Introduction

The financial condition of Fannie Mae and Freddie Mac (the Enterprises) and the Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities) largely depends on their ability to earn an appropriate return on assets and capital. Consistently strong earnings performance enables the regulated entities to replenish and/or increase capital to protect against unexpected future losses and to fund asset growth.

At the Enterprises, the principal sources of earnings are interest income and guaranty fees. At the FHLBanks, the principal source of earnings is interest income. The regulated entities must price products, establish fees, and manage expenses such that they generate sufficient earnings to provide the net income, and thus the capitalization, needed to protect the institution against losses and provide adequate compensation for assumed risks.

Examiners evaluating earnings should coordinate closely with examiners conducting other aspects of the examination so that other safety and soundness concerns are integrated into the final conclusions on earnings. The examination of earnings should consider a number of factors and how these factors affect the adequacy and sustainability of a regulated entity’s earnings. These factors include, but are not limited to: the level and quality of earnings; future earnings prospects; the regulated entity’s capital position; the adequacy of the financial planning process; asset quality and the degree of credit risk exposure; governance and management philosophy; and the regulated entity's interest rate risk exposure and risk appetite.

The primary earnings performance factor to consider is the past, present, and future level of earnings. Generally, the level of earnings is adequate when it is sufficient to pay all expenses, including necessary provisions to the allowance for losses, in order to maintain capital at a level sufficient to compensate for current and future on- and off-balance sheet risks, to provide for anticipated growth, and to provide an appropriate return to shareholders. However, if earnings are not from sustainable sources, a regulated entity’s future earnings performance could be threatened.

Examiners should keep in mind that the level of earnings is but one evaluative factor in assessing earnings. A complete earnings evaluation must consider not only the level of earnings, but also the quality of earnings. Although fluctuations in earnings may result from certain accounting treatments, notably derivatives accounting and fair market accounting discussed under the examination module on Financial Reporting, stability is a measure of the consistency of earnings performance and the likelihood that earnings will continue. In assessing earnings stability, examiners should review past and present performance to determine the causes of any significant fluctuations in net income and identify nonrecurring sources of income.
Depending upon the regulated entity, sources of revenue may include interest income generated from securities, mortgage loans, advances, investments, guarantee fees on mortgage loans, gains in extinguishment of debt securities of consolidated trusts, gains on the retirement of debt, gains on debt recorded at fair value, derivative gains, recoveries on impaired loans, gains on investment securities, and transactional fees. To determine the quality of earnings, examiners must first analyze the composition of net income, including key sources of income and significant expense items to determine their sustainability and reasonableness. In addition, they should examine key measures of earnings performance including:

1) *Net Interest Income (NII)*—NII (interest income minus interest expense) is the primary source of quality earnings. NII is comprised of the following key components: the difference between (a) interest income on interest-earning assets, primarily inclusive of mortgage loans held in portfolio, mortgage loans held in consolidated trusts, and non-mortgage-related securities and (b) interest expense on interest-bearing liabilities, primarily inclusive of short-term debt, long-term debt, and debt securities of consolidated trusts held by third parties. For the Enterprises, guaranty fee income, which represents contractual guarantee fees received from consolidated trusts for assuming and managing the credit risk on the guarantee book of business, is included in interest income. Amortization or accretion of hedging-related basis adjustments, including those related to de-designated GAAP hedging relationships, can affect reported net interest income/expense. Examiners should identify the specific sources of NII, such as regular accrual loans, restructured loans, and investments, to determine the likelihood of continued interest accruals.

2) *Noninterest Income*—Noninterest income arises from several sources, the most common being financially related services (FRS), fees, patronage, dividends, and compensation received for servicing assets. Some sources in this list are unique to the Enterprises. For the FHLBanks, these sources include such fees as collateral fees, safekeeping fees, and wire fees.

3) *Noninterest Expenses*—Noninterest expenses are primarily operating expenses. Some of these expenses are relatively fixed such as employee and occupancy expenses; others may be variable expenses which fluctuate with the level of operations. These may include costs associated with originating loans and managing problem assets.

4) *Provisions for Losses*—Provisions for losses are charges to income for estimable and probable losses in the regulated entity's assets.

5) *Net Gains and Losses from Derivative Activities*—If management generally holds hedged items to call/maturity, and does not hedge items with substantial credit risk, generally derivatives gains/losses are offset by price moves in the underlying, and both derivative gains/losses and the fair value of the underlyings trend to par/zero as
they near maturity. Some FHLBanks report non-GAAP “adjusted” interest income numbers to illustrate derivatives gains/losses recognized in the current period that they expect to reverse in future periods. Examiners should understand the sources of net gains or losses from derivative activities.

