, which provides guidance on establishing anti-predatory lending policies to govern the FHLBank's purchase of mortgages and calculation of the level of advances that can be made to its members.

Advisory Bulletin 07-01, dated April 12, 2007, which establishes regulatory expectations for the FHLBanks to adopt and implement policies and risk management practices that establish appropriate risk limits for, and appropriate mitigation of, credit exposure on nontraditional and subprime mortgage loans.

Advisory Bulletin 08-02, dated July 1, 2008, which establishes expectations regarding the application of guidance contained in Advisory Bulletin 07-01 concerning

subprime and nontraditional residential mortgage loans for specific FHLBank assets, including advances.

Advisory Bulletin 10-01, dated April 6, 2010, which provides further clarification on Advisory Bulletin 08-02 regarding subprime and nontraditional residential mortgage loans.

6) *Article 9 (Secured Transactions) and Article 5 (Letters of Credit) of the Uniform Commercial Code (UCC):*

Article 9 of the UCC primarily applies to secured transactions involving personal property, including goods, documents, instruments, general intangibles, chattel paper or accounts. Article 9 sets forth the specific requirements governing attachment and perfection of security interests (including the method of perfecting a security interest in specific types of collateral, such as promissory notes secured by mortgages), the contents and filing of financing statements, changes in name and identity of debtors, rights and duties in connection with default, and enforcement of security interests.

Article 5 of the UCC applies to letters of credit and to certain rights and obligations arising out of transactions involving letters of credit.

The UCC is a uniform nonbinding model code which must be adopted by the legislature of each state before it becomes the law of that state. Typically, the legislature of a particular state will modify some provisions of the model UCC in order to reflect commercial customs or practices in that state when it adopts the UCC as part of state law. As a result, the UCC will not be identical in each state, and certain provisions of Article 9 and Article 5 may vary from state to state. Legal counsel for the FHLBanks should monitor any changes in state law relating to the UCC and should periodically review the documents and operating practices of the FHLBank to ensure that they continue to comply with the UCC, as adopted by their state.

7) *Accounting Standards Codifications (ASC) adopted by the Financial Accounting Standards Board establish standards of financial accounting and reporting governing the preparation of financial reports and are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants (AICPA). Specific ASC applicable to advances activities, include, but are not limited to, the following:*

- a) ASC 450-20 - Loss Contingencies establishes standards of financial accounting and reporting for loss contingencies. This requires a creditor's accrual by a charge to income (and disclosure) for an estimated loss from a loss contingency if two conditions are met: (1) information available prior to the issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements; and (2) the

amount of loss can be reasonably estimated.

- b) ASC 310 - Receivables requires a creditor to recognize loan impairment through the creation of a credit loss reserve and a charge to bad debt expense. Loan impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. This statement is applicable to advances and to acquired member assets.

8) *State privacy laws that require disclosures to customers of the recording of conversations to which they are a party.*

Specific requirements may vary by state jurisdiction.

Issues Specific to the FHLBanks

Organizational Structure

Within the FHLBank System, organizational structures vary and differences in assigning functional responsibilities related to advances and SLOCs are acceptable. The most important functional areas related to advances and SLOCs are the money desk, the credit department, and the collateral operations department. Auxiliary departments include safekeeping and wire transfer services. The typical processes are set out below.

Money Desk

The money desk is typically responsible for processing advance requests that are received on recorded telephone lines. The money desk staff works closely with the treasury department to determine advances interest rates and specials (*e.g.*, maturity related discounts) and markets those products to members. They also act as the member's primary contact for questions about advances and rates.

Credit Department

Underwriting and the credit quality of members are typically monitored by an FHLBank's credit department. However, some FHLBanks coordinate efforts in these areas with the enterprise risk management function. Staff responsible typically performs quarterly credit analysis on all members via a credit scoring model, written credit analyses, or both. The results of these analyses may be to place amount or maturity restrictions on future advances, to deny advances and SLOCs requests, or to require either listing or delivery of collateral before funding future advances. An FHLBank's advance system is generally updated for any such conditions imposed by the credit risk staff. If an FHLBank does not use an automated system for ensuring that credit

restrictions are adhered to, examiners should ensure that the FHLBank has effective procedures to ensure compliance with credit restrictions.

Upon approval for membership, the member signs a borrowing agreement and collateral pledging agreement. These documents cover all future advance requests, which allow most FHLBanks to fully automate the process of approving individual advances. The FHLBanks frequently use secure internet sites to provide information on advances such as products, terms, and rates as well as to transact the advance request. The member submits a request for an advance either by telephoning the money desk on recorded telephone lines or via the secured internet site that interfaces with the advances system. The advances system contains all relevant credit underwriting and collateral information, including any restrictions placed on the member's borrowing capacity. The advance system automatically checks all required borrowing criteria including sufficiency of collateral, compliance with FHFA regulations, and credit restrictions imposed. Discrepancies may result in disapproval, pledging of additional collateral, or further credit analysis depending on the situation. If approved, the FHLBank initiates any required activity stock purchase, after which advance proceeds are credited to the borrower's deposit account at the FHLBank.

Collateral Operations

An FHLBank's collateral staff is typically responsible for all aspects of collateral for the advances. This includes maintenance of the collateral management system, management of collateral on listing or delivery status, valuation and haircuts applied to collateral, and receipt and maintenance of all security agreements including UCC-1 financing statements.

Safekeeping Operations

All FHLBanks require that securities pledged as collateral for advances and SLOC be held in safekeeping for the FHLBank's benefit (see Examination Manual *Securities Safekeeping* module). Typically, the collateral is held at the FHLBank or its securities custodian, although in some instances the FHLBank approves a member's third-party custodian to safekeep the securities on their behalf. In the event of the latter, it is particularly important that the FHLBank have strong monitoring and notification procedures over the collateral. The responsibilities of the FHLBank's securities safekeeping operations function generally include the control of securities that are pledged as collateral, including the review, receipt, and release of, and accounting for, principal and interest payments received. Typically, the FHLBank's collateral operations department is responsible for pricing the securities. Close coordination between the safekeeping department and the collateral operations function is necessary to monitor the maturity of securities held for safekeeping in order to ensure that adequate collateral for advances is maintained at all times.

Wire Transfer Operations

An FHLBank’s wire transfer operations function generally has responsibility for the control of disbursements and payments received from the members and housing associates. The wire transfer department typically coordinates with the money desk to ensure that advances and stock purchases are funded and reconciled to member deposit accounts.

Management Committees

Various management committees are established to assist the board of directors and senior management in the oversight of advances activities. Specific examples of these include, but are not limited to, the following:

Credit Committee

The credit committee customarily has the responsibility for the management of the credit risk arising from the FHLBank’s activities. Examples of specific duties and responsibilities of this committee include:

- 1) Establishing credit and collateral policies that address underwriting guidelines for the evaluation and monitoring of the borrower and collateral, maximum portfolio exposures for specific types of concentrations, limits and standards for the approval of credit, eligible collateral, collateral valuation, collateral “haircuts,” and compliance with federal and state requirements (such as the UCC and state predatory lending laws);
- 2) Approval of extensions of credit in accordance with delegated authorities;
- 3) Monitoring of asset quality, composition, trends, and risk diversification in the portfolios; and
- 4) Monitoring of compliance with credit and collateral policies, including the identification and reporting of exceptions, and the review of the adequacy of the allowance for loan losses.

Asset/Liability Management Committee

The asset/liability management committee or “ALCO” customarily has the responsibility for monitoring the FHLBank’s financial management activities and exposures, ensuring that they are consistent with the FHLBank’s mission, limits, and strategic objectives. Examples of specific duties and responsibilities of this committee include:

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- 1) Development of asset/liability risk management philosophy and policy and recommending risk limits to the FHLBank's board of directors;
 - 2) Monitoring and management of the FHLBank's interest rate and liquidity risk exposures in accordance with established limits, including the oversight of the process for the periodic valuation of the FHLBank's interest rate risk model;
 - 3) Review of new emerging accounting and regulatory issues that may affect the FHLBank's financial strategies or performance;
 - 4) Approval of specific investment, credit, funding, hedging, and pricing policies and programs;
 - 5) Review of new business or product initiatives, or of material changes to existing products, including the review of the overall portfolio and product line performance in accordance with the FHLBank's strategic goals; and
 - 6) Review of pricing objectives and philosophies; balancing profitability, member value and market penetration; and monitoring of business activities that were negotiated with discretionary pricing.

