

## **OF Statement Regarding Independent Report to the Federal Home Loan Banks Office of Finance on its Combined Financial Report and Audit Committee**

**August 13, 2009**

Consistent with its commitment to continuous improvement in combined financial reporting, in mid-2008 the Federal Home Loan Banks Office of Finance engaged the law firm of Williams & Connolly LLP to develop a set of workable principles and procedures for combined financial reporting for the 12 Federal Home Loan Banks, focusing on three areas:

- Principles underlying the drafting of the combined financial report of the 12 FHLBanks, which individually file financial reports with the Securities and Exchange Commission (SEC) and whose financial data are the foundation for the combined financial report;
- Process for engaging its regulator's input to the combined financial report; and
- The Office of Finance audit committee's charters and audit committee report.

Williams & Connolly subsequently arranged for Pat Scatena of Scatena Legal to assist it with the legal analysis and FTI Consulting, Inc., and Lynn Turner, former Chief Accountant of the SEC, to provide accounting expertise for this project. The members of this independent review team produced a report containing recommendations and various best practices that, when implemented by the Office of Finance, would further enhance the FHLBanks' combined financial report disclosures. The Office of Finance appreciates the review team's valuable contribution.

The Office of Finance has begun to develop a plan to best implement the recommendations that would work within the current decentralized structure of the FHLBanks and the Office of Finance, including recommendations with respect to the audit committee charters and audit committee report.

- In coordination with the FHLBanks and their regulator, the Federal Housing Finance Agency (FHFA), the Office of Finance will continue its efforts to improve comparability and clarity in combined financial reporting.
- The Office of Finance will review how individual FHLBank information is presented, seeking to enhance the overall disclosure of information.
- Controls over the combined financial report will be reassessed, and will be refined through the application of best practices, as necessary.

- As suggested by the report, the Office of Finance will formalize many of the existing processes associated with the regulator's input into the combined financial report.

The independent reviewers also recommended that the Office of Finance should work with the FHLBanks and the FHFA to undertake a study of the legal, legislative, regulatory and structural issues involved in implementing some form of centralized management and control over the FHLBank system akin to what is required for consolidated financial reporting. Undertaking this type of study was beyond the scope of the independent review team's engagement. The reviewers have stated their opinion that the ultimate objective of the highest-quality, transparent, consistent and comprehensive disclosure within a single report cannot be achieved within the constraints of the existing structure of the FHLBanks and the Office of Finance.

The Board and Management of the Office of Finance have carefully considered this recommendation and believe that high-quality, transparent, consistent and comprehensive disclosure can continue to be achieved within the context of combined financial statements – without modifying the regional nature of the FHLBank system that has served its members effectively for over 75 years.

This regional structure offers two significant advantages:

- First, the decentralized management and operating structure of the 12 FHLBanks diversifies risk, which helps ensure the safety and soundness of the overall system. Measures for avoiding inappropriate levels of risk concentration are currently part of the broader discussions and proposals for new regulation of financial institutions.
- Second, the 12 FHLBanks operate on a regional basis, consistent with the decentralized nature of the U.S. banking system. This decentralized structure enables each FHLBank to help its member financial institutions meet the specific credit and affordable housing needs of the communities in their regions.

Because this structure entails regional ownership and decentralized management, each FHLBank is a separate SEC registrant subject to Sarbanes-Oxley and, therefore, files its own financial reports with the SEC.

The Board and Management of the Office of Finance, along with the FHLBanks, are committed to maintaining the highest standards in combined financial reporting. The Office of Finance's goal has always been to enhance the quality, transparency and consistency of the combined financial reports as the FHLBanks' businesses evolve.

An example of the FHLBanks' commitment to consistent disclosure is their adoption of a common framework for other-than-temporary (OTTI) impairment analysis. In close consultation with the FHFA, the FHLBanks expeditiously worked to create a set of

processes that ensure timely and consistent treatment of OTTI analysis. All 12 FHLBanks implemented this framework in the first quarter of 2009. The Office of Finance and FHLBanks will continue to work with the FHFA to expand the successful OTTI framework approach to other critical areas of FHLBank accounting policy and financial disclosure.

Through their decentralized, cooperative structure, the FHLBanks have provided an important source of stability amid turmoil in the U.S. banking system over the last two years. The FHLBank system is financially sound and the FHLBanks remain committed to meeting the liquidity needs of their member financial institutions and providing affordable housing for millions of Americans.

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**REPORT TO THE FEDERAL HOME LOAN BANKS OFFICE OF FINANCE  
ON ITS COMBINED FINANCIAL REPORT AND AUDIT COMMITTEE**

**August 10, 2009**

***WILLIAMS & CONNOLLY LLP***

*Paul Martin Wolff  
Stephen P. Sorensen  
Patrick H. Kim*

***SCATENA LEGAL (Pat Scatena)***

***FTI CONSULTING, INC.***

*Patricia Woodbury  
Thomas Rees  
Kenneth Fick*

***LYNN TURNER***

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## **I. EXECUTIVE SUMMARY**

The Federal Home Loan Banks (“FHLBanks”) Office of Finance engaged Williams & Connolly LLP to conduct an independent review of certain aspects of the Office of Finance’s financial reporting and governance.<sup>1</sup> The review team was asked to consider and make recommendations regarding: (A) the guiding principles underlying the drafting of the FHLBanks Combined Financial Report (“CFR”), (B) the process by which the Office of Finance receives the input of its regulator regarding the CFR, and (C) the Office of Finance Audit Committee’s charters and Audit Committee Report.

Having completed the necessary fact gathering, research, and analyses, including interviews of several users of the CFR, we have developed the recommendations set forth below. The recommendations include guiding principles that, if applied, would substantially expand and enhance the disclosures in the CFR. The principles incorporate rules and guidance regarding financial reporting and disclosure promulgated by the Securities and Exchange Commission (“SEC”) and U.S. generally accepted accounting principles (“GAAP”). The principles also reflect the expressed desire of CFR users to have financial reporting that provides a more transparent, consistent, comparable, and comprehensive view of the FHLBank system in one report—without reference to other reports.

The current combined financial reporting and decentralized structure of the FHLBank system and the Office of Finance is not conducive to achieving the desired goal of providing the highest-quality financial disclosure for several reasons. First, limits on the Office of Finance’s authority adversely impact its ability to assess and disclose risk in the FHLBank system. Second, the Office of Finance currently does not have the authority, or the resulting resources and ability, to compel the consistency in accounting policies, systems, and data production (both narrative and quantitative) from the individual FHLBanks that is necessary to achieve consistent and comprehensive system-wide disclosure. While implementation of our recommended principles under the current decentralized FHLBank system would improve the CFR, achieving

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<sup>1</sup> Williams & Connolly LLP subsequently arranged for Pat Scatena of Scatena Legal, FTI Consulting, Inc., and Lynn Turner, former Chief Accountant of the Securities and Exchange Commission, to assist with the independent review. This report is written for the Office of Finance and is not intended to be used or relied upon by third parties.

the desired level of transparency, consistency, comparability, and comprehensiveness in system-level disclosure would require some form of centralized management and control over the FHLBank system akin to what is required for consolidated financial reporting.

The implementation of any form of centralized management and consolidated reporting by the FHLBanks raises legal, legislative, regulatory, accounting, management, structural, operational, and resource issues that were outside the scope of our engagement and would require substantial study and careful consideration. Given the importance of system-level disclosures to the users of the CFR, particularly the investors in the FHLBanks consolidated debt obligations, we believe such a study is necessary, and we recommend that the Office of Finance work with the individual FHLBanks and the Federal Housing Finance Agency (“FHFA”) to undertake one.

#### **A. Guiding Principles**

We summarize here the guiding principles that should underlie the drafting of, and substantive disclosure in, *any* FHLBank system-level financial report, whether combined or consolidated (for purposes of clarity, we refer generally to such reports as “System Financial Reports”). Before doing so, we first address issues that relate to all of the recommended principles.

We do not view the decentralized structure of the FHLBank system, the SEC periodic reports filed by the individual FHLBanks, or the status of the FHLBanks as government-sponsored enterprises<sup>2</sup> as somehow mitigating the need for the highest-quality disclosure at the FHLBank system level. The need for disclosures meeting or exceeding current best practices cannot be understated given that the FHLBank system has approximately \$800 billion of outstanding advances, plays a critical role in facilitating the stability of the United States banking system, and has debt investors around the globe relying upon the joint and several liability of all twelve FHLBanks. The recent turmoil in the global financial markets further underscores the

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<sup>2</sup> The consolidated debt obligations are not obligations of the United States, but the FHLBanks’ status as government-sponsored enterprises raises the prospect of an “implicit guarantee” (as it is sometimes referred to in the press and by analysts) of the Federal government to support the FHLBanks’ consolidated debt.

need for robust disclosure, as regulators and market participants have repeatedly called for improved public disclosures from all financial institutions.