6) Net Realized Gains or Losses—Common examples include gains and losses from sales of other real estate owned, securities, and other assets. Net gains and losses are typically not a recurring source of income. However, if the regulated entity has demonstrated a steady history of net realized gains or losses from a common source, examiners should give this due consideration in the earnings analysis.

7) Affordable Housing Program (AHP) Assessments—The FHLBanks are assessed a portion of their income to fund their Affordable Housing Programs.

8) Extraordinary Items—Extraordinary items are material events and transactions that are unusual and infrequent. Both of these conditions must exist for an event or transaction to be reported as an extraordinary item. To be unusual, an event or transaction must be highly abnormal or clearly unrelated to the ordinary and typical activities of the entity. An event or transaction that is beyond management's control is not automatically considered to be unusual. To be infrequent, an event or transaction should not reasonably be expected to recur in the foreseeable future. Although the past occurrence of an event or transaction provides a basis for estimating the likelihood of its future occurrence, the absence of a past occurrence does not automatically imply that an event or transaction is infrequent. Seldom do events or transactions qualify for treatment as extraordinary items. An example may be a one-time adjustment due to an accounting principle change.

The quality of management is another essential evaluative factor in assessing earnings. A regulated entity’s management must be able to adapt to changing market and risk conditions to ensure sufficient, stable, high quality earnings. Key governance areas relative to earnings include pricing, financial planning, budgeting, expense control, interest rate risk management, and investment portfolio management.

The risk appetite and strategic plan developed by the board of directors and management will have a significant effect on the regulated entity’s earnings performance. A regulated entity may register high profitability ratios and high earnings by assuming an unacceptable degree of risk. For example, the institution may take on increased credit risk in order to achieve higher rates on earning assets. In addition, the institution may increase interest rate risk exposures by using short-term liabilities to fund long-term assets. Management may choose to limit expense growth by underinvesting in infrastructure or staffing, and thereby increase operations risk. Although these strategies would result in increased earnings in the short term, long-term earnings would suffer if these higher-risk strategies and exposures result in losses. Given these interrelationships among risks, the analysis of earnings quality must include credit risk, interest rate risk,
operations risk, and other relevant risks.

The board and management should establish a risk appetite to determine an acceptable level of risk taking associated with various business lines and ensure the regulated entity is compensated for risk appropriately. Products and services should be priced to compensate for inherent risks associated with various business lines. It is important for each regulated entity to have a system in place to price for risk and monitor the financial contribution of various business lines. Higher risk assets should be priced commensurate with the higher credit, market, and other risks inherent in the assets. Ongoing monitoring of the financial performance on a business line basis is essential to enable management to adapt to changing conditions.

Another essential element of financial management is controlling costs. Generally, longer-term assets will be more costly to fund than shorter-term assets. Risks associated with embedded options in mortgage loans present funding and hedging concerns and related costs. Operating expenses represent the costs associated with doing business and should be reasonable. On a regular basis, operating costs should be compared to budget and variances from budget should be adequately explained. Trends in operating expenses can be indicators of underlying problems. High operating expenses, or significant increases in operating expenses, may indicate inefficiencies in the day-to-day operations of the institution or represent a significant change in the business practices or asset quality of the regulated entity. Unusually low operating expenses, or a significant decline in operating expenses, could indicate an inadequate level of internal controls.

Strategic planning and establishment of a risk appetite allows the regulated entity’s board and management to evaluate various business opportunities and potential associated risks. The board and management should monitor the income contribution of various business lines on a regular basis to evaluate the overall contribution to the regulated entity’s financial performance. Comparing actual performance to planned performance is essential to determine whether earnings are adequate and consistent with expectations. Significant differences between expected and actual performance should be evaluated and explained. The board and management should consider this information when they evaluate financial management strategies and practices and the institution’s performance.
Earnings

Version 1.0
July 2013

Regulatory Environment

The primary authorities governing or relevant to earnings activities of the regulated entities are set forth below. The examiner should ensure that such authorities have been considered by the regulated entity and its legal counsel.

1) Federal National Mortgage Association Charter Act (12 USC 1716 et seq.), which includes the following sections relevant to Fannie Mae’s earnings:

Section 309(k) addresses the submission of quarterly and annual financial statements as required by the Director. 12 USC 1723a(k).