Operations Committee

The operations committee customarily assists senior management in the review and evaluation of risk exposures, tolerance limits, and compliance with established controls that are associated with the business activities, operational areas and departments of, and risks undertaken by, the FHLBank.

Risks Associated with Advances and Standby Letters of Credit

Credit Risk

The FHLBank controls credit risk for advances and SLOCs by establishing an appropriate credit risk management environment that includes credit strategies, ongoing credit analysis, credit and collateral policies and procedures, and allowance for loan losses. The FHLBank must have an effective and timely ongoing credit analysis process that complements collateral management procedures. The FHLBank's procedures should ensure that appropriate risk mitigation controls (such as the listing or delivery of collateral, restrictions on advances amounts or maturities, or cessation of new advances) are implemented for higher risk members in a timely manner.

The FHLBank's credit risk management procedures must be tailored to address risks unique to each type of member. Most members are depository institutions that are insured by the FDIC or the National Credit Union Administration (NCUA). For institutions whose deposits the FDIC or the NCUA insures, a member's failure most

likely results in the payoff of FHLBank advances by the FDIC or the NCUA. The FDIC or NCUA typically takes this course of action to obtain collateral free of any liens held by an FHLBank. Despite this past experience with failed insured depository institution members, the FHLBank must still have credit risk management procedures that are robust and properly executed. The FHLBanks also have insurance companies and CDFIs as members, as well as nonmember housing associate borrowers that are not insured depository institutions. Insurance companies, CDFIs, and housing associates are not covered by the same receivership laws as insured depository institutions. Insurance companies are covered by rehabilitation or liquidation laws that will vary from state to state, and housing associates and CDFIs would likely be covered by the federal bankruptcy statutes.

In the case of insurance companies, the powers granted state insurance commissioners or state law may limit the ability of an insurance company member to pledge collateral or may include “clawback” authorities that create greater credit risk for an FHLBank in the event of an insurance company failure. Most FHLBanks have little experience with insurance company failures, and it may be that an FHLBank would have to liquidate collateral to pay off the advances.

The accounting convention for insurance companies is generally different from depository institutions. Many insurance companies are mutual organizations. They also may not be required to prepare GAAP financials. Examiners must also be aware that statutory reports submitted to insurance commissioners may differ from GAAP financials. Examiners should assess how the FHLBank evaluates the financial strength of its insurance company members. An FHLBank should conduct its own periodic financial analysis of insurance company members as well as consult available third-party evaluations. If an FHLBank’s analysis differs significantly from a third-party evaluation, the variance needs to be explained and documented.

Insurance companies are regulated at the state level, and the procedures for dealing with the liquidation of an insurance company vary from state to state. Each FHLBank with insurance company members should obtain a legal opinion from competent legal counsel for each state in its district addressing the ability of the FHLBank to liquidate collateral if the insurance company fails or is reorganized by the state insurance commissioner (or equivalent). The FHLBank should have a process to update these legal opinions as laws and regulations change.

FHLBanks offer SLOCs to members and housing associates for purposes prescribed in regulation. When drawn, the SLOCs become advances. Credit analysis and collateral operations for SLOCs should be no less rigorous than those for advances.

Operational Risk

Without appropriate controls, advances and SLOC activities may result in increased operational risk. Advances and SLOCs are reliant on sound information technology

systems, including the FHLBank's secured internet site, the advances system, the collateral system, the credit rating system, and member capital stock system. The absence of strong internal controls and disaster recovery plans over these systems may expose the FHLBank to unexpected losses or other problems.

An FHLBank sometimes takes possession of a member's collateral, either loans or securities, or engages a third party custodian to act on its behalf for these purposes. As a result, the FHLBank should take care to ensure that strong vault and safekeeping controls are in place to prevent risk of loss of important loan documents or inappropriate release of securities collateral.

An FHLBank must also ensure that legal documents related to advances and SLOCs (such as advances and security agreements and UCC-1 filings) and reports of examination and other supervisory communications are appropriately recorded and safeguarded.

Finally, the FHLBank needs to establish strong monitoring and reconciliation processes to ensure activity stock requirements related to advances and SLOCs are accurate.

Lien Types

The majority of FHLBanks file a "blanket lien" on a member's assets to secure advances. A blanket lien creates a lien on the assets that are specified in the security agreement and may be all assets of a member. Most FHLBanks rely on a blanket lien to secure advances without taking possession of the collateral.

Historically, FHLBanks placed a blanket lien on all assets of the member, including ineligible collateral, premises, furniture and fixtures, and intangibles. However, as FHLBanks began to expand their membership base in the 1990s, some FHLBanks accommodated large members, like large commercial banks and insurance companies, by filing "specific liens" rather than blanket liens. Specific liens cover only specifically identified assets or categories of assets pursuant to the security agreement, generally 1-4 family mortgage portfolios or the mortgage assets in a subsidiary/affiliate.

Blanket Lien

Under a blanket lien, a security agreement and UCC-1 financing statement create an FHLBank's security interest in a member's eligible collateral. To determine the amount of eligible collateral held by a member, the FHLBank obtains information from member regulatory reports, such as the Call Report, or the member provides customized reports designed by the FHLBank. To determine a member's maximum borrowing capacity (MBC), most FHLBanks use the unpaid principal balances (UPB) of a loan portfolio (e.g., 1-4 family mortgages portfolio, commercial real estate (CRE) portfolio, and/or multifamily portfolio, as reported by the member), to which the FHLBank applies "haircuts" or discounts to determine the MBC. To ensure that members are reporting

correct loan portfolio information, the FHLBanks conduct onsite collateral reviews by FHLBank staff or approved third-party vendors (*e.g.*, audit firms).

Because blanket control does not involve possession of the collateral or detailed information about the collateral, FHLBanks that rely solely on blanket liens should have frequent reporting of information by members, analytically-supported “haircuts” for collateral, robust collateral reviews, and strong member monitoring.

Specific Liens

Some FHLBanks take security interests in specific member assets, rather than a blanket lien against all eligible assets of a member. A specific lien also requires filing of a UCC-1 and security agreement that identify the specific collateral pledged, for example, 1-4 family mortgages. Some FHLBanks do not use a blanket lien because members are unwilling to pledge all of their eligible assets to the FHLBank. This is more often the case with large members that do not want a lien on all assets and insurance company members that may lack the legal ability to provide a blanket lien. Many FHLBanks also require specific liens if they discern credit quality problems with the member.

Listing

An FHLBank may require a member to identify specific mortgages or securities as collateral. This practice is commonly referred to by FHLBanks as “listing.” Listing provides more information about the member’s pledged collateral than under a blanket lien. A benefit of listing is that the FHLBank can more easily monitor the collateral’s value and more accurately evaluate collateral margins. FHLBanks often require listing information for members that exhibit a higher risk profile. While some FHLBanks require less of a haircut on collateral listed than required for assets pledged under a blanket lien, because more is known about the specific collateral. However, the FHLBank might apply higher haircuts or be more restrictive with respect to eligible collateral if it is obtaining a listing because of credit concerns about the member.

If a member is on listing status, the FHLBank should obtain updated information about the collateral from its members at least quarterly. The frequency of the updates should increase commensurate with a member’s risk profile. Best practices should include members reporting loan level attributes such as unpaid principal balance, loan-to-value, combined loan-to-value (CLTV), coupon, fixed/floating rate, appraised value of property, origination date, maturity date, property location, and loan type (*e.g.*, 1-4 family conventional).