In the guiding principles and elsewhere in this report, we recommend that the Office of Finance voluntarily comply with provisions of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”) and other federal securities laws that do not currently apply to the Office of Finance by virtue of its not being an SEC registrant. In some cases, the Office of Finance would need to adapt these statutory and regulatory requirements to fit its unique structure. These recommendations are based on our view that these provisions are best practices that are appropriate for an issuer with the size and characteristics of the FHLBank system (in fact, many of these provisions codified what were commonly regarded as best practices prior to the enactment of the Sarbanes-Oxley Act).

Against this backdrop, we recommend the following guiding principles:

1. **Objective.** The System Financial Reports of the FHLBanks should be prepared with the overarching purpose of providing transparent, meaningful, timely, comprehensive, and accurate information that will enable report users to understand and to evaluate the business, risks, financial condition, liquidity and results of operations of the system of FHLBanks.
2. **Report users.** Users of the System Financial Reports include any person who has an interest in understanding the operations, performance, and financial condition of the system of FHLBanks. Users include debt investors, FHLBank members, Congress, government agencies and regulators, U.S. taxpayers, rating agencies, financial analysts, counterparties, and creditors. Report users typically will have similar interests, so disclosure of information relevant to debt investors and FHLBank members should generally meet the needs of other users.
3. **Clarity.** The System Financial Reports should be written in “plain English” following the SEC’s rules and guidance for writing prospectuses and periodic reports.
4. **System-wide perspective.** The System Financial Reports should be written from a system-wide perspective to enable users to evaluate and analyze the FHLBank system as a whole. If centralized management is not in effect, System Financial Reports should specifically address the impact of the absence of centralized management.
5. **Management perspective.** The System Financial Reports should provide disclosure that allows readers to see the FHLBanks on a system-wide basis as if through the eyes of centralized management. If centralized management is not actually in effect, appropriate disclosure controls and procedures should exist to

facilitate development of disclosures *as if* such management were in place, and disclosure should address the impact of the absence of centralized management.

6. **Comprehensive material information.** The System Financial Reports should be prepared in accordance with all applicable SEC rules and regulations, including Regulations S-K and S-X, GAAP, and the underlying literature published by the SEC and accounting standards bodies. The System Financial Reports should include all information that would be material to the reasonable investor, even if not required by a specific rule, and regardless of whether such information is included in the periodic SEC filings of any of the individual FHLBanks.<sup>3</sup>
7. **Internal Controls Over Financial Reporting.** The Office of Finance should voluntarily maintain internal accounting and disclosure controls over financial reporting that are compliant with Sections 302 and 404 of the Sarbanes-Oxley Act, as implemented in the securities laws and the rules of the SEC and the Public Company Accounting Oversight Board (“PCAOB”).
8. **Transparency and Accountability in Disclosure Process.** To produce combined disclosures that meet the above principles, the Office of Finance and the FHLBanks should use transparent disclosure processes, and the individual FHLBanks, as well as the Office of Finance, should have responsibility and accountability for the form of and content in the System Financial Reports.

These principles are discussed in more detail in Section III. below. Additionally, a stand-alone document setting forth the principles, with explanatory sections, is attached as Appendix A.

## **B. Process**

The FHFA has indicated that it is willing to work with the Office of Finance to improve the process by which FHFA comments on the CFR are communicated, and we understand that progress already has been made in that regard. The FHFA, however, also indicated that it will not consider recommendations or possible solutions that inhibit its regulatory authority, such as pre-agreements between the Office of Finance and FHFA about methods or forms of communication or deadlines for FHFA comments before CFR publication. In considering potential improvements to this process, we therefore focused on those matters that the Office of Finance can address within the current regulatory framework. Our process recommendations

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<sup>3</sup> The individual FHLBanks are only required to include information in their SEC filings that is relevant and material to that particular FHLBank’s operations and financial condition. All twelve FHLBanks, however, must provide the necessary information to the Office of Finance so that it can prepare the system-level disclosure for any topic that is material to the System Financial Reports.

mainly concern the quantity and timing of communication with the FHFA, and the Office of Finance's response to FHFA comments.

Regarding the former, the foundation for efficient interaction with a regulator is, of course, frequent, timely, and direct communication. The Office of Finance should continue its efforts to engage the FHFA early and often during the drafting of the CFR and through a single point of contact at both organizations when there are issues that require such discussion. This includes raising novel and complex business transactions and events with the FHFA in a manner consistent with the SEC's Staff Accounting Bulletin ("SAB") No. 99, *Materiality* (August 12, 1999).<sup>4</sup>

The Office of Finance should review, track, and resolve all comments from the FHFA even if it believes that those comments are no longer applicable. When FHFA comments are received in writing, the Office of Finance should respond in writing and try to obtain a written confirmation of resolution. Moreover, when disagreements between the Office of Finance and the FHFA occur that cannot be resolved with the initial contacts at the FHFA, the Office of Finance should follow the appropriate dispute resolution procedure within the FHFA to resolve the disagreement or confirm the regulator's view of the issue. At that point, any remaining disagreement should end and compliance should begin. If the cooperation of individual FHLBanks necessary for compliance cannot be obtained, the Office of Finance should promptly bring this to the FHFA's attention. Finally, if material, unresolved FHFA comments exist when the System Financial Report is published, they should be disclosed, as is required for certain large SEC registrants.<sup>5</sup>

### **C. Audit Committee**

Our recommendations regarding the Office of Finance Audit Committee seek to update its oversight responsibilities and structure to reflect current standards for typical, publicly-traded entity audit committees. The recommendations include the addition of independent directors and other voluntary compliance with Sarbanes-Oxley Act and SEC requirements. We understand

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<sup>4</sup> See final paragraph of SAB No. 99.

<sup>5</sup> See Securities Exchange Act of 1934 ("Exchange Act") Form 10-K, Item 1B, Unresolved Staff Comments.

that certain regulations and regulatory interpretations on which the current Audit Committee structure and scope of responsibilities are based will require modification. It is critical to start the necessary dialogue with the FHFA to update these regulations to be consistent with current best practices. Our specific recommendations, discussed in Section V. below, include the following:

1. **Independence.** The Office of Finance Board of Directors should be comprised of a majority of independent directors, and the Audit Committee should be comprised solely of independent directors.
2. **Single charter.** The Audit Committee should combine its two charters into a single charter and eliminate duplicative language. The Audit Committee should also clarify that its responsibilities include oversight of all aspects of the Office of Finance’s operations that fall within a typical audit committee’s purview.
3. **External auditor independence.** The Office of Finance and Audit Committee should follow the external auditor independence requirements set forth in the Sarbanes-Oxley Act and SEC and PCAOB rules and literature. This includes Audit Committee oversight of additional aspects of the external auditor relationship that are not contemplated in the current charters.
4. **Internal audit.** We recommend expansion of the degree of Audit Committee oversight of internal audit activities contemplated in the current charters.
5. **Disclosure process.** The Audit Committee should ensure adequate procedures exist to minimize the risk of errors in the System Financial Reports and the risk of including disclosures that are incomplete or that do not satisfy regulatory requirements. For example, the Audit Committee should oversee the activities of the CFR Disclosure Committee related to system-wide reporting, as well as periodically receive a tracking report to monitor the status of any open comments from the external auditor, internal audit, and the FHFA.
6. **“Tone at the top.”** The Audit Committee should monitor ethics and compliance policies in order to set the appropriate “tone at the top” of the Office of Finance. This includes overseeing the “whistle-blowing” process that is led by the independent internal audit function, and protecting whistleblower confidentiality in the investigation and resolution of complaints.
7. **Other best practices.** The Audit Committee must have express authority in its charter for the engagement and compensation of Committee advisors and the external auditors retained by the Committee and be provided with adequate funding to achieve these purposes. The Audit Committee should adopt continuing education and annual self-assessment requirements. Upon adopting a revised charter, the Audit Committee should establish a self-review process to ensure it meets its obligations on an annual basis, including those recommendations set

forth above. Audit Committee members should periodically meet with the independent and internal auditors and with management in separate executive sessions. The Audit Committee should also meet with management, the independent and internal auditors, and the CFR Disclosure Committee to review the quarterly and annual financial reports prior to completion and issuance.

We also provide specific suggestions regarding the substance and language of the Audit Committee Report in Section V.I.

## **II. PROJECT OVERVIEW**

The FHLBanks Office of Finance engaged Williams & Connolly LLP to review certain aspects of the Office of Finance’s financial reporting and governance practices. More specifically, the Office of Finance sought:

1. A draft set of guiding principles for consideration by the Office of Finance to be used when drafting the CFR;
2. A review of the process by which the Office of Finance garners the input of its regulator—the FHFA, as successor to the Federal Housing Finance Board (“Finance Board”)—during the CFR drafting process, as well as recommendations regarding that process; and
3. A review of the Office of Finance’s Audit Committee Charter and Audit Committee Report (including the General Operations / Imprest Fund Charter), in light of the best practices for audit committees resulting from the passage of the Sarbanes-Oxley Act and the unique structure of the Office of Finance, the Office of Finance Board of Directors, and the FHLBanks.