Section 309(l) addresses an annual audit by an independent accounting firm. 12 USC 1723a(l)

2) Federal Home Loan Mortgage Corporation Act (12 USC 1451 et seq.), which includes the following sections relevant to Freddie Mac’s earnings:

Section 307(c) addresses the submission of quarterly and annual financial statements as required by the Director. 12 USC 1456(c).

Section 307(d) addresses an annual audit by an independent accounting firm. 12 USC 1456(d).

3) Rules and Regulations of the Federal Housing Finance Agency (FHFA) and its predecessor, the Office of Federal Housing Enterprise Oversight (OFHEO), including the following parts and sections relevant to the Enterprises’ earnings:

12 CFR 1777.10 of OFHEO’s regulations addresses the requirement that publicly reported net income for the most recent calendar quarter that is less than one half of its average quarterly net income for any four quarter period during the prior eight quarters will trigger Prompt Supervisory Response.

4) Rules and Regulations of the Federal Housing Finance Agency and its predecessor, the Federal Housing Finance Board (Finance Board), including the following parts and sections relevant to the FHLBank’s earnings:

12 CFR part 917 of the Finance Board’s regulations addresses powers and responsibilities of FHLBank boards of directors and senior management. In particular, 12 CFR 917.3 (Risk Management), and 12 CFR 917.6 (Internal Control System), are pertinent.

12 CFR 917.5 of the Finance Board’s regulations requires an FHLBank’s board of directors to adopt a strategic business plan that describes how the business activities
of the FHLBank will assist the institution achieve its mission, consistent with 12 CFR Part 1265 (Core Mission Activities).

12 CFR 917.8 of the Finance Board’s regulations requires an FHLBank’s board of directors to adopt an annual operating expense budget that takes into account the institution’s responsibility to protect both its members and the public interest by keeping its costs to an efficient and effective minimum.

12 CFR 917.9 of the Finance Board’s regulations permits an FHLBank’s board of directors to declare and pay a dividend only from previously retained earnings or current net earnings and only if the par value of the institution’s stock is not impaired and such payment will not result in a projected impairment of the par value of the institution’s capital stock.

12 CFR 1274.2 of the FHFA’s regulations requires the FHLBanks to among other things, obtain annually an independent, external audit of each FHLBank’s individual financial statements, and also requires the external auditor to meet at least twice a year with the audit committee of each FHLBank.

12 CFR 1274.3 of the FHFA’s regulations addresses, among other things, the delivery by each FHLBank of its financial and other information to the Federal Home Loan Bank System’s Office of Finance to facilitate the preparation of combined Bank System annual and quarterly reports.

5) **Advisory Bulletins of the Federal Housing Finance Agency that provide supervisory guidance relating to earnings are the following:**

Advisory Bulletin 2012-03 dated December 19, 2012, describes the FHFA examination rating system, known as CAMELSO (Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risk, and Operational Risk). Among other things, AB 2012-03 provides guidance to examiners when rating a regulated entity’s earnings and instructs them to determine the quantity, trend, sustainability, and quality of earnings.

6) **Advisory Bulletins of the Federal Housing Finance Board that provide supervisory guidance relating to earnings are the following:**

Advisory Bulletin 03-01 dated January 3, 2003, provides guidance on the acceleration of filing dates for the combined financial reports and call reports.

Advisory Bulletin 03-13, dated December 1, 2003, provides guidance on the form, content, and timeliness of the financial reports that are completed by the FHLBanks pursuant to Finance Board regulations.
Advisory Bulletin 05-04, dated April 21, 2005, provides guidance on regulatory reporting and assessment calculation in connection with the adoption of SFAS 150 (Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity).

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

Advisory Bulletin 06-03, dated July 18, 2006, provides guidance on disclosure in SEC filings of unpublished information as defined in 12 CFR part 911 of the Finance Board Rules and Regulations.
Issues Specific to the Enterprises

Guaranty Fee

Each Enterprise guarantees the payment of principal and interest on mortgage-backed securities (MBS) it issues and charges a fee for providing that guarantee. The guarantee fee covers projected credit losses from borrower defaults over the life of the loans, administrative costs, and a return on capital. Lender guarantee fee payments generally take the form of ongoing monthly payments and frequently also include an upfront payment at the time of Enterprise loan acquisition.

To determine the guarantee fees, each Enterprise estimates the cash it expects to collect and expend over the estimated life of the mortgages. Estimated cash inflows and outflows are converted into annualized rates expressed in terms of basis points of outstanding loan principal. One basis point is equal to 1/100th of one percent. The difference, or “gap,” between the estimated fee and estimated cost (including expected outflows and target rate of return on required capital) provides a measure of the expected profitability of the guarantee.