Delivery

Delivery of collateral means that the FHLBank maintains physical possession of the asset by holding the relevant legal documents (*e.g.*, the promissory notes or certificated securities). Delivered collateral, with appropriately filed liens, provides the FHLBank

control over the collateral. Delivery is often required when the member is other than an insured depository institution. The collateral may be held at the FHLBank or at a third-party provider/custodian. Given the liquid nature of securities, FHLBanks have historically required delivery of securities regardless of the member's risk profile. "Uncertificated securities" and "security entitlements" do not exist in tangible form and thus cannot be delivered. An FHLBank accepting such items as securities collateral must comply with the UCC requirements for obtaining "control" of those items in order to perfect its security interest and obtain a first priority status for its security interest.

As a practical matter, most pledged securities collateral will be in the form of "security entitlements," which are securities that exist only on the books and records of a securities intermediary, such as a broker-dealer or custodian bank. In order to obtain "control" of a security entitlement, an FHLBank must become the "entitlement holder," which will occur when a member "delivers" its security entitlements to the FHLBank's custodian for deposit into the FHLBank's custodial account. In such cases, the FHLBank will be the only party authorized to direct the release or sale of the security entitlements from that account.

An FHLBank also can acquire control over securities collateral by entering into a tri-party control agreement with its member and a securities custodian under which the member agrees to allow the custodian to sell the securities upon the order of the FHLBank without further consent from the member.

Collateral Management Practices

FHLBanks will often require listing or delivery of collateral of a member with the following characteristics: large members unwilling to submit to a blanket lien; de novo members; members subject to enforcement actions; members with a Uniform Financial Institution Rating System composite of "3" or lower; non-insured members, or members with other risk issues that suggest a higher degree of risk.

Examiners should assess the frequency that the FHLBank obtains information on the collateral pledged from its members, paying particular attention to requirements for members with higher risk profiles. Examiners should assess the source of the FHLBank's information. When members provide information based upon a FHLBank-created report format, examiners should assess the reports to ensure the information can be corroborated by regulatory reports. Examiners should assess the process and time it takes for the FHLBank to update member's MBC after receiving loan portfolio information. Examiners should assess the FHLBank's certification process.

Some FHLBanks accept collateral from affiliates of a member that are either subsidiaries of the member or subsidiaries of the member's holding company. Accordingly, the FHLBanks may need to establish a different reporting mechanism to obtain information about collateral from a member's non-member affiliate.

Segregation of Collateral

Whether an FHLBank relies on a blanket lien, a specific lien, or listing, FHLBanks should consider whether circumstances warrant requiring the member to segregate mortgage collateral, whether on the member's premises or with a third party. Segregation involves ensuring that the written security agreement gives the FHLBank the right to obligate the member to always hold enough separate mortgage notes to cover its collateral commitment. The exact composition of the collateral will change over time, but the aggregate mortgage assets should never fall below the level necessary to secure the member's indebtedness to the FHLBank. While not a common practice, segregation is most often required for members that are not insured depository institutions, institutions that use document custodians, or larger financial institutions that may deliver mortgages to Fannie Mae and Freddie Mac. When the FHLBank requires segregation of collateral, it must implement verification procedures to ensure that the member has complied with the terms of the general security agreement.

Documentation

UCC Filings

FHLBanks need to file a UCC-1 within the state where the borrowing member or affiliate providing collateral is located for UCC purposes, which is usually the state where the member is organized. The FHLBank should conduct a search to determine if another creditor has filed a financing statement giving it a senior interest in the collateral. The FHLBank should also have a process to ensure UCC-1 filings are renewed timely.

Inter-Party Creditor Agreements

It is not unusual for members to borrow from other secured lenders, including the Federal Reserve Banks and corporate credit unions. A member that has acquired another depository institution in the past may also have acquired outstanding advances that the other institution had previously obtained from another FHLBank before the acquisition. To protect its security interest, an FHLBank might enter into inter-party creditor agreements with these other parties. Inter-party creditor agreements should address the allocation of rights to the collateral. This is of particular importance when another FHLBank is involved or the other lender had perfected its security interest before the FHLBank and is otherwise in a senior lien position.

Release Letters

When a member has creditors other than the FHLBank, they too, generally want the same high-quality collateral pledged for FHLBank advances. In order to pledge, or sell, the collateral free of an FHLBank's lien, the member should obtain a release letter from the

FHLBank. The release letter can serve as part of the FHLBank's monitoring and control process over collateral.

Third-Party Servicer and Third-Party Custodian Agreements

Members may service their own portfolio mortgage loans or use a third-party servicer. Members may also retain ownership of servicing rights and sell the underlying mortgage, or sell the mortgage servicing rights to a third-party. FHLBanks must ensure that third-party servicing does not impede the FHLBank's access to cash flow from the collateral should a member fail or for some other reason default on the repayment of advances. Accordingly, FHLBanks should require members to disclose when servicing on mortgage collateral is sold or performed by a third-party, and have an established process to review servicing agreements. Each FHLBank should consider addressing disclosure requirements in its security agreements.

Members can hold their loan files in-house or use a third-party custodian. Members may use third-party custodians for a number of reasons, including cost efficiency, space requirements, and/or records retention. FHLBanks should ensure that agreements between members and third-party custodians do not impede the FHLBank's ability to obtain physical possession of the collateral, or the ability to transfer possession of collateral, in the event of member failure or default on a loan. In addition, FHLBanks should ensure that the custodians retain files in fireproof storage and in a manner that makes the files easily accessible,(e.g., labeled and segregated).

Collateral Held by Member Affiliates

12 CFR 1266.7 of the FHFA regulations allows the pledging of assets held by a member's affiliate. Per the regulation, an affiliate means any business entity that controls, is controlled by, or is under common control with, a member.

An FHLBank must be aware of the risks associated with affiliates pledging assets. The FHLBank may accept collateral from a member's holding company or affiliates owned by the holding company. In either case, the FHLBank must ensure that it has obtained the legal right to collateral. To accept collateral from a member's affiliate, the FHLBank must maintain a legally enforceable security interest pursuant to which the FHLBank's legal rights and privileges with respect to the collateral are functionally equivalent in all material respects to those that the FHLBank would possess if the member were to pledge the same collateral directly.

In order to ensure that the FHLBank has effective processes in place to mitigate the risks associated with affiliate pledging of collateral, the FHLBank should be fully apprised of a member's corporate structure and the business purpose of affiliates pledging collateral. The FHLBank may also require the member to inform the FHLBank of any significant transfers of eligible collateral in and out of non-pledging affiliates and subsidiaries

between reporting periods in order to ensure that the member's borrowing capacity is updated timely.

Collateral often includes portfolios of assets pledged on a flow basis. For example, the UPB unpaid principal balance and number of 1-4 family mortgages pledged as collateral as a portfolio changes over time. An affiliate's pledge of collateral could be invalidated in certain circumstances if it was given for less than equivalent value or if it left the affiliate with insufficient assets to meet its obligations. Another creditor or minority shareholder could allege that the pledge to the FHLBank was essentially a transfer of assets without the receipt of fair consideration by the affiliate, and therefore fraudulent.

The risk from bankruptcy or insolvency is similar to that of fraudulent conveyance. Federal bankruptcy law permits the trustee or a bankrupt debtor to set aside transfers made by the debtors, where the debtor received less than a reasonably equivalent value in exchange and the transaction rendered the debtor insolvent. There is risk that a pledge of assets by an affiliate of a member to secure FHLBank obligations could be deemed invalid if a court determines that the pledge contributed to the affiliate's insolvency.

Valuation of Mortgage Collateral

The Federal Home Loan Bank Act requires that there be sufficient collateral to fully secure an advance. FHLBanks generally use the UPB as the starting point in determining a value for the pledged collateral. Historically this practice was an acceptable starting point for determining value, since most mortgages contained principal amortization and interest repayment and the UPB should have been a close proxy to the market value of the mortgage, which presumably was originated at a market rate of interest.

FHLBanks discount or apply a haircut to the UPB to account for certain risks or uncertainties, including different underwriting standards for different members, market risk (volatility in interest rates), illiquidity of the collateral, credit risk, inability to provide representations and warranties for the collateral, sold mortgage servicing rights, and custodian risk. For 1-4 family mortgages, the FHLBanks typically use anywhere from 15 to 40 percent haircuts, lending 60 percent to 85 percent of UPB.