The purpose of the project was to develop a set of workable policies that the Office of Finance Board of Directors could present to the FHFA for its consideration. The scope of the engagement excluded any recommendations about the elimination of CFRs, because the Office of Finance believes that the CFRs are essential to support the issuance of FHLBanks consolidated debt obligations. Although we reviewed the 2007 CFR and certain parts of individual FHLBank Forms 10-K to gain familiarity with the content so as to develop recommendations for guiding disclosure principles, the review team was not engaged to conduct a review of historical or current financial reports or to evaluate compliance. We also were not engaged to consult on any specific topics relevant to the 2008 CFR, such as other-than-temporary impairment of private-label, mortgage-backed securities.

Williams & Connolly LLP and Pat Scatena of Scatena Legal, a corporate and securities lawyer, provided the legal analysis. Accounting expertise was provided by accountants from FTI Consulting, Inc. and Lynn Turner, a former Chief Accountant of the SEC.

In reaching our conclusions and recommendations, the independent review team collected and analyzed information from a variety of sources. This review was conducted from approximately December 2008 through February 2009. The Office of Finance provided information relating to the CFR and Audit Committee, as well as access to certain individuals who are involved, directly or by way of oversight, in the preparation of the CFR and Audit Committee Reports.

One or more interviews were conducted with representatives from:

1. The Office of Finance's outside securities law firm, Squire, Sanders & Dempsey L.L.P.;
2. The independent auditor of the CFR, PricewaterhouseCoopers LLP;
3. The FHFA and the Finance Board, including the FHFA Office of the Chief Accountant, as well as the Finance Board Office of Supervision and Office of General Counsel;
4. Investors in the FHLBanks consolidated debt obligations; and
5. Moody's Investors Service and Standard & Poor's.

The independent review team also collected examples of other combined financial reports and legal and accounting materials relevant to the guiding principles for the CFR.<sup>6</sup> Notably, combined financial reports are relatively rare and are even more rarely the subject of commentary.<sup>7</sup> We therefore looked to well-established general principles underlying GAAP and securities law disclosure requirements, as well as the disclosure of banks, other financial institutions, and the Federal government. The review also considered the reporting structure of

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<sup>6</sup> See Appendix B for a list of the most significant legal and accounting references on which our analyses and recommendations are based.

<sup>7</sup> The Farm Credit System, the Federal Reserve Banks, and the Federal government are the only other significant examples of combined financial reports that we identified. The annual reports of the Federal Reserve Banks are not based on GAAP, but rather accounting principles specifically developed by its Board of Governors. The Federal government's combined financial statements are based on accounting standards promulgated by The Federal Accounting Standards Advisory Board.

various Federal government entities, quasi-governmental entities, and other government-sponsored entities.

### **III. GUIDING PRINCIPLES**

In this section, we discuss each of our recommended guiding principles for the drafting of System Financial Reports, including the reasons for these principles, their source and derivation, and how we see these principles in use. Before doing so, we first address some general issues that relate to all the recommended principles.

The importance of high-quality, industry-leading disclosures by the FHLBank system is self-evident considering that the FHLBank system has approximately \$800 billion of outstanding advances, plays a critical role in the stability of the United States banking system, and sells its debt to investors around the world. We do not believe that either the SEC registration of the individual FHLBanks or their status as government-sponsored enterprises in any way mitigates this need. Indeed, regulators and market participants recently have called for improved public disclosures from all financial institutions in light of the turmoil in the housing and financial markets.<sup>8</sup>

In the principles and elsewhere in this report, we recommend that the Office of Finance voluntarily comply with provisions of the Sarbanes-Oxley Act and the securities laws that do not currently apply to the Office of Finance because it is not an SEC registrant. The Office of Finance would need to adapt these statutory and regulatory requirements in some cases to fit its unique structure. These recommendations are based on our view that these provisions are best practices that are appropriate for an issuer with the size and characteristics of the FHLBank system.

Our recommended principles are specific to the unique business and situation of the FHLBank system, including the Office of Finance. The principles are not intended to expand or otherwise to change the standards of liability under applicable securities laws and judicial or administrative interpretations. Instead, these principles are designed to achieve much more than

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<sup>8</sup> See, e.g., the U.S. Government's Financial Stability Fact Sheet (February 10, 2009) (at: <http://www.financialstability.gov/docs/fact-sheet.pdf>).

the minimum required for the FHLBank system. Adoption of this set of principles is important; in fact, most of the principles reflect current best-practice standards.

Finally, during the course of our work, representatives of the FHFA provided us with views on appropriate principles for the preparation of the CFR, which we believe are generally consistent with our principles. A summary of the FHFA's views is set forth in Appendix C.

Our recommended guiding principles are as follows:

**Principle 1: Objective.** *The System Financial Reports should be prepared with the overarching objective of providing transparent, meaningful, timely, comprehensive, and accurate information that will enable a report user to understand and to evaluate the business, risk profile, financial condition, liquidity, and results of operations of the FHLBank system as a whole.*

*To be transparent, disclosure must meet the fundamental qualitative characteristics of comprehensiveness, relevance and timeliness, reliability, comparability (across institutions and over time), and materiality.*

The aforementioned principle is fundamental to GAAP (and International Financial Reporting Standards) and to the securities laws. Variants are found throughout the universe of accounting and legal authority and commentary.<sup>9</sup> Notably, the objective is neither defensive nor protective in nature, but rather is aimed at providing users of the System Financial Reports with the information they seek. Our interviews with several current CFR users, while anecdotal, confirmed the desire for this type of disclosure.

Having comparable and consistent financial reporting among the twelve individual FHLBanks is critical to achieving comprehensive and transparent system-wide disclosure. The individual FHLBanks currently have different accounting systems and policies, as GAAP permits alternative accounting approaches in certain areas. Eliminating differences will foster better disclosure and engender greater user confidence in the information provided. For example, users identified the FHLBanks' private-label mortgage-backed securities, an area in which there were differences in individual FHLBank accounting practices at the time of our

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<sup>9</sup> See, e.g., FASB Statement of Financial Accounting Concepts No. 2 (As Amended), *Qualitative Characteristics of Accounting Information* ("FASB Concepts Statement No. 2"); Basle Committee on Banking Supervision, *Enhancing Bank Transparency* (September 1998); Securities Act of 1933 ("Securities Act") Release No. 6349, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (September 29, 1981), §I.A.

review, as one area in which they were uncertain about the comparability, and ultimately the transparency, of the asset values.

Similarly, achieving comprehensiveness is critical to the usefulness of the system-wide disclosure. Users indicated that they want all material information about the FHLBank system in a single report with minimal need to reference the individual FHLBank Forms 10-K and Forms 10-Q.

**Principle 2: Report Users.** *Users of the System Financial Reports include any person who has an interest in understanding the operations, performance, and financial condition of the FHLBank system on a combined basis. At a minimum, report users include:*

- *Investors in the FHLBanks consolidated debt obligations,*
- *FHLBank members,*
- *Congress,*
- *Government agencies and regulators (including the FHFA, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the SEC),*
- *Rating agencies and financial analysts,*
- *Counterparties and creditors, and*
- *U.S. taxpayers.*

*Report users will typically have similar interests, so disclosure of information relevant to debt investors and FHLBank members should generally meet the needs of other users.*

This user list is broader than that contemplated by the current CFR, which is aimed at debt investors. There are at least two reasons for the additions. First, a broader user group is supported by the accounting literature. FASB Concepts Statement No. 1 indicates that potential users of financial statements should include individuals with both direct and indirect interests in the reporting entity.<sup>10</sup> We therefore believe FHLBank members, rating agencies, counterparties,

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<sup>10</sup> FASB Statement of Financial Accounting Concepts No. 1 (As Amended), *Objectives of Financial Reporting by Business Enterprises* (“FASB Concepts Statement No. 1”) ¶24. See also Statement of Federal Financial Accounting Concepts No. 4, *Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government* (January 27, 2003); *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* (August 1, 2008), n. 1 (at: <http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf>).

and creditors should be added to the list of users. Second, given the government-sponsored enterprise status of the FHLBanks, we believe that the contemplated users of the System Financial Reports should include those with a specific interest in the financial condition of the Federal government, including Congress, government agencies, and U.S. taxpayers.<sup>11</sup>

This does not mean specific disclosures need to be designed for each user group. As a general matter, the information relevant to debt investors and FHLBank members should meet the needs of the other users, as all are interested primarily in the financial stability of the FHLBank system as a whole. Excessive focus on the needs of non-investors could diminish the value of a financial report because the information that is truly material to the investor would not stand out from other information. The broader list of users, however, should be considered in determining the level of explanation to include with respect to particular topics and in drafting disclosures that are clearly understood.