Estimated Fee = annualized projected cash inflows, in basis points

Estimated Cost = annualized projected cash outflows and return on capital, in basis points

Estimated Gap = estimated fee minus estimated cost, in basis points

The estimated fee gap is zero when an Enterprise expects to earn its target rate of return on capital (or substituted capital measure, given the Enterprises’ lack of capital) on average across the forecasted simulations generated by its internal costing model. A negative or positive estimated gap means the Enterprise expects to earn below or above its target rate of return, respectively. Whereas negative gaps that are lower (closer to zero) are still generally expected to be cash-flow positive, larger negative gaps may be indicative of transactions that are expected to generate a loss.

The FHFA conducts a study of the guaranty fees annually and submits a report to Congress detailing the results of the study. This report is available on the FHFA’s website.
Issues Specific to the FHLBanks

Cooperative Structure

The FHLBank System is a cooperative structure and the primary customers of an FHLBank, its members, are also its shareholders. This structure may result in tension between a member’s interests and an FHLBank’s interests. An example is the relationship between advances pricing strategies and dividend payments. Some FHLBanks strategically price advances to compensate members with higher dividend payments. Other FHLBanks have a philosophy that members that borrow should be charged lower advances rates, even if it means lower dividends for all members. Either strategy can be acceptable provided earnings remain sufficient to maintain retained earnings and capital at a level appropriate for the FHLBank’s risk profile.

Advances Volatility

Changes in members’ needs for liquidity may result in volatility in the volume of advances. In the event of declining advance levels, FHLBanks have looked to other types of assets to replace lost interest income, including Acquired Member Assets programs and both secured and unsecured investments. In those situations, an FHLBank should ensure changes in its balance sheet composition are consistent with its strategic plan and mission and evaluate all risks associated with new or different investments. Further, the quality of earnings from non-mission sources should be evaluated. Reliance on earnings from sources other than advances warrants increased regulatory oversight.
**Examination Guidance**

The workprogram for the Earnings 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 analysis 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 the institution’s earnings.

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

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### 1. Scope of Examination Work Performed

1) Review past reports of examination for outstanding issues or previous problems related to earnings.

2) Review FHFA off-site monitoring or analysis reports, and workpapers produced as part of on-going monitoring, related to earnings.

3) Assess the status of outstanding Matters Requiring Attention and Violations pertaining to earnings.

4) Review internal audit reports for outstanding issues relating to earnings.

5) Review minutes of meetings of the board of directors and relevant board and management committees for any issues regarding earnings.

6) Review on-going reporting completed related to the regulated entity’s earnings, including reports in the FHFA Call Report System.
7) Identify potential risks to the institution’s earnings. In conjunction with examiners responsible for the credit, market, and operational risk areas, consider earnings prospects and vulnerabilities.

8) Review the regulated entity’s filings with the SEC to identify outstanding issues or concerns related to earnings.

Summarize the work performed in the examination of the institution’s earnings. 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) Does the regulated entity have a sound financial planning and budgeting process? (Does management periodically review financial performance in relation to plans? Actual results should be compared to projections, and any significant variances should receive appropriate review by management and the board. The initiation and periodic review of a financial plan and budget for earnings not only provide management with an effective administrative control, but also allow the examiner to gain a more thorough understanding of any unfavorable income and expense performance.)

2) Are the financial plans and budget accurate and do they reflect realistic projections of expected income and expenditures? The budget should be consistent with the first year of the financial plan. Does management conduct stress analyses to identify the potential effect on earnings from changing operating environments? (Coordinate review with examiner or analyst assigned to review Strategic Planning.)

3) Has interest rate risk (IRR) been accurately identified, measured, and appropriately managed? Conclude on the potential effect of IRR on the regulated entity's earnings and ensure management actions in this area are consistent with financial plans and, specifically, earnings objectives.

4) Does management determine the costs and profitability of proposed programs prior to implementation? Does management monitor the profitability of such programs on an ongoing basis to enable the board to make sound decisions regarding continuation of such programs?

5) Are operating expense levels reasonable? Does management adequately monitor and control expenditures? What action is management taking to control costs? Are salary and benefits expenses reasonable? Management's spending philosophy and
practices should demonstrate prudence and result in expenditures that are consistent with safe and sound business practices. *(The ratio of operating expenses/average loans is a useful measure when analyzing the level of expenses.)*

6) How effectively have management and the board considered the effects on earnings of funding and hedging decisions? Have potential risks been appropriately controlled?