The 1-4 family residential mortgage market has evolved beyond traditional 30-year and 15-year conventional, conforming mortgages and government guaranteed programs. Lenders may offer nontraditional products such as interest only (IO), hybrid, negative amortization, subprime, Alt-A, low/no documentation, low/no down payment, and 40- to 50-year mortgages. These products present more complex credit risk characteristics than traditional mortgage products, and make the probability of default challenging to model. In addition, creditors may provide simultaneous, near-simultaneous, and silent-second mortgages to the borrower. This practice requires careful evaluation of the LTV ratio and consideration of the combined loan-to-value ratio (CLTV). CLTV reflects the combination of the first mortgage and second mortgage relative to the appraised value of the property. In the past, underwriting practices permitted many of these risks to be

layered in the same mortgage. The result was a mortgage that combined a low/no down payment (high LTV/CLTV), low/no documentation (no verification of borrower financial capacity), subprime (blemished or limited borrower payment history), and hybrid-ARM characteristics (potential payment shock at rate/payment reset dates). These factors significantly increased the probability of default and rendered the traditional haircut level insufficient.

Nontraditional underwriting standards and second mortgages present complex risk characteristics and must be evaluated by the member and the FHLBank. The FHLBanks must be diligent in monitoring trends in origination and underwriting practices and adapt their practices accordingly. The best practice for an FHLBank is to haircut for these risk credit risk characteristics, as appropriate.

Home equity lines of credit (HELOC) and second lien mortgages can elevate credit risk even to the creditor in the senior lien position and can raise the CLTV to 100 percent or even higher. These second position mortgages tend to have a greater loss when a mortgagor defaults. Accordingly, haircuts for mortgages with junior liens should be higher than those applied to 1-4 family mortgages.

Multifamily, CRE, and farmland properties are generally income-producing properties, where the cash flow is dependent upon rent rolls, leased space (occupancy levels), or yield on acreage. Repayment terms may be interest-only, 10-year principal and interest payments at a 20-year amortization and 10-year balloon payment, or some other combination. Multifamily, CRE, and farmland mortgages present different risks and greater complexities than 1-4 family mortgages. Rather than use the UPB to determine the value of the collateral, an FHLBank could use models that can discount cash flows. In those instances where the FHLBank does not use a cash flow model to value CRE and multifamily mortgages, the FHLBank should have layers of risk control to mitigate risk including steeper haircuts, CRE/multifamily pledging limits, and onsite reviews that evaluate CRE/multifamily mortgages.

The collateral FHLBanks generally hold are residential mortgages, in addition to securities and cash. Mortgage loans are secured by real property, such as 1-4 family residential property, multifamily property, commercial real estate, and farmland. The mortgage instruments entitle the mortgagee (i.e., the member) to certain contractual cash flows, including principal and interest payments and prepayment fees. The ability of the mortgagor to make those payments is dependent upon the income producing capability of the real property, in the case of investment 1-4 family residential property, multifamily residences, CRE, and farmland. In the case of owner-occupied 1-4 family residences, the cash flow is dependent upon the mortgagor's financial condition, including employment status, income level, debt burden, and other credit characteristics. In all instances, the mortgage instrument gives the mortgagee the right to take possession of the underlying collateral through foreclosure in the event of default by the mortgagor.

The FHLBanks provide advances based upon the value of the member's pledged collateral. In the case of mortgage loan collateral, the value of the mortgage loan is dependent upon the expected cash flow of the promissory note discounted to a present value, using a discount rate that reflects the credit risk, market risk, and liquidity risk in the mortgage loan. The FHLBanks do not lend against the value of the real property that serves as collateral for the mortgage loan, though the value of the mortgage loan and the real property are highly correlated. The FHLBank must provide quantitative support for the "haircuts" used in calculating borrowing capacity to ensure member advances are fully supported by the value of the collateral.

FHLBanks use valuation models to develop a collateral value, generally market value. In general, FHLBanks use valuation models for income producing properties such as CRE and multifamily residences. Valuation models can also be used for 1-4 family mortgages; however, this requires substantial IT capability by the FHLBank and a member's willingness to provide mortgage specific data about attributes that the FHLBank can use to stratify and categorize the collateral.

Examiners should evaluate the use of valuation models by the FHLBank. Specifically, the examiner should assess the frequency of valuations. Generally, collateral should be valued at least quarterly using updated information provided by the member. The results of the valuation should be incorporated into the calculation of the member's borrowing capacity within thirty days and disclosed to the member. The valuation models should take into account market risk, credit risk, and liquidity risk. The models should be validated and use a current release version. FHLBanks should use valuation models when risk is concentrated and in high volumes. When FHLBanks have a few large members that provide substantial volumes of collateral, the use of a valuation model rather than UPB could be more beneficial for risk mitigation.

Member Specific Adjustments

FHLBanks often adjust discounts because of the results of onsite collateral reviews, the financial condition of the member, or the type of lien, whether blanket, listing, or delivery. Adjustments should be made with a frequency that is commensurate with the member's risk profile and underwriting standards. Member specific adjustments that are several years old without a recent review indicate an underlying weakness at the FHLBank, such as insufficient collateral management staffing and/or inadequate information systems. Examiners should evaluate the basis and frequency of member specific adjustments for members that are large borrowers, members that pledge higher-risk collateral, and members that have heightened risk profiles.

Collateral Data Survey

FHFA prepares a Collateral Data Survey (Survey) of the FHLBanks annually. The purpose of the Survey is to better understand the composition of the collateral on which

FHLBanks rely when making advances. The Survey also provides information which FHFA summarizes for congressional reporting.

The Survey consists of two parts: Part A collects the total collateral pledged by members and housing associates with outstanding advances or using FHLBank products other than advances (letters of credit, interest rate swaps and member mortgage purchases) and includes excess collateral pledged over and above the amounts necessary to secure FHLBank products.

Part B of the Survey collects information on the minimum levels of collateral required by the FHLBank's policies to secure only those advances that are outstanding as of the Survey date. This part further requires the FHLBanks to report the expected value of the most marketable and liquid collateral that the FHLBank would anticipate using if needed to address a borrower's default. The FHLBanks are asked to report the specific collateral in the FHLBank's collateral liquidation "hierarchy." The collateral pledged to the FHLBank by borrowers that do not have outstanding advances or other products are not reported for purposes of either part of this Survey.

The FHFA collects data provided by the FHLBanks for the types and amounts of collateral delivered, listed, or secured by blanket lien. The types of collateral securing advances are: residential, 1-4 family whole loans; U.S. Agency mortgage backed securities and collateralized mortgage obligations; private-label mortgage backed securities and collateralized mortgage obligations; U.S. Treasury securities, other U.S. Agency (non-mortgage backed securities); cash deposits in FHLBanks; other real estate related collateral; and Community Financial Institution collateral (CFI). The data are also tabulated by type and size of member. The member size categories are less than \$100 million in total assets, \$100 million to the CFI average asset limit, greater than CFI average asset limit to \$10 billion, and greater than \$10 billion.

FHFA summarizes the collateral data in an annual report to Congress titled Report on Collateral Pledged to the Federal Home Loan Banks (starting with the 2011 Report) and Reports on Collateral Securing Advances at the Federal Home Loan Banks (for previous years). These reports are available on the FHFA public website.

Examination Workprogram

The workprogram for the Advances and Collateral examination module is detailed below. If this module is included in the examination scope, the examiner must perform worksteps sufficient in coverage to document the basis for conclusions on the quantity of risk and quality of risk management pertaining to this area. Transaction testing is mandatory and the examiner must document sufficient worksteps from Section 4, *Testing*, to support the findings and conclusions from this examination module.

In determining the extent of review and testing to be conducted in completing each examination, the examiner should take into account any applicable FHFA off-site monitoring or analysis reports, such as analyses of the quality and effectiveness of corporate governance practices, financial condition and performance, economic and housing industry conditions, internal controls, and audit coverage relating to advances.

NOTE: Text in (*italics*) referenced in a workstep represents illustrative guidance that serves as suggestions for specific inquiry.