**Principle 3: Clarity.** *The System Financial Reports should be written in “plain English” following the SEC’s rules and guidance for writing prospectuses and periodic reports.*

“Plain English” is in some ways the most important principle, as disclosures are ineffective if users do not understand the information provided. We do not summarize or repeat all the SEC’s specific instructions here,<sup>12</sup> but we urge careful and periodic consideration of the SEC’s guidance on this goal—one that is easy to state, but difficult to achieve.

“Plain English” System Financial Reports should provide concise, comprehensive, and meaningful descriptions of the combined operations, cash flows, liquidity, and financial position of the twelve FHLBanks, and the material differences among the individual FHLBanks’ business, operations, and financial condition. Users should not need to look to individual FHLBank reports for material information.

Writing in “Plain English” does not mean excluding complex information to make the report easier to understand. Disclosure for financial institutions inevitably entails discussion of

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<sup>11</sup> See Government Accounting Standard Board Concepts Statement No. 1, *Objectives of Financial Reporting* (May 1987): the three primary users of governmental financial reports are citizens (taxpayers), their representatives (Congress), and investors and creditors.

<sup>12</sup> See Securities Act Rule 421; SEC Release No. 33-7497, *Plain English Disclosure* (January 28, 1998); the SEC’s “*A Plain English Handbook: How to Create Clear SEC Disclosure Documents*” (“Plain English Handbook”) (August 1998) (at: <http://sec.gov/pdf/handbook.pdf>).

complex transactions and issues, and determining the appropriate level of reader sophistication is critical. Paragraph 34 of FASB Concepts Statement No. 1 states that the information included in financial reports “should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.” The SEC’s “plain English” guidance instructs issuers to determine who their report users are and to write to that level.<sup>13</sup>

For users such as large institutional investors and derivatives counterparties, the FASB Concepts Statement No. 1 standard is clearly appropriate. Since the broader audience of System Financial Report users may include readers with varying levels of experience and understanding, the System Financial Reports must sufficiently explain complex topics, including those that require significant financial industry or accounting knowledge, to enable report users to understand the disclosure. Use of short, simply structured sentences and words of few syllables aids the less sophisticated reader. Extensive use of technical phrases, industry jargon and acronyms does not. A detailed table of contents and a glossary that defines necessary industry terms and acronyms would be helpful.

All pertinent information on key topics should be in one location. For instance, the most critical information to allow a reader to understand a current issue, such as impairments or FHLBank credit rating changes, should all be in one place. It is important to note that “plain English” does not require that extensive background explanations be repeated in every section of the report. Repetition of background information often makes the report harder to digest and diminishes the impact of the material information provided. Derivatives-related disclosures, for example, could be divided so that discussion of what derivatives are and their use is in the business section, while the approach followed to account for derivatives is in the accounting policy footnote. Other sections of the report, including the Management’s Discussion and Analysis section<sup>14</sup>, could then simply cross-reference the background information. This would make the required information for those sections more readily discernible and understood by the report users. The System Financial Report should provide clear links to help the reader easily find related information located throughout the report.

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<sup>13</sup> See Plain English Handbook, Chapter 3.

<sup>14</sup> The current CFRs refer to this section as “Financial Discussion and Analysis.”

**Principle 4: System-Wide Perspective.** *The System Financial Reports should be written from a system-wide perspective to enable users to evaluate and analyze the FHLBank system as a whole. If centralized management is not in effect, System Financial Reports should specifically address the impact of the absence of centralized management.*

The existence of joint and several liability of the individual FHLBanks for the consolidated debt is the primary reason that a system-level view of the business, risk profile, financial condition, liquidity, and results of operations of the FHLBanks should be incorporated in the System Financial Reports. Debt investors have a stake in the FHLBank system and seek disclosures about the system's financial status. Similarly, members of individual FHLBanks also desire information about system-level issues and risks, since ultimately the FHLBanks in which they invest may be impacted if such risks materialize.

Currently there is no centralized management or oversight by a central board of directors that ensures consistency in the accounting and risk management policies of the individual FHLBanks. This decentralized structure makes it difficult to prepare disclosures from a system-wide view. For instance, analysis about risks to the FHLBank system (as opposed to any individual FHLBank) may require information that the Office of Finance does not have, as well as subjective judgments about which one or more individual FHLBanks may disagree. These obstacles, however, are insufficient reason not to provide this information. Directing debt investors and other users to twelve individual FHLBank Forms 10-K or Forms 10-Q is not a substitute for centralized disclosure. The debt investor holds bonds issued collectively by the FHLBanks—not separate bonds issued by twelve individual FHLBanks.

The FHLBanks' status as government-sponsored enterprises does not eliminate the need for system-level disclosure. Debt investors indicated a strong interest in an improved CFR. Moreover, the other users of the System Financial Report—including member banks, Congress, and counterparties—have a strong interest in system-level risks, given the collateral events that might follow the realization of any such risks.

System-level disclosures do not inherently mislead users into believing that there is central or holding company-level management. The absence of such management should continue to be emphasized in the CFR, and the description of the FHLBank system, including the

limited scope of the Office of Finance’s authority, should still be described.<sup>15</sup> Notably, while centralized management or oversight by a central board of directors is not in effect, the CFR or System Financial Reports should address the material impact of its absence, fully discussing any shortcomings or benefits.

**Principle 5: Management Perspective.** *The System Financial Reports should provide disclosure that allows readers to see the FHLBanks on a system-wide basis, as if through the eyes of centralized management. If centralized management is not actually in effect, appropriate disclosure controls and procedures should exist to facilitate development of disclosures as if such management were in place, and disclosure should address the impact of the absence of centralized management.*

The SEC’s Management’s Discussion and Analysis (“MD&A”) requirements are based on the premise that numerical presentations, accompanied only by factual descriptions of those numbers, are insufficient to adequately disclose material information to investors.

Management’s analysis and interpretation of the current information, including explanations of how it differs from past periods, and how matters may change in the future, is critical.

Additional disclosure must be provided “through the eyes of management” for an investor to judge the quality of earnings, the likelihood that past performance is indicative of future performance, and how an issuer’s financial condition has changed and could change in the future.<sup>16</sup>

For an investor in the consolidated debt of the twelve FHLBanks, separate financial reports from any one or more of the individual FHLBanks do not currently provide this critical information because those reports lack an assessment “through the eyes of management” at the system level. We have discussed elsewhere why system level information is important to investors, and why we find it desirable to include such information even though there is no system-level management. The same reasoning applies to disclosures of management’s perspective.

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<sup>15</sup> If the Office of Finance believes that a particular disclosure implies that there is system-level management, the absence of a centralized management structure can be reiterated.

<sup>16</sup> See generally Regulation S-K Item 303. See also the SEC’s various releases on MD&A, including Release No. 33-8350 (December 29, 2003) (“2003 MD&A Release”), Release No. 33-8056 (January 22, 2002), Release No. 33-6835 (May 18, 1989), and Securities Act Release No. 6349 (collectively, “MD&A Releases”).

**Principle 6: Comprehensive Material Information.** *The System Financial Reports should be prepared in accordance with all applicable SEC rules and regulations, including Regulations S-K and S-X, GAAP, and the underlying literature published by the SEC and accounting standards bodies. The System Financial Reports should include all information that would be material to the reasonable investor, even if not required by a specific rule, and regardless of whether such information is included in the SEC filings of any of the individual FHLBanks.*

Applicable regulations generally require the CFR to be consistent with Regulations S-K and S-X and GAAP.<sup>17</sup> In this context, we emphasize the well-known “reasonable investor” materiality standard<sup>18</sup> and stress its separate application and importance for System Financial Reports for two reasons, both of which are related to the fact that the individual FHLBanks operate largely independently and without central management or oversight by a central board of directors.

First, there may be a tendency in such situations only to disclose information common to all twelve FHLBanks, as anything more is considered not to be system-wide. For example, one might contend that unless a majority, or even all, of the twelve FHLBanks have a certain line of business, no system-level disclosure of that business is required. Such a position is incorrect. Materiality is determined by reference to what the reasonable investor considers significant. If an issue is material to the investor, it should be disclosed in the System Financial Report, regardless of whether it impacts one, some, or all of the FHLBanks. Second, the absence of central management or central board of directors oversight may make it more difficult for the

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<sup>17</sup> See 12 C.F.R. § 985.6. See also Finance Board Statement of Policy No. 98-27, *Disclosures in the Combined Annual and Quarterly Financial Reports of the Federal Home Loan Bank System* (July 24, 1998), in which the Finance Board indicated it “fully intends to provide disclosure on an ongoing basis that is consistent ... with the SEC’s reporting and disclosure requirements, even if the SEC changes its rules.” This principle also emphasizes that understanding the underlying literature is critical to complying with the letter and spirit of these rules and accounting principles.

<sup>18</sup> See SAB No. 99; *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (“[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important ... What the standard [contemplates] is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.”).

Office of Finance to obtain the information necessary for comprehensive material disclosures at the system level. As with system-wide disclosures, this should not stop the effort to disclose information material to the reasonable investor.