7) Evaluate the effectiveness of the institution’s risk assessment and determine if it reasonably identifies all material risks, both quantitative and qualitative aspects, of the institution’s earnings. Investigate any action plans arising from the assessment and check corrective actions for effectiveness.

### 3. Risk Management

**Risk Identification Process**

1) Assess the major risks to the regulated entity’s earnings. *(What are the current trends in net income and its significant components? What are the underlying causal factors behind any such trends? An analytical review of trends can assist the examiner in identifying areas of weakness which require further evaluation, such as loan pricing problems or high operating expense levels.)*

2) Determine if certain business lines represent greater risks to the organization. *(Is the regulated entity compensated commensurate with such risks?)*

3) Identify and assess any changes in the economy, capital markets, regulatory environment, or financial industry that might affect earnings.

4) Is income sufficient to cover all expenses, including the provision for loan losses?

5) How do the regulated entity's earnings statistics and ratios compare to a peer group of similar institutions? *(Care should be taken when using peer data as institutions of similar size may have significantly different portfolio characteristics or unique levels of capital and risk. In addition, some FHLBanks have a high advance price/high dividend strategy, while others have a low advance price/low dividend strategy.)*

6) Interview management to identify potential changes to the overall composition of earnings and potential threats to the regulated entity’s earnings performance.
7) Identify and assess any changes in the regulated entity’s products or condition that might affect earnings. *(Have the changes resulted in increased risks to the institution?)* Identify any effect on earnings associated with the following:

a) Have there been any changes to the regulated entity’s investment strategy or product line that may increase risk to the organization?

b) What is the effect of nonearning assets on earnings performance? Are significant future transfers of assets into or out of nonaccrual likely?

c) Does the regulated entity differentiate pricing based on risk? Assets should be priced to compensate for increased risk.

d) Has the regulated entity accurately identified and recorded known loan losses? Are probable losses accurately estimated and accounted for via provisions to the allowance for losses?

e) Does the regulated entity regularly assess the effect of changes and potential changes in portfolio risk on earnings?

f) Is the regulated entity achieving sufficient earnings to meet capital needs and achieve capital goals? The level, quality, and management of capital are key determinants of the necessary level of earnings.

g) Has the regulated entity achieved its business plan earnings targets? Examiners should identify the causes of variances in actual performance from projected performance. Consideration should also be given to whether the regulated entity's earnings targets were reasonable and appropriate to the level of risk. *(Coordinate review with examiner or analyst assigned to review Strategic Planning.)*

**Organizational Structure**

1) Identify the key personnel and their primary duties, responsibilities, and technical expertise to determine if resources are effectively deployed to accurately prepare the regulated entity’s financial statements and plan for and monitor earnings performance.

2) Assess and conclude on the effectiveness of management committees to plan for the regulated entity’s financial position and identify potential threats.

3) Assess and conclude on senior managements’ compensation to ensure higher income (and potentially higher risks) over the short term is not a basis for compensation.

4) Determine if the individuals responsible for making funding and hedging decisions that affect the institution’s earnings performance are independent of those responsible for monitoring and reporting on the regulated entity’s financial results.
Earnings

Policy and Procedure Development

1) Assess the adequacy of accounting policies relating to earnings. Work with staff from FHFA’s Office of the Chief Accountant when completing this work.

2) Review the reasonableness of the strategic plan and budget, including an evaluation of the procedures for drafting and approving the strategic plan and budget. Review board of directors minutes to determine level of involvement in the process. (Coordinate review with examiner or analyst assigned to review Strategic Planning.)

Risk Metrics

1) Assess the appropriateness of any established earning risk metrics, such as return on assets, return on equity, provisions for credit losses expenses, net interest income, operating expenses, and gains or losses on securities and derivatives. (Are the models used to calculate various risk measures validated and assumptions supported?)

Reporting

1) Evaluate the board reporting of earnings and associated risk metrics.

2) Conclude on the adequacy of the information provided to the board and management. (Is information provided on all potential threats to the regulated entity’s earnings performance? Do the board and management receive comprehensive information on the institution’s earnings performance? Are actual earnings compared to budgeted forecasts and are the causes of variances appropriately identified? Is information provided on a business-line basis? Is reporting related to the contribution of various business lines to the institution’s financial performance appropriate and accurate?)