1. Scope of Examination Work Performed

- 1) Review past reports of examination and workpapers for outstanding issues or previous problems related to advances and collateral.
- 2) Review FHFA off-site monitoring or analysis reports, and workpapers produced as part of on-going monitoring, related to advances and collateral.
- 3) Assess the status of any outstanding examination findings (*e.g.*, Matters Requiring Attention, Violations, or Recommendations) pertaining to advances and collateral.
- 4) Review internal audit or quality assurance reports for outstanding issues relating to advances and collateral.
- 5) Review minutes of meetings of the board of directors and relevant board and management committees for any issues regarding advances and collateral.
- 6) Determine whether the FHLBank has been granted authority to accept new types of collateral under the FHFA's new business activity regulations. If so, determine whether the FHLBank is complying with any conditions imposed in the approval letter.

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- 7) Determine if the business model used by the FHLBank for advances and other secured credit, is consistent with the FHLBank's broader strategic objectives and the needs of its members. *(Does the FHLBank focus on traditional bank or credit union members or nontraditional members such as insurance companies and community development financial institutions? Has the FHLBank adequately addressed any increased risk associated with lending to nontraditional members? Is the FHLBank a blanket lien-, listing-, or delivery-focused FHLBank, and what are the risks and benefits of that business model?)*

 - 8) Review the strategic business plan for compliance with 12 CFR 917.5(a) of the Finance Board regulations as it relates to advances. *(Does the strategic plan enumerate operating goals and objectives for advances? Address credit needs and marketing opportunities? Establish quantitative performance goals for FHLBank products related to multifamily housing, small business, small farm and small agri-business lending? Describe new business activities or enhancements to existing activities related to advances. Are assumptions supported by appropriate market research?)*

 - 9) Review and evaluate board minutes to determine if the board was fully engaged in the policymaking and strategic planning process related to advances and collateral.

 - 10) Evaluate any significant changes related to advances and collateral that have been implemented since the last examination or are being considered that may affect the FHLBank's risk profile.

 - 11) Review [for and address] any applicable portions of FHFA issued Advisory Bulletins or other examination guidance (Supervisory Directives or Examiner Practices Bulletins).

Summarize the work performed in the examination of the FHLBank's advances and collateral activities. To the extent there were modifications to the originally planned scope based on concerns identified during the examination, document those changes and the reasons for such changes.

2. Description of Risks

- 1) Review credit risk committee, asset/liability management committee, and operations risk committee minutes to determine any changes in policies or procedures.

- 2) Review and evaluate the FHLBank's Risk Management Policy (RMP), or similar policy, to determine and identify what, if any, risk limits are established and how they are monitored. *(Are the established limits reasonable and appropriate? Are controls established adequate?)*

- 3) Review the Member Products Policy and evaluate the FHLBank's requirements for underwriting, collateralization, fees, and pricing. *(Does the policy provide for differential pricing? If so, it is risk-based and equitable to all members? Are underwriting criteria risk-based?)*
- 4) Review advances concentrations with members and product types³. Determine trends and identify and analyze controls mitigating risk. *(Does the FHLBank perform impact analysis for the loss of a large borrower?)*
- 5) Evaluate the effect of any new products on the level of risk in the advances portfolio. *(Are new product recommendations carefully researched and fully vetted by the appropriate management committee?)*
- 6) Review the FHLBank's analysis of state law on an insurance company member's ability to join the FHLBank as a member, any limitation on pledging of assets, and any limitation on the purchase of FHLBank stock. Determine if the FHLBank has correspondence from state insurance commissioners acknowledging the insurance company's membership in the FHLBank. *(Has the FHLBank adequately determined the insurance company's compliance with state statutes pertaining to membership, pledging of assets, and purchasing of stock? Did the FHLBank obtain a legal opinion addressing its ability to liquidate collateral if the insurance company is liquidated or reorganized?)*
- 7) Select a sample of security agreements the FHLBank executes with insurance company members, including funding agreements. *(Does the FHLBank use different security agreements with insurance companies than with other members? If so, are there any risks associated with the different security agreements? Does the FHLBank use a blanket lien or a specific lien with its insurance company members? If collateral is not delivered by an insurance company, there must be sufficient documentation to ensure other methods of collateral security be equal to, or greater than, delivery of collateral. Is the FHLBank's security interest limited to only certain assets? Has the state insurance commissioner reviewed security agreements executed between the FHLBank and the insurance company member?)*
- 8) How does the FHLBank address "claw-back" risk and ability of the insurance company commissioner to obtain collateral pledged to another party? *(Does the FHLBank limit the types of collateral it allows insurance companies to pledge? Does it require delivery of collateral?)*
- 9) Does the FHLBank require the insurance company member to certify that it complies with all state law and limits when obtaining a new advance?

³ See Q:\OS\OS Data\Membership\Top 10 List

- 10) Assess the FHLBank's members' financial condition and trends. For insured financial institutions, use the FHFA's Member Performance Report and for all members assess publicly available information. Determine if appropriate controls and restrictions were implemented. *(Does the FHLBank's membership include a significant number of problem institutions? If so, does the FHLBank have procedures to limit credit risk to these institutions? Does the FHLBank have procedures to place problem institutions with outstanding advances in delivery status?)*
- 11) If the FHLBank has advances to housing associates, evaluate the FHLBank's procedures for analyzing and monitoring these members and their outstanding advances.
- 12) If the FHLBank has advances to community development financial institution (CDFI) members, evaluate the FHLBank's procedures for analyzing and monitoring these members and their outstanding advances.
- 13) Review member credit rating, outstanding advances, collateral, and concentration reports to determine potential areas of increased risk or changes in the FHLBank's credit risk profile.
- 14) Evaluate the market value pricing programs or software used to periodically value the pledged loans and securities. Analyze staff experience and knowledge, policies, procedures, periodic testing and validation, and guidance and standards for using the valuation models or pricing software to determine market and/or lendable collateral values. *(Are market values of securities collateral obtained from external third party pricing services reasonable and supported by documentation?)*
- 15) Assess the program or guidance FHLBank staff uses when conducting onsite collateral reviews of members. *(How does the FHLBank's onsite collateral review program assess members' compliance with the FHLBank's Member Product Policy? Does the program evaluate a member's underwriting standards such as debt service levels, products offered (prime, subprime, Alt-A, nontraditional mortgage product), appraisal standards, and/or documentation requirements?)*
- 16) Assess how the FHLBank monitors members' non-borrowing affiliates or subsidiaries that pledge collateral. Determine if the FHLBank employs the same rating/ranking system for these affiliates or subsidiaries. *(Does the FHLBank analyze members' holding companies to determine if they are a source of strength? If so, how do the results affect the members' rating and/or borrowing capacity?)*

3. Risk Management

Risk Identification Process

- 1) Based on worksteps performed under **Description of Risks**, assess and conclude on the adequacy of the FHLBank’s risk identification process. *(Has the FHLBank appropriately identified all areas of potential risk resulting from advances? Is risk exposure monitored on an ongoing basis? Does the FHLBank report on risk exposure to the appropriate parties within the organization? Has the identification of potential risk resulted in establishing appropriate controls for advances?)*
- 2) Determine if the FHLBank has implemented sufficient procedures to identify, monitor, and manage the credit, market, and operational risk issues related to advances. *(Do FHLBank personnel coordinate the mitigation of such risks appropriately throughout the organization and among the divisions of the FHLBank? Coordinate examination activities with other examiners appropriately to ensure potential risk to the organization is assessed.)*
- 3) Review advances procedures to determine if internal controls are sufficient to ensure compliance with applicable policies and regulations.
- 4) Evaluate the effectiveness of the annual risk assessment and determine if it reasonably identifies and evaluates all material risks, both quantitative and qualitative aspects, of the advances activities. Investigate any action plans arising from the assessment and check corrective actions for effectiveness. *(Does the risk assessment include all elements of risk and support the conclusions drawn?)*

Organizational Structure

- 1) Identify the key personnel and their primary duties, responsibilities, and technical expertise to determine if resources are effectively deployed to execute the FHLBank’s advances and collateral strategies.
- 2) Evaluate the staffing segregation of duties, and cross-training of personnel to determine if resources are sufficient to execute the FHLBank’s advances and collateral strategies. *(Does staff have appropriate training and experience to carry out their responsibilities within the organization? What steps has the FHLBank taken to address identified deficiencies in staff expertise? Are such steps appropriate?)*
- 3) Evaluate coordination between departments such as risk management, information technology, treasury and cash management, and accounting to determine if advances products are processed and delivered in an efficient and effective manner. *(Do*

different departments within the organization coordinate efforts to limit the risk exposure to the FHLBank resulting from advances? How are these efforts coordinated? How does the FHLBank make specific funding and hedging decisions related to advances? How have such actions mitigated risk to the organization?)