The System Financial Reports should incorporate the following points<sup>19</sup>:

- Critical accounting and disclosure policies and practices, and their application, should be consistent and comparable among the individual FHLBanks. The current differences in accounting and disclosures should be eliminated. The System Financial Reports should fully describe any remaining differences to the extent relevant and material while applying, at a minimum, Statement of Financial Accounting Standards No. 131 (As Amended), *Disclosures about Segments of an Enterprise and Related Information*.
- When quantitative information is disclosed, sufficient narrative discussion should be provided for the reader to fully understand the material aspects of the quantitative information.
- The System Financial Reports should discuss known trends, risks, demands, commitments, events, or uncertainties that are reasonably likely to have a material effect on the FHLBank system's operations and financial condition, including liquidity, capital, credit ratings, and ability to issue and repay consolidated obligations.<sup>20</sup>
- The System Financial Reports should discuss unusual or infrequent events and transactions or significant economic changes that materially affected the reported results and, in each case, the extent to which such results were so affected.
- To the extent material, System Financial Reports should discuss matters that may impact future operations and had not previously, as well as matters that currently impact reported operations but are not expected to do so in the future.
- The financial statements and disclosures should reflect the underlying economics of the FHLBanks' operations and transactions.<sup>21</sup>

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<sup>19</sup> See generally Regulation S-K Item 303 and the SEC's MD&A Releases.

<sup>20</sup> See the SEC's MD&A Releases for further information regarding the guidance in this and the next two bullet-points.

<sup>21</sup> See the 2003 MD&A Release ("Companies also should consider whether the economic characteristics of any of their business arrangements, or the methods used to account for them, materially impact their results of operations or liquidity in a structured or unusual fashion, where disclosure would be necessary to understand the amounts depicted in their financial statements.").

**Principle 7: Internal Controls Over Financial Reporting.** *The Office of Finance should voluntarily maintain internal accounting and disclosure controls over financial reporting that comply with Sections 302 and 404 of the Sarbanes-Oxley Act of 2002, as implemented in the securities laws and the rules of the SEC and the Public Company Accounting Oversight Board.*

Report user confidence in the System Financial Reports will be substantially enhanced if the Office of Finance voluntarily complies with the SEC and PCAOB rules implementing Sections 302 and 404 of the Sarbanes-Oxley Act. Section 404 emphasizes management's responsibility for the company's financial statements and internal controls over financial reporting, and requires the auditors to express an opinion on those controls. Rules implementing Section 404 also set standards for how management discharges its control-related responsibilities and establish limits on management's ability to rely on the independent auditor's work. Section 302 emphasizes management's responsibility to have controls that ensure material information is made known to management, particularly during the periods in which the financial reports are prepared.<sup>22</sup>

The individual FHLBanks have been required to comply with Sections 302 and 404 since they registered equity securities with the SEC.<sup>23</sup> However, the controls over the process of combining financial data and information and the preparation of the System Financial Reports are not, by statute or regulation, subject to Sections 302 and 404. Since the Section 302 and 404 rules presume an issuer with centralized management, adoption of these rules will require adaptation. If other issuers' experiences with these Sarbanes-Oxley Act provisions are indicative, adoption of these requirements will result in substantial improvements to the Office of Finance's internal controls. These improvements, and the improved disclosures regarding

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<sup>22</sup> See Regulation S-K, Rule 601(b)(31). See also Exchange Act Rule 13a-15(e) (registrants are required to maintain disclosure controls and procedures "designed to ensure that information required to be disclosed by the issuer in the reports ... is recorded, processed, summarized and reported" in a timely manner and "that information required to be disclosed is accumulated and communicated to the issuer's management ... as appropriate to allow timely decisions regarding required disclosure.").

<sup>23</sup> The Federal Housing Finance Regulatory Reform Act of 2008 ("Reform Act") codified this requirement. See Reform Act §1112; Exchange Act §38(b)(2). The Finance Board confirmed it in 2004 in Advisory Bulletin 2004-AB-06, *SEC Registration* (October 29, 2004). We were informed that the Office of Finance's debt servicing activities are also subject to an audit pursuant to Statement on Auditing Standards ("SAS") No. 70, *Service Organizations*, (AU Section 324).

management's and the external auditor's testing and assessment of controls, will bolster investor and regulator confidence in the reliability of the System Financial Reports.

**Principle 8: Transparency and Accountability in Disclosure Process.** *The Office of Finance and the FHLBanks should use disclosure processes that are transparent to their regulators, the Office of Finance Board of Directors and Audit Committee, and other interested parties. Both the Office of Finance and the individual FHLBanks should have responsibility and accountability for the content of System Financial Reports.*

- *Each FHLBank should be responsible and accountable for providing timely, complete and accurate individual financial information, and work cooperatively with the Office of Finance to develop System Financial Reports.*
- *The combined disclosures should be coordinated with, but not controlled by, the individual FHLBanks' disclosures in their respective SEC periodic filings.*
- *The Office of Finance and the FHLBanks should develop a process by which the individual FHLBanks provide a certification of the System Financial Report to the Office of Finance, and the Office of Finance Chief Executive Officer and Chief Accounting Officer provide a certification of the System Financial Report. The process for, and content of, the certifications should be similar to the process under Section 302 of the Sarbanes-Oxley Act and implementing SEC rules, with modifications as necessary to fit the structure of the Office of Finance.<sup>24</sup>*

To enhance investor and regulator confidence in the combined disclosures in the System Financial Reports, the Office of Finance's information gathering and disclosure drafting processes should be transparent. The Board of Directors, Audit Committee, and regulator of the Office of Finance, as well as System Financial Report users, should trust that the Office of Finance collects and assesses all information that could be material to investors, and prepares the appropriate, required disclosures.

To this end, each individual FHLBank must be responsible and accountable for assisting in the collective development of the content of the System Financial Reports. The current process for producing the System Financial Reports, the committee charters, and current regulatory interpretations and advisory bulletins are not conducive to achieving the appropriate level of responsibility and accountability. For instance, while the Office of Finance has the authority, by regulation, to compel the production of data for the System Financial Reports<sup>25</sup>, our interviews suggest that, in practice, there are real-world limits on its ability to exercise this authority. In addition, the Office of Finance and individual FHLBanks do not sufficiently

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<sup>24</sup> See Regulation S-K Item 601(b)(31); Exchange Act Rule 13a-14(a).

<sup>25</sup> See 12 CFR §989.3.

coordinate with each other with respect to the timing of their respective filings. The FHLBanks often file their Forms 10-K or Forms 10-Q prior to the filing of the combined report. This lack of coordinated timing may hinder the Office of Finance's ability to include relevant combined disclosures due to potential conflicts with those filings or other issues.

Section 302 of the Sarbanes-Oxley Act imposes a process by which designated company officers are required to take responsibility for the accuracy and completeness of the company's financial reporting through personal certifications.<sup>26</sup> We recognize that there would be difficulties with implementing the exact Section 302 requirements for the Office of Finance and FHLBank system. For example, the Office of Finance chief executive and principal accounting officers likely could only certify the System Financial Reports based on sub-certifications<sup>27</sup> from FHLBanks Presidents and CFOs, and each FHLBank's officers would likely be unwilling to certify another FHLBank's financial statements. We believe, however, that these challenges are not insurmountable, and that a certification process and appropriate certification language could be designed to address these structural issues and achieve the desired result. If the Office of Finance and the individual FHLBanks adopt a properly-designed certification process for the System Financial Reports, improved disclosure processes inevitably would result because the certification signatories would mandate them.

#### **IV. PROCESS RECOMMENDATIONS**

As the Federal supervisor over the FHLBanks and the Office of Finance, the FHFA reviews the CFR to determine its compliance with applicable laws and regulations, such as 12 C.F.R. §985.6(b).<sup>28</sup> The process by which the Office of Finance receives input from the FHFA

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<sup>26</sup> See SEC Release No. 33-8124, *Certification of Disclosure in Companies' Quarterly and Annual Reports* (August 29, 2002).

<sup>27</sup> Sub-certifications are not contemplated by the Section 302 rules but many issuers use sub-certifications from key officers and other personnel to back up the primary CEO and CFO certificate. Sub-certifications work most effectively within a disclosure process that also incorporates other mechanisms for material information to roll up to senior management and report preparers. See Compliance Week, *Sub-Certifications Are Not Guarantees For SOX 302* (March 7, 2006).

<sup>28</sup> 12 C.F.R. §985.6(b) sets forth the content requirements for the CFR, which are based on the SEC's requirements applicable to SEC registrants, with some specific adaptations for the FHLBank system.

during this review should be characterized by frequent and timely communications. The Office of Finance should review, track, and formally resolve all FHFA comments.