Internal/External Audit

1) Evaluate the adequacy of the scope, testing, and workpapers completed by internal audit related to financial reporting and earnings performance. (Has the audit function considered potential threats to earnings and evaluated the appropriateness and accuracy of reporting earnings levels?)

2) Evaluate the adequacy of the scope and testing completed by external audit and determine the status of applicable corrective actions. (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?)
**Information Technology**

1) Identify and assess the automated and manual systems and applicable controls used in preparation of the financial statements. *(Coordinate review with examiner or analyst assigned to review Financial Reporting.)*

2) Conclude on the accuracy of reports prepared to monitor the earnings performance of the organization. *(Are reports from different sources consistent?)*

3) Determine if reports are appropriately automated and not reliant on manual entry.

4) Do management information systems provide management with sufficient and timely pricing information, such as cost data, product data, and competitor information? *(Poor information systems may ignore funding and servicing costs, and encourage dependency on the practice of pricing to meet competition while acting as a precursor to predatory or other unsound pricing practices.)*

**Compliance**

1) Evaluate procedures to ensure compliance with internal policies and the effectiveness of those procedures.

2) Coordinate work with examiners looking at the institution’s compliance with regulatory reporting requirements. Evaluate and conclude on the regulated entity’s compliance with accounting standards.

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**4. Testing**

1) Evaluate the long-term and recent level and trends in net interest income.

2) Evaluate the long-term and recent level and trends in net income.

3) Evaluate the reliability of earnings. Conclude on whether earnings are from recurring sources.

4) Evaluate the level and trend of provisions to the loan loss reserves. *(Are reserve levels adequate based on historical and projected loan losses? Are charge-off practices timely?) Work with staff from the Office of the Chief Accountant when completing work in this area.*

5) Assess whether realized gains/losses from the sale of hold-to-maturity (HTM) securities, available-for-sale (AFS) securities, and sale of securities held at fair value
Earnings

Version 1.0
July 2013

(EHF) are: (a) recurring or non-recurring and (b) whether they are timed to manage earnings.

6) Assess the long-term and recent trend of net gains/losses on derivatives and hedging trend. Are the net gains/losses real or due to accounting effects? (Note that the net gains/losses on derivatives will be offset to a substantial degree by net losses/gains on securities held at fair value. The examiner should work closely with the examiner performing the Derivatives workprogram to complete this workstep.)

7) Evaluate the levels and trends in operating expenses and whether they have been appropriately managed.

8) Assess the long-term and recent level and trend of Return on Assets.

9) Assess the long-term and recent level and trend of Return on Equity.

10) Assess the long-term and recent level and trend of Net Interest Spread.

11) Assess the contribution of the each of the main business segments to overall profitability.

12) Assess business segment reporting of the regulated entity, if any, and its usefulness in financial management.

13) For FHLBank examinations: Determine whether the FHLBank conducts comparative financial analysis to assess its financial performance relative to other FHLBanks. Assess the adequacy of such comparative financial analysis.

5. Conclusions

1) Summarize conclusions for all examination work performed, including work performed by other FHFA staff as it relates to the regulated entity’s earnings. Develop a memorandum describing the risks to the institution’s earnings and the regulated entity’s management of those risks. 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’s earnings are 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. The memorandum should include a recommended rating for the Earnings component based on the FHFA examination rating system.
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 examination 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 earnings.
Workprogram

1. Scope of Examination Work Performed
   Workpapers must document the examination activities undertaken to evaluate potential risks related to earnings.

2. Description of Risks
   - Identify areas of concern related to earnings
   - Assess current risks and trends in the risk to the institution related to earnings
   - Evaluate changes within the institution 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 institution’s risk identification process
   - Assess and conclude on the overall adequacy of internal controls, including an evaluation of:
     - The regulated entity’s organizational structure
     - Policy and procedure development for earnings
     - Appropriateness of risk metrics established for earnings
     - 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 earnings
   - Assess and conclude on the adequacy of the organization’s efforts to ensure:
     - Compliance with laws, regulations and supervisory guidance
     - Compliance with the institution’s policies and procedures

4. Testing
   - Complete testing, as appropriate, to assess adherence with applicable standards

5. Conclusions
   - Summarize conclusions for all examination work performed related to earnings
     - Conclude on the level of risk to the institution
     - Include an assessment of the adequacy of an institution’s monitoring of risk and establishment of internal controls to mitigate risk
   - Conclude on responsiveness to examination findings from previous examinations
   - Develop examination findings, as appropriate
   - Identify areas requiring follow-up examination activities or monitoring