Policy and Procedure Development

- 1) Review the member products policy and evaluate the FHLBank's requirements for underwriting, collateralization, fees, and pricing. Reference 12 CFR 917.4(b) of the Finance Board regulations.
- 2) Assess policies and risk management practices the FHLBank implemented as part of its credit risk management program that establishes appropriate risk limits for, and appropriate mitigation of, credit exposure on nontraditional and subprime mortgage loans. *(Are established limits reasonable to mitigate potential risk exposure in the nontraditional and subprime mortgage portfolio?)*
- 3) Review departmental policies and procedures regarding advances and credit risk management practices. *(Are policies and procedures current, sufficiently detailed, and consistent with the FHLBank's policies and regulations? Do the policies provide adequate guidance in controlling risk to the institution? Do policies and procedures clearly define responsibility for adhering to established parameters? Are ongoing reporting requirements established and reasonable to adequately monitor potential concentration and other risks to the institution resulting from the advances portfolio?)*
- 4) Assess policies and risk management practices for control and perfection of advances collateral. *(Does the FHLBank's policy require delivery of collateral for higher risk members How does the FHLB manage the risk of losing its security interest in a mortgage loan promissory note that was perfected only by filing a UCC-1 financing statement when another purchaser/secured party takes possession of the note after the FHLBank has filed the UCC-1? How does the FHLBank ensure that pledged collateral in the member's possession is not sold or provided to another secured party? How does the FHLBank ensure that it remains in a first lien position? If the FHLBank believes that a security interest in a mortgage promissory note that has been perfected only by filing a UCC-1 has priority over the interest of a purchaser/secured party that is in possession of the same note, what statutory or case law has the FHLBank relied on to reach that conclusion?)*
- 5) Review the FHLBank's collateral valuation policies and procedures and evaluate the use of book value and/or market value, and/or methodology, the frequency of the valuations, and the overall adequacy of the valuation process. *(Are valuation models validated in a manner consistent with Advisory Bulletin 2013-07 Model Risk Management Guidance)*

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- 6) Review the collateral liquidation plan and determine if it is current, sufficiently detailed, and consistent with FHLBank policies and regulations.
 - 7) Verify that the FHLBank's board of directors has approved a policy detailing collateral standards and collateral valuation techniques.

Risk Metrics

- 1) Evaluate the FHLBank's risk limits pertaining to advances to determine if they provide effective control over the level of risk in the advances portfolio. *(Are the limits reasonable? Do the metrics appropriately consider all aspects of potential risk to the organization?)*
- 2) Evaluate the FHLBank's risk limits pertaining to collateral securing advances to determine if they provide effective control over the level of risk in the secured credit portfolio. *(Are the limits reasonable given the current level of risk? Do the limits differentiate between depository institutions and insurance companies?)*
- 3) Determine if risk metrics are consistent with the risk appetite of the organization. *(Do risk parameters established for advances result in risk exposure beyond the FHLBank's overall risk appetite?)*
- 4) Evaluate the adequacy of the board and management's efforts to ensure compliance with risk metrics. *(Is information reported to the board and management accurate and comprehensive? What actions have been taken when risk metrics are not met by the FHLBank?)*

Reporting

- 1) Evaluate the board of directors' committee structure and delegation of authorities to determine if they are effective in helping the full board to understand the level of risk in the advances portfolio. *(Do board and committee minutes reflect an understanding of pertinent issues related to its members and the advances portfolio?)*
- 2) Evaluate management committees and delegated authorities to determine if they are effective in identifying and reporting the level and trends of risk in the advances portfolio. *(Are there specific instances of risk (or potential risk) which were not identified by FHLBank personnel or were not considered by management? If so, has management taken action to prevent the recurrence of such events in the future?)*
- 3) Evaluate the adequacy and accuracy of reports used by management and the board of directors. *(Do board committees report pertinent information to the full board appropriately?)*

- 4) Review board and credit risk committee minutes to ensure adequate discussion and reporting of member credit risk. (*Are minutes comprehensive and include sufficient discussion of member credit risk, potential risks, and the quality of the advances portfolio?*)
- 5) Determine if the FHLBank uses a watch list to identify and monitor members exhibiting higher than normal risk and evaluate the adequacy of the credit criteria, financial analysis and reporting mechanisms that are used by the FHLBank's board of directors, senior management, and board and management committees to identify, manage and monitor troubled, financially weakened, problem and/or adversely classified members. (*Are the criteria used for the watch list comprehensive?*)
- 6) Evaluate the FHLBank's requirements for periodic reporting by its members of eligible assets that may be accepted as collateral for advances. (*Does the FHLBank require different reporting frequency or detail from a member that has a security agreement for specified assets as compared to a member that is on listing or delivery status?*)
- 7) Determine if the FHLBank requires each member to complete a collateral reporting form and review a sample of member submitted forms. If the FHLBank relies on other sources of information such as regulatory Call Reports, describe those sources.

Internal/External Audit

- 1) If there are no prior findings, select internal audits related to Advances and Collateral to evaluate the adequacy of the scope, testing, and workpapers completed by internal audit. (*Do procedures include testing for cases of fraud? Do pertinent audits consider the effect of risks associated with the advances portfolio on all other areas of the organization?*)
- 2) For internal audits completed in the Advances and Collateral area since the previous examination, consult with the Office of the Chief Accountant (OCA) regarding any findings about the adequacy of scope and testing by internal audit.
- 3) Coordinate with the Office of the Chief Accountant to determine the adequacy of the scope and testing completed by external audit and determine the status of corrective actions for findings. (*Are all areas of potential risk considered? If not, why not? Are reasons for not including certain areas within the scope of the audit work reasonable and supported?*)
- 4) Evaluate the adequacy of the objectives and scope of reviews performed by outside consultants and determine the status of management's actions regarding recommendations. (*Review the actions taken in response to consultant recommendations.*)

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- 5) Evaluate the effectiveness of the evaluations conducted pursuant to pertinent provisions of the Sarbanes Oxley Act of 2002 that identify the key risks and controls pertaining to financial reporting and evaluate potential fraud, and procedures implemented to periodically attest to the adequacy of the control environment.

Information Technology

- 1) Identify and assess the automated and manual systems and applicable controls for processing transactions for advances, SLOCs, collateral, and members, including:
 - a) Authorized users;
 - b) Authorized functions for each user;
 - c) Utilization of spreadsheets;
 - d) Credit risk rating models; and
 - e) Business continuity and recovery.
- 2) Determine if the FHLBank's information systems are aligned with its goals and strategies.
- 3) Determine if the FHLBank has developed and tested a business continuity plan for advances. *(Are systems specific to advances considered in the business continuity plan? Does the FHLBank have appropriate actions in place to ensure the advances program continues to operate despite unexpected interruptions? What additional steps are needed to ensure the FHLBank's operations are not adversely affected?)*
- 4) Evaluate the adequacy of the FHLBank's collateral management system. *(Does the collateral management system interface with the advances system and member stock system?)*
- 5) Determine if the FHLBank uses valuation models to determine value for commercial real estate, multifamily, or 1-4 family mortgage portfolios. If so, has the FHLBank validated these models pursuant to Advisory Bulletin 2013-07 *Model Risk Management Guidance*?
- 6) Assess the frequency that the FHLBank updates and runs the credit risk models to determine a value for collateral.