The FHFA has indicated that, while it wishes to improve the process of communicating its regulatory input to the CFR (and has already taken steps to do so), it will not inhibit its regulatory authority or otherwise impose limits on its ability to provide comments to the Office of Finance.<sup>29</sup> Therefore, the Office of Finance should not expect pre-approval by the FHFA for the CFR; rather, the Office of Finance and the FHLBanks must continue to consider themselves ultimately responsible for its disclosures. This is consistent with the practices of the SEC and other regulators.

In this context, we recommend, as set forth below, steps the Office of Finance should take to continue to improve its interaction with the FHFA. Generally, the Office of Finance should communicate with the FHFA in the same manner that the individual FHLBanks, or other financial institutions, communicate with the SEC—that is, with timely, accurate, complete, and internally-vetted responses to each regulatory comment received. The SEC’s guidance regarding interaction with registrants<sup>30</sup> has informed our recommendations, which are:

- **Open communications.** When there are issues that require discussion, the Office of Finance should seek frequent and direct conversations with the FHFA. Generally, in-person conversations are preferable to written letters, as letters have a tendency to harden positions and thereby to decrease the prospect of resolution. When, however, the FHFA provides comments in writing, the Office of Finance should respond in writing.
- **Timeliness.** When issues require pre-filing review, the Office of Finance should engage the FHFA early in the process of drafting the CFR, or even before drafting begins, with the goal of facilitating a timely review of the issues by the FHFA. The Office of Finance also should provide prompt responses to any FHFA comments, and actively seek to resolve all comments prior to publication of the next CFR.
- **Novel and Complex Business Transactions and Events.** If an FHLBank has novel and complex business transactions or events for which the accounting and/or disclosure requirements are unclear, the Office of Finance should

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<sup>29</sup> This was communicated to us by the FHFA during a meeting on January 7, 2009.

<sup>30</sup> See SEC Division of Corporation Finance, *Filing Review Process* (January 2009) (at: <http://www.sec.gov/divisions/corpfin/cffilingreview.htm>).

encourage the FHLBank to consult with the SEC.<sup>31</sup> If the Office of Finance has novel and complex business transactions or events for which the accounting or disclosure is unclear, it should consult with the FHFA about the matters in a manner similar to the individual FHLBanks' consultation with the SEC.<sup>32</sup>

- **Single points of contact.** The Office of Finance should attempt to address any FHFA comments on the CFR through single points of contact at both organizations. This will aid tracking of the status of comments and avoid inconsistent responses.
- **Tracking.** The Office of Finance should have an internal tracking mechanism to monitor the status of all open comments from the FHFA. This includes the distribution of a monthly report, copied to the Audit Committee, that notes the status of and progress in resolving each comment.
- **Completeness.** The Office of Finance should respond to all FHFA comments, even if the Office of Finance believes that the comments are no longer applicable. Responses to FHFA requests for additional disclosure in the CFR should be accompanied with draft disclosures where possible, so the FHFA has the opportunity to determine if its comments have been addressed.
- **Closure.** The Office of Finance should seek closure from the FHFA for every comment. When FHFA comments cannot be resolved by mutual agreement with the initial contact at the FHFA, the Office of Finance should use the FHFA's escalation and appeals process until such disagreements are resolved. Upon the FHFA's final confirmation of its views, the Office of Finance and FHLBanks should comply with the regulator's view. If the cooperation of individual FHLBanks necessary for compliance cannot be obtained, the Office of Finance should promptly bring this to the FHFA's attention.
- **Disclosure.** The Office of Finance should disclose any open comments with the FHFA in a manner similar to that required by Item 1.B of the Form 10-K.<sup>33</sup>

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<sup>31</sup> This is consistent with the final paragraph of SAB No. 99, which among other things encourages consultation with the SEC in preparing disclosures regarding any transactions and events for which the treatment under existing accounting literature is unclear.

<sup>32</sup> See SEC Office of Chief Accountant, *Guidance for Consulting with the Office of the Chief Accountant* (August 2008) (at: <http://www.sec.gov/info/accountants/ocasubguidance.htm>).

<sup>33</sup> Item 1.B of the Form 10-K provides that if certain types of large, seasoned registrants have received written comments from the SEC staff regarding periodic or current reports not less than 180 days before the end of the fiscal year to which the Form 10-K relates, and such comments remain unresolved at the time of filing, the registrant must "disclose the substance of any such unresolved comments that the registrant believes are material. Such disclosure may provide other information including the position of the registrant with respect to any such comment."

## V. AUDIT COMMITTEE AND REPORT

The oversight responsibilities and structure of the Office of Finance Audit Committee should be updated to reflect current standards for audit committees. Such standards require the addition of independent directors and consistency with Sarbanes-Oxley Act requirements and best-practice recommendations. We understand that certain regulations and regulatory interpretations on which the current Audit Committee structure and scope of responsibilities are based, such as 12 C.F.R § 985.8(d)(4) and Finance Board Regulatory Interpretation 2000-RI-26 (November 21, 2000), will require modification. The Office of Finance should commence the necessary dialogue with the FHFA to update these requirements to be consistent with current best practices. Our specific recommendations are discussed below.

### A. Independence

Audit committees function most effectively when comprised of independent members. The current composition of the Office of Finance Audit Committee is prescribed by regulation that is inconsistent with the independence requirements of the Sarbanes-Oxley Act. In addition, by regulation the Audit Committee has fiduciary duties akin to directors' duties under state corporate laws.<sup>34</sup> The scope and extent of these fiduciary duties, and to whom the duties are owed, is unclear. This uncertainty raises concerns, particularly when the non-independent Audit Committee members exercise duties that directly impact the individual FHLBanks, giving rise to potential conflicts of interest.

Pursuant to the Federal Housing Finance Regulatory Reform Act of 2008 ("Reform Act"), the individual FHLBanks (but not the Office of Finance) must comply fully with the audit committee independence requirements of the Exchange Act §10A(m) and related SEC rules.<sup>35</sup> We recommend that the Office of Finance request that the FHFA revise the regulations governing the composition and responsibilities of the Office of Finance's Board of Directors and Audit Committee to include the following:

- The Board of Directors should be composed of a majority of independent directors. Given that the Board is usually composed of two FHLBank Presidents

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<sup>34</sup> See 12 CFR §985.8(a) (referencing 12 CFR §917.2(b)).

<sup>35</sup> See Reform Act §1112; Exchange Act §38(b)(2).

and one independent director, at least two additional independent director positions should be added so that the majority of the Board is independent.

- The Audit Committee should be comprised of at least three directors all of whom meet the independence and other eligibility requirements of Exchange Act §10A(m), SEC rules, and the listing standards of an exchange selected by the Office of Finance Board or the Audit Committee.<sup>36</sup> Independent directors should be independent both in fact and appearance.<sup>37</sup> At least one independent director should qualify as an “audit committee financial expert” as defined in Reg. S-K Item 407(d)(5).

## **B. Single Charter**

Currently, the Audit Committee has two charters (Combined Financial Reports and General Operations/Imprest Fund). These should be combined into a single charter, eliminating duplicative language. The Audit Committee responsibilities should be clarified and expanded to be consistent with investor expectations of an Audit Committee’s role, as reflected in the Sarbanes-Oxley Act, SEC, and PCAOB requirements. It is unclear, for instance, whether the Imprest Fund charter covers the Audit Committee’s oversight of internal controls related to the Office of Finance’s responsibility for servicing FHLBanks consolidated debt obligations. The current charters also do not clearly specify the Audit Committee’s oversight of regulatory compliance.

We recommend the following revisions to the Audit Committee Charter:

- The Audit Committee must have sufficient funding authority in its charter to compensate the outside auditors and any independent counsel and advisors it employs and to fund ordinary administrative expenses necessary in carrying out its duties.
- The statement of purpose at the beginning of the charter should be revised to indicate that the Audit Committee’s oversight role is equivalent to that of a typical audit committee of a public company. A sample with Office of Finance-specific modifications, is as follows:

*“The purpose of the Audit Committee of the Office of Finance (“OF”) of the Federal Home Loan Banks (“FHLBanks”) is to provide general oversight of the*

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<sup>36</sup> See, e.g., Reg. S-K Item 407(a)(1)(ii).

<sup>37</sup> See *Audit Committees: A Guide for Directors, Managers and Consultants*, CCH Incorporated (Fifth Edition 2008) ¶ 8.02 (“The essence of independence is an audit committee member’s mental objectivity.... In addition to mental objectivity or independence in fact, independence also involves the appearance of objectivity.”).