Compliance

- 1) Determine if the FHLBank has appropriately complied with pertinent regulations and regulatory guidance, including but not limited to sufficient collateral protection and the equitable treatment of members. *(For instances of violations, identify the cause of the violation. Determine how internal controls should be strengthened to ensure there are no future regulatory violations.)*

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- 2) Evaluate the efforts of the board and management to ensure compliance with policies and procedures related to advances and SLOCs. (*Conclude on the appropriateness of these actions.*)
 - 3) Assess compliance with PMOS Standard 6 (Management of Asset Growth) and Standard 9 (Management of Credit and Counterparty Risk) (12 CFR 1236). (*Has the board established policies governing asset growth that includes advances? Is advances growth managed in a manner that is consistent with the FHLBank's business strategy, board-approved policies, and safe and sound operations? Has the board and senior management established appropriate policies, procedures, control, and systems over member credit risk?*)
 - 4) Determine if all advances are fully secured pursuant to 12 CFR 1266.2(c) of the FHFA regulations. If not, evaluate the collateral deficiencies, monitoring, reporting, and any actions taken to correct the violation.
 - 5) Determine if all SLOCs are fully secured pursuant to 12 CFR 1269.2 of the FHFA regulations. If not, evaluate the collateral deficiencies, monitoring, reporting, and any actions taken to correct the violation.
 - 6) Evaluate the collateral types accepted for compliance with 12 CFR 1266.7(a) and (b) of the FHFA regulations.
 - 7) Determine how the FHLBank identifies and excludes potential predatory loan collateral in compliance with AB 05-08 (*Guidance on FHLBank Anti-Predatory Lending Policies*), particularly with the blanket status members. Evaluate the use of quarterly certifications and/or the onsite collateral verification process regarding potential predatory collateral.
 - 8) Review the subprime and high loan-to-value identification process for compliance with AB 99-15 (*Collateral Considerations for Sub-Prime and High Loan to Value Single Family Mortgage Loans*), AB 07-01 (*Nontraditional an Sub-Prime Residential Mortgage Loans*), AB 08-02 (*Application of Guidance on Nontraditional an Sub-Prime Residential Mortgage Loans to Specific FHLBank Assets*), and AB 10-01 (*Clarification of Advisory Bulletin 2008-AB-02: Application of Guidance on Nontraditional an Sub-Prime Residential Mortgage Loans to Specific FHLBank Assets*). Specifically, determine how the FHLBank identifies these loans, particularly with the blanket status members. Evaluate the use of quarterly certifications and/or the onsite collateral verification process regarding subprime collateral.

4. Testing

- 1) Follow-up on previous examination findings and evaluate management's efforts to implement corrective actions.
- 2) Determine if management effectively corrected deficiencies noted by internal audit.
- 3) Review the ongoing analysis and monitoring of members' financial condition and performance. Identify the sources and adequacy of information used such as call report data, regulatory websites and examination reports, Nationally Recognized Statistical Rating Organization ratings, and stock prices and trends. Assess the reporting to board of directors and management. *(Determine if the FHLBank is accurately assessing the financial condition of its members. Ensure that sources of financial and regulatory information are tested for accuracy and timeliness.)*
- 4) Perform a credit risk review on a sample member and classify the member's exposure. Specific criteria to consider in developing the asset classification include, but are not limited, to an evaluation of the following:
 - a) Ability of the member to repay advances and any other extensions of credit extended by the FHLBank; and
 - b) Ability of the member to repay advances and unsecured extensions of credit from secondary sources of income, such as collateral.
- 5) Evaluate the FHLBank's risk analysis regarding insurance company membership. Assess the FHLBank's analysis of state statutes on an insurance company member's ability to join the FHLBank as a member, any pledging of asset limitation, and any limitation on the purchase of FHLBank stock. If the FHLBank has correspondence from the state insurance commissioner acknowledging the insurance company's membership to the FHLBank, review a copy.
- 6) Analyze a sample of recent member monitoring reports for accuracy and appropriate risk identification. Determine if internal credit scores/grades are accurate, current and reflect risks. Review a sample of adversely classified assets for justification.
- 7) Review and evaluate the analysis performed on the members on the FHLBank's "Watch List." Determine if the FHLBank uses an internal credit review and/or model/scoring program for members. Evaluate the adequacy of the process including the use of a watch list and reporting to the board and management.
- 8) Review the FHLBank's efforts to establish on-going communication with federal regulators, particularly with regard to weaker members.

- 9) Assess how the FHLBank monitors members' non-borrowing affiliates or subsidiaries that pledge collateral. Determine if the FHLBank uses the same rating/ranking system for these affiliates or subsidiaries. *(Does the FHLBank analyze members' holding companies to determine if they are a source of strength? If so, how do the results affect the members rating and/or borrowing capacity?)*
- 10) Review the asset review and classification practices for compliance with AB 01-08 (*Asset Review and Classification*). Specifically, review the frequency of the classifications, reporting to management and the board of directors, the assets classified less than satisfactory, and the corrective actions taken to resolve problem assets. If significant weaknesses are identified with the FHLBank's risk identification, loan classification policies and procedures, and credit and collateral monitoring, consider performing an adverse classification review.
- 11) Determine if the new advances/product development process is guided by a comprehensive vetting policy involving all appropriate departments and is driven by overall membership needs.
- 12) Review the FHLBank's marketing, outreach, and member penetration. *(Are efforts sufficient to meet strategic planning goals?)*
- 13) Review a sample of advances to determine if the FHLBank has calculated limits accurately and is monitoring adherence with the established limits.
- 14) Determine if the FHLBank has established limitations on advances for specific members, such as insurance companies. If so, evaluate the supporting analysis for the limitations. Reference 12 CFR 1266.4(a) of FHFA regulations.
- 15) Review a sample of advances for authorization, pricing, disclosure, recording, and disbursement. The sample should include a variety of advance types, as well as some that are differentially priced.
- 16) Evaluate the FHLBank's controls to address "claw-back" risk and the ability of the state insurance regulator to obtain collateral pledged to another party.
- 17) Review advances applications and security agreements and determine if they have been reviewed by the FHLBank's legal counsel and approved by the board of directors. Reference 12 CFR 1266.2 of FHFA regulations.
- 18) Determine how the FHLBank prices advances. *(Does advance pricing exceed the marginal cost of funds? For puttable and convertible advances, does advance pricing sufficiently address increased interest rate risk?)*

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- 19) Determine if the FHLBank uses differential pricing of advances and verify that pricing is risk-based and members are treated equitably. Reference 12 CFR 1266.5(b)(2) of FHFA regulations. *(Does the FHLBank's member products policy detail the terms for receiving advance pricing discounts such as large volume and are those policies followed?)*
 - 20) Review the terms and conditions for pricing advances. With respect to putable and convertible advances, review the disclosures provided to members. Reference 12 CFR 1266.5 of FHFA regulations.
 - 21) Determine how the FHLBank sets prepayment fees. Determine if any prepayment fees have been waived and evaluate the reasons for such actions. Reference 12 CFR 1266.6 of FHFA regulations. Determine if the FHLBank has adequately compensated itself when pricing prepayable advances.
 - 22) Determine if all advances are fully secured pursuant to 12 CFR 1266.2(c) of FHFA regulations. If not, evaluate the collateral deficiencies, monitoring, reporting, and corrective actions. See suggested collateral worksteps.
 - 23) Review the Anti-Predatory Lending Policy for adherence with AB 05-08 (*Guidance on FHLBank Anti-Predatory Lending Policies*). *(Does the FHLBank have adequate policies to ensure that collateral for advances does not include predatory loans as defined by regulations?)*
 - 24) Review the purposes that the FHLBank issues or confirms SLOCs for compliance with 12 CFR 1269.2(a) of FHFA regulations.
 - 25) Determine if all SLOCs are fully secured pursuant to 12 CFR 1269.2(b) of FHFA regulations. If not, evaluate the collateral deficiencies, monitoring, reporting, and corrective actions.
 - 26) Review the SLOCs for compliance with 12 CFR 917.4(b) of the Finance Board regulations.
 - 27) Determine if any draws on SLOCs have occurred. If so, and repayment was financed with an advance, determine compliance with 12 CFR 1269.4 of FHFA regulations.
 - 28) Review a sample SLOC to assess whether the FHLBank is in compliance with policies, procedures (including those governing purpose, authorization, expiration date, and fees) and internal controls, and to assess the adequacy thereof.
 - 29) Determine if the FHLBank has perfected its lien, such as by filing a UCC-1 financing statement on all borrowers regardless of collateral status or by obtaining physical possession or control of the collateral. Determine if there are any conflicting UCC-1

lien filings between the FHLBank and other lender(s). Review and assess FHLBank management's actions to remedy any conflicting lien issues.