*integrity of the combined financial reports of the FHLBanks and the financial reports for the OF Imprest Fund. In addition, it has oversight of:*

- the OF's accounting and financial reporting processes,*
  - the OF's internal controls and procedures,*
  - the financial statement audits,*
  - the appointment, qualifications, independence, performance and compensation of the OF's external and internal auditors, and*
  - compliance with legal and regulatory requirements and ethical standards adopted by the OF.”*
- Audit committee charters typically incorporate language making clear that the Audit Committee's role is one of oversight and that the ultimate responsibility for financial reporting and internal controls rests with management. The current charter was written based on a regulatory interpretation obtained from the Finance Board in 2000, prior to the adoption of the Sarbanes-Oxley Act.<sup>38</sup> The following suggested language is more consistent with current standards:

*“Management is primarily responsible for the preparation, presentation and integrity of the combined financial reports and Imprest Fund financial reports, the OF's accounting policies and the OF's internal controls and procedures designed to address operational and administrative risks and promote compliance with accounting standards, financial reporting and disclosure requirements, applicable laws and regulations and the OF's ethical standards. The independent auditor is responsible for performing an audit of the annual combined financial statements, expressing an opinion as to the conformity of those financial statements with generally accepted accounting principles, and reviewing the quarterly combined financial statements. The individual FHLBanks are responsible for their respective underlying financial statements, accounting policies and internal controls and procedures. The Audit Committee members oversee but are not intended to duplicate or to certify the activities of management and the independent auditor.”*
  - If the Office of Finance Board's and Audit Committee's composition is revised so that the Audit Committee members are a subset of the full board, the charter will need to provide for regular reports to the Office of Finance's Board on the Audit Committee's activities.

The lists of specific responsibilities set forth in the current charter should be reviewed and updated regularly based on reviews of current guidance and other issuer charters.

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<sup>38</sup> See Finance Board Regulatory Interpretation 2000-RI-26.

## D. External Auditor Independence

Auditor independence is a fundamental premise underlying our financial markets.<sup>39</sup> By regulation, the Office of Finance Audit Committee currently has the exclusive authority (1) to select, employ, and contract for the services of an independent, external auditor for the combined financial statements and (2) to select, evaluate, determine the compensation of, and, where appropriate, replace the internal auditor.<sup>40</sup> This authority is included in the current Audit Committee charters. The individual FHLBanks, on the other hand, are subject to the full panoply of external auditor independence requirements set forth in the Sarbanes-Oxley Act and related SEC and PCAOB rules and literature.<sup>41</sup> We recommend that the Office of Finance also follow these more comprehensive requirements and seek any necessary regulatory revisions from the FHFA to do so. We make the following specific recommendations on external auditor independence:

- The Audit Committee should annually confirm the external audit firm’s independence both in fact *and* appearance.<sup>42</sup> The current charter implies that the review is to determine only independence “in fact.”
- To be independent, the external auditors must report directly to the Audit Committee, not management. The current charters give the Audit Committee sole authority to appoint, renew (or terminate), and review the performance of the external auditor and approve the external auditor’s engagement letter. The Audit Committee’s authority should be expanded to include the annual review and approval of the external auditor’s budget and the scope of the auditor’s work.
- The current charters address the Audit Committee’s responsibility to review and approve audit plans related to the combined financial reports. This provision should be expanded to cover the review of all other audit plans, such as those related to the Imprest Fund and debt servicing activities.

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<sup>39</sup> See generally SEC Release No. 33-7919, *Revision of the Commission's Auditor Independence Requirements* (February 5, 2001).

<sup>40</sup> See 12 CFR §985.8(d)(7) & (8).

<sup>41</sup> See Reform Act §1112; Exchange Act §38(b)(2).

<sup>42</sup> Regulation S-X Rule 2-01, preliminary note 1, states that the requirements set forth in the rule are “designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance.” See also AICPA Code of Professional Conduct, ET Section 100.01.06.

- The Audit Committee should pre-approve all audit and non-audit services, following the independence rules regarding permissible and prohibited services. The current charters merely require the Audit Committee to discuss consulting and other non-audit services provided by the external auditors. In determining whether to approve such services, the need to preserve independence must be considered. This decision, however, requires the exercise of business judgment by the Audit Committee. In considering whether to approve non-audit services, the Audit Committee should consider the following factors:
  1. Whether the service is being performed principally for the audit committee,
  2. The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity’s financial reporting process,
  3. Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support,
  4. Whether the service would be performed by audit personnel and, if so, whether it will enhance their knowledge of the entity’s business and operations,
  5. Whether the role of those performing the service (e.g., a role where neutrality, impartiality and auditor skepticism are likely to be subverted) would be inconsistent with the auditor’s role,
  6. Whether the audit firm’s personnel would be assuming a management role or creating a mutuality of interest with management,
  7. Whether the auditors, in effect, would be “auditing their own numbers,”
  8. Whether the project must be started and completed very quickly,
  9. Whether the audit firm has unique expertise in the service, and
  10. The size of the fee(s) for the non-audit service(s).<sup>43</sup>
  
- The Audit Committee should assure that the audit firm follows the Sarbanes-Oxley Act’s audit partner rotation requirements.<sup>44</sup> We believe it would be beneficial to rotate audit firms at least once every seven to ten years.<sup>45</sup> The Audit

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<sup>43</sup> See *Report of the Panel on Audit Effectiveness of the Public Oversight Board* (August 31, 2000) (this panel was chaired by Shaun F. O’Malley, a former Chair of Price Waterhouse LLP, and is commonly referred to as the “O’Malley Panel”); SEC Release No. 33-7919, *Revision of the Commission’s Auditor Independence Requirements* (February 5, 2001) (“We believe that the O’Malley Panel recommendations represent a thoughtful and appropriate approach to these issues by audit committees, and we encourage audit committees to consider [them].”).

<sup>44</sup> See Exchange Act §10A(j) and related regulations.

<sup>45</sup> See *Restoring Trust: Report to The Hon. Jed S. Rakoff, The United States District Court For the Southern District of New York, On Corporate Governance For The Future of MCI, Inc.*, prepared by Richard C. Breeden, Corporate Monitor (August 2003) (“Breeden Report”),

Committee also should review the degree of overlap between the audit teams for the FHLBanks and the Office of Finance for potential conflict.

- The Audit Committee should meet with the external auditors quarterly to discuss the financial statements, any issues from their review of the narrative discussion, and any internal control issues that came to their attention. Annually, the Audit Committee should review the external auditor's independence, the auditor's engagement letter, the audit/review budget, and all audit and non-audit services. The Audit Committee should receive copies of all material written communications from the auditors to management or the regulators.<sup>46</sup>

#### **E. Internal Audit**

The Audit Committee should set the tone with management for an independent and objective internal audit function. Independence is achieved through a reporting relationship with the Audit Committee that effectively insulates the internal audit function from management actions that would hinder objective decision-making and reporting. The Audit Committee should ensure that the internal audit staff does not review its own work, and is not relied upon to actually perform any controls that it tests.<sup>47</sup>

The General Operations/Imprest Fund charter incorporates reporting requirements, as mandated by 12 C.F.R § 985.8(d)(4) and Regulatory Interpretation 2000-RI-26. Internal audit's role, however, is not addressed in any detail, which is the reason for the following recommendations:

- Internal audit should have a critical role in auditing the controls and procedures that underlie the preparation of the System Financial Reports. The Office of Finance's voluntary implementation of Sarbanes-Oxley Section 404 requirements would formalize internal audit's role in reviewing controls and procedures to support the Office of Finance management's attestation as to adequacy.

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Recommendation 5.15; *Remarks of Public Company Accounting Oversight Board Member Charles D. Niemeier Before the Brazilian Association of State and Regional Banks, Brasilia, Brazil* (August 15, 2006), §II.A(2) (at: [http://www.pcaobus.org/news\\_and\\_events/events/2006/speech/08-15\\_niemeier.aspx](http://www.pcaobus.org/news_and_events/events/2006/speech/08-15_niemeier.aspx)).

<sup>46</sup> See Exchange Act §§ 10A(b), 10A(k)(3).

<sup>47</sup> AU Section 322 ¶¶ 9-11; *International Standards for the Professional Practice of Internal Auditing*, The Institute of Internal Auditors ¶ 1130.A1 (October 2008); Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements* ("Auditing Standard No. 5") ¶¶ 16-19.

- The Audit Committee should meet quarterly with the Director of Internal Audit in connection with the reviews of the System Financial Reports. At least annually, the Audit Committee should review the Internal Audit function and evaluate work plans for audits and risk assessments, the performance and compensation of the Director of Internal Audit, the adequacy of staffing levels, and competence of the Internal Audit department personnel.

We were not asked to, and did not, conduct any review to determine how the Office of Finance’s internal audit function operates in practice, or the extent to which its operations may meet the above recommendations.

#### **F. Disclosure Process**

The Audit Committee should ensure that adequate procedures are in place to minimize the risk of errors and incomplete or non-compliant disclosures in the System Financial Reports. Existing procedures require each FHLBank’s President and CFO to deliver to the Office of Finance Board a representation letter regarding that FHLBank’s information in the System Financial Reports. There is also a CFR Disclosure Committee in operation, but oversight of its activities is not included in the Audit Committee charter. We recommend that the CFR Disclosure Committee provide regular reports of its activities related to system-wide reporting directly to the Audit Committee and copy the Audit Committee on its minutes.