- 30) Review the FHLBank's collateral verification policies and procedures. Evaluate how the verifications are performed, the frequency of the verifications, and the overall adequacy of the verification process. (*Does the FHLBank require the member to certify reported information to the FHLBank?*)
- 31) Review the FHLBank's practices for accepting collateral pledged by affiliates of members. If the FHLBank executes security agreements with nonmember affiliates that pledge collateral on behalf of members, assess the reporting requirements for nonmember affiliates.
- 32) Review the FHLBank's practices for using third party custodians and servicers. Evaluate the agreements and controls regarding member access to collateral. (*Has the FHLBank evaluated how a bankruptcy or insolvency of a third-party servicer might affect the FHLBank's ability to access cash flow from the collateral?*)
- 33) Determine if the FHLBank conducts evaluations of third-party servicers for financial condition and servicing quality and evaluate a sample of recent evaluations. (*How does the FHLBank use the evaluations when determining the level of haircut for a member?*)
- 34) Determine if the member has sold the servicing rights of the collateral and evaluate whether and how the FHLBank adjusts the haircut for the collateral.
- 35) Determine under what circumstances the FHLBank requires members to provide a listing of loans (Listing) eligible for collateral.
- 36) Evaluate the frequency that the FHLBank requires an updated Listing from members. (*What loan level data does the FHLBank require from members, e.g., loan balance, collateral type, interest rate, and/or others?*)
- 37) Evaluate the FHLBank's timeliness to adjust a member's MBC for the information contained in the Listing report. Evaluate the FHLBank's validation of a member's reporting of listing information.
- 38) Assess the analysis conducted with the listing information provided by members.
- 39) Determine under what circumstances the FHLBank requires delivery of collateral from members.
- 40) Determine if the FHLBank requires the delivery of securities prior to extending advances collateralized by securities.

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- 41) Evaluate the process that the FHLBank uses to determine the value of collateral that secures advances and/or the haircut used.
 - 42) Determine if the FHLBank makes member-specific adjustments to a member's borrowing capacity. *(What conditions/circumstances causes an FHLBank to make member specific adjustments? How often does the FHLBank revisit or validate member specific adjustments? Does the FHLBank track member specific adjustments in a report?)*
 - 43) Assess any restrictions on nontraditional and subprime residential mortgage collateral, including limits and acceptable adjustments to collateral coverage requirements or "haircuts," that the FHLBank has implemented.
 - 44) Determine if the FHLBank has a written member failure contingency plan and assess if it evaluates the failure of a large member; the assumption of member assets on the FHLBank's books; the effect of such assumption relative to the FHLBank's capital leverage, retained earnings, net income, and/or, funding and hedging requirements; the transfer of servicing to another third-party provider; and the transfer of possession to the FHLBank or other third-party provider.
 - 45) Investigate any collateral deficiencies and how they were or will be cured.
 - 46) Verify through judgmental sampling, the amount of time the FHLBank takes to adjust a member's MBC after receipt of an on-site collateral review. Describe conditions for which the frequency of member reporting can increase or decrease. *(How are the results from onsite collateral reviews incorporated into the members' haircuts and MBC?)*
 - 47) If the FHLBank uses several different security agreements, review a sample that includes agreements with the FHLBank's five largest members (as determined by average advances volume outstanding for the preceding twelve months), a commercial bank, a thrift, a credit union, an insurance company, and housing associate. Describe the agreement (blanket/specific) and the attendant member and determine whether an increased risk is observed.
 - 48) Assess the haircuts/discounts the FHLBank uses for each type of collateral the FHLBank accepts from members. *(Does the FHLBank stratify 1-4 family mortgage portfolios to refine haircuts for different mortgage product such as prime, Alt-A, and subprime?)*
 - 49) Evaluate how often the FHLBank reviews the haircut/discount rates applied to collateral to determine a member's borrowing capacity. Describe the factors the FHLBank considers in reviewing haircut/discount rates. If the FHLBank reports the results of the review to a management or board committee, provided detail. *(Can the*

FHLBank demonstrate that haircuts/discount rates are qualitatively sound and advances are fully supported by the value of the collateral?)

- 50) Summarize the FHLBank’s two most recent actions changing haircut(s)/discount rate(s) on collateral for all members. How did these changes address weaknesses existing in the current mortgage market?

5. Conclusions

- 1) Summarize conclusions for all examination work performed, including work performed by other FHFA staff as it relates to the FHLBank’s advances and collateral practices. Develop a memorandum describing the risks to the institution resulting from weaknesses identified. The memorandum should clearly and articulately describe the basis of conclusions reached and summarize the analysis completed. Within the memorandum, discuss the types of risk the regulated entity is exposed to (*e.g.*, market, credit, operational); the level of risk exposure; the direction of risk (stable, decreasing, increasing); and the quality of risk management practices (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner’s assessment is positive or negative.
- 2) Conclude on the responsiveness to previous examination findings. Evaluate the adequacy of the regulated entity’s response to previous examination findings and concerns.
- 3) Develop findings and prepare findings memoranda, as appropriate. Based on examination work performed, develop findings communicating concerns identified during the examination. Findings should identify the most significant risks to the institution and the potential effect to the regulated entity resulting from the concerns identified. Findings memoranda should describe a remediation plan specifying the appropriate corrective action to address examination concerns and establish a reasonable deadline for the regulated entity to remediate the finding. Communicate preliminary findings to the EIC. Discuss findings with regulated entity personnel to ensure the findings and analysis are free of factual errors.
- 4) Develop a list of follow-up items to evaluate during the next annual examination. In addition to findings developed in the steps above, include concerns noted during the examination that do not rise to the level of a finding. Potential concerns include issues the regulated entity is in the process of addressing, but require follow-up work to ensure actions are completed appropriately. In addition, potential concerns should include anticipated changes to the institution’s practices or anticipated external changes that could affect the institution’s future governance practices.

Workprogram

1. Scope of Examination Work Performed

Workpapers must document the examination activities undertaken to evaluate potential risks related to advances and collateral activities.

2. Description of Risks

- Identify areas of concern related to advances and collateral activities.
- Assess current risks and trends in the risk to the organization emanating from the FHLBank's advance and collateral activities.
- Evaluate changes within the organization or industry affecting risk.
- Evaluate the entity's own risk-identification practices and conclude on their adequacy.

3. Risk Management

- Assess and conclude on the adequacy of the organization's risk identification process.
- Assess and conclude on the overall adequacy of internal controls, including an evaluation of:
 - The FHLBank's organizational structure
 - Policy and procedure development for advances and collateral
 - Appropriateness of risk metrics established for advances and collateral
 - Reporting by management and the board
- Assess and conclude on the internal and external audit of risks.
- Assess and conclude on the adequacy of information technology and controls related to advances and collateral activities.
- Assess and conclude on the adequacy of the organization's efforts to ensure:
 - Compliance with laws, regulations and other supervisory guidance
 - Compliance with the organization's policies and procedures

4. Testing

- Complete testing, as appropriate, to assess adherence with examination standards.

5. Conclusions

- Summarize conclusions for all examination work performed related to advances and collateral activities:
 - Conclude on the level of risk to the organization
 - Include an assessment of the adequacy of an organization's monitoring of risk and establishment of internal controls to mitigate risk
- Conclude on responsiveness to examination findings from previous examinations.
- Develop findings and Matters Requiring Attention, as appropriate
- Identify areas requiring follow-up examination activities or monitoring