We did not conduct a full review of the operations of the existing CFR Disclosure Committee. We did review the CFR Disclosure Committee charter, which provides in part:

“Notwithstanding the formation of the Disclosure Committee, the OF remains ultimately responsible for the contents of the Combined Financial Reports and any operating highlights press release published by the OF and each FHLBank only remains responsible for the accuracy of its information in such Combined Financial Reports and press releases. *However, suggestions and input on matters of Systemwide [sic] relevance would be valued from each member of the Disclosure Committee.*”

*Emphasis added.* The Audit Committee should review the CFR Disclosure Committee’s charter and expand the CFR Disclosure Committee’s role in developing disclosures for the System Financial Reports consistent with our recommended disclosure principles. In addition, the CFR Disclosure Committee structure should be consistent with SEC regulations and guidance, as well as with best practices for such committees. Other committee charters and the FHLBank officer representation letters may also need revision to implement these new principles.

We recommend that the Audit Committee ensure that it regularly receives a report that summarizes the status of open comments on disclosures from external audit, internal audit, the FHFA, and any other regulatory body. The Audit Committee should periodically discuss the comments with Office of Finance management to confirm that the comments were resolved appropriately.

**G. “Tone At The Top”**

A review to determine whether the Office of Finance has Sarbanes-Oxley-like procedures addressing ethics matters was beyond the scope of our engagement. To reinforce the “tone at the top,” the Audit Committee should ensure that the Office of Finance has effective ethics and compliance policies that:

- are enforced with respect to employees and third parties (counterparties, suppliers, and others);
- are regularly communicated to employees (by the Chief Executive Officer and every level of management, not just compliance personnel) in a way that emphasizes that ethics and compliance are a crucial part of the organization’s culture;
- require employees to certify annually that they are in compliance with the policies;
- make integrity, ethics and compliance a part of employee promotion, compensation and evaluation processes;
- incorporate procedures for handling complaints regarding accounting, internal accounting control or auditing matters, including procedures for the confidential, anonymous submission by employees to an independent party of concerns regarding questionable accounting or auditing matters;
- require prompt reporting of any complaints to the Audit Committee; and
- protect whistleblowers from retaliatory actions.

Internal Audit should receive any confidential, anonymous complaints and should conduct investigations in a manner that preserves confidentiality. Submitted complaints should be reviewed in a timely manner. The Audit Committee should annually review and approve the ethics and compliance policies, whether or not there are proposed changes.

## H. Other Best Practices

We make the following additional recommendations:

- The Audit Committee should ensure that discussions with auditors and management are candid and thorough. Members must be prepared and knowledgeable, and display a healthy degree of skepticism. Many companies schedule more than four regular meetings per year to allow adequate time to address the various matters within their audit committee's charter.
- When the external auditor or the Director of Internal Audit attends Audit Committee meetings, the Audit Committee should meet with them separately in closed sessions without management present. Under the current Audit Committee structure, it also may be appropriate to exclude non-independent directors from certain closed sessions. Making these executive sessions routine, rather than annual, influences the overall culture of the organization and the nature of management's interactions with the Audit Committee. In addition, the Audit Committee should periodically meet with the Chief Accounting Officer and the Chief Executive Officer in separate executive sessions.
- The current charters include statements confirming that the Audit Committee members have unrestricted access to representatives of the external auditor, the Director of Internal Audit, and the Senior Director of Accounting Policy & Financial Reporting, and that such persons have unrestricted access to the Audit Committee members without the need for any prior management knowledge or approval. Any new charters should preserve these statements.
- Audit Committee meeting minutes should be prepared with advice from legal counsel and document the processes followed by the Committee, the conclusions reached, and the basis for those conclusions.
- Compensation for the independent directors on the Audit Committee should be adequate to ensure recruitment of high-quality individuals who will devote the time needed to effectively perform responsibilities.<sup>48</sup>
- Assuming that there is a sufficient number of members with the necessary expertise and capabilities, the Audit Committee should consider rotating the chair position every three years. Such rotation would not preclude the former chair from remaining as a committee member and serving as chair in the future.<sup>49</sup>

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<sup>48</sup> See, e.g., Breeden Report, Recommendation 5.05. Independent director compensation is currently set pursuant to 12 CFR §§985.7(d), 918.2 and 918.3.

<sup>49</sup> See Breeden Report, Recommendation 5.04. The current regulations require the private citizen member to be the Board chair, but do not expressly apply this requirement to the Audit Committee. See 12 CFR §§985.7(c) & 985.8(d)(4). The Office of Finance advised us that the Finance Board has allowed other Office of Finance directors to be the Audit Committee chair in lieu of the private citizen member.

- The Audit Committee should adopt a continuing education requirement. The policy should focus on specific accounting and disclosure topics that are of current relevance and topics that expand knowledge of the Office of Finance and FHLBanks' businesses and transactions.
- The Audit Committee should perform a self-assessment annually. PCAOB standards relating to assessment of an audit committee's effectiveness should be considered in the design.<sup>50</sup>

#### **I. Audit Committee Report**

We have reviewed the Audit Committee Report and provide the following suggestions:

- The last sentence of the first paragraph of the Audit Committee Report provides that the Office of Finance Board members "are not required to satisfy any express qualification or independence standards governing their service as an "audit committee." This language should be revised to be consistent with 12 C.F.R. §985.7(a)(2), which provides that the private citizen member of the Office of Finance Board may not be an officer, director, or employee of an FHLBank or FHLBank system member, hold shares, or any other financial interest in, any member of an FHLBank, or be affiliated with any consolidated obligation selling or dealer group member under contract with the Office of Finance.
- The 2007 Audit Committee Report met the disclosure requirements of Regulation S-K, Item 407(d).<sup>51</sup> The 2007 Audit Committee Report also contains explanatory text describing the limitations on the Audit Committee's role. The text describing independence requirements for the FHLBanks' Audit Committees will need to be updated to reflect the changes in requirements, including independence requirements, under the Reform Act. In addition, the Audit Committee should add to its list of disclaimers a disclaimer of responsibility for oversight of the individual FHLBanks' internal controls over financial reporting or disclosure controls and procedures.

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<sup>50</sup> See Part III, The AICPA Audit Committee Toolkit—Public Companies (2008 edition); KPMG's Audit Committee Institute, *Ten To-Do's For Audit Committees In 2008*, reprinted in Practising Law Institute, *Audit Committee Workshop 2008: What Audit Committee Members & Those Who Advise Them Need to Know Now* (June 2008); *Audit Committees: A Roadmap for Establishing Accountability*, Remarks of SEC Chief Accountant Lynn Turner at Seminar on Corporate Accountability, Scottsdale, Arizona, (March 10, 2001) ("Turner Remarks on Audit Committees"); Auditing Standard No. 5, ¶¶ 25 and 27.

<sup>51</sup> Finance Board regulations require the Office of Finance Audit Committee to comply with the requirements pertaining to audit committee reports set forth in Item 306 of Regulation S-K. See 12 C.F.R. §985.8(d)(4). The SEC amended audit committee report requirements after these Finance Board rules were adopted, and Item 306 was superseded by Regulation S-K Item 407(d). See SEC Release No. 33-8732A, *Executive Compensation and Related Person Disclosure* (November 7, 2006), n. 48 and § V.D.

- Many issuers include in their audit committee reports a summary of the oversight activities of the committee during the prior year, including the oversight of the external auditor and the preparation of the System Financial Reports. This type of summary is a sound corporate governance practice because it gives investors greater confidence that active and adequate oversight is in place. The audit committee reports of The Coca Cola Company and Sun Microsystems, Inc. provide good examples of such summaries.<sup>52</sup> The Audit Committee should provide a summary of its performance and note whether any specific responsibilities in its charters were not performed.
- As discussed above, action should be taken to eliminate the regulatory and structural limitations on the Audit Committee’s authority and resulting ability to exercise typical audit committee responsibilities. Such an effort will require substantial structural, process, and regulatory changes (or possibly even statutory amendments). If and when such changes (or any other changes within the current regulatory framework) are made, the Audit Committee Report will require revision. In the meantime, the Audit Committee should expand the description of the limitations on its authority and ability to exercise typical audit committee responsibilities.
- The Audit Committee is not currently required to designate whether it has identified one of its members as an “audit committee financial expert” within the SEC’s rules.<sup>53</sup> When the Audit Committee is composed entirely of independent directors and functioning more consistently with current corporate governance best practices, the Audit Committee Report should consider disclosing which member(s) meet the SEC’s minimum requirements to be considered “audit committee financial experts.”
- Some audit committees have adopted practices, initially recommended by Warren Buffett, in which certain questions regarding the financial reports are asked of auditors and management and then the question and answer process is described in the Audit Committee’s minutes and report. We recommend that the Office of Finance Audit Committee do this. The original Buffett questions, paraphrased, are as follows:
  1. If the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way different than the manner selected by management? The audit committee should inquire as to both material and non-material differences. If the auditor

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<sup>52</sup> Coca Cola Company Schedule 14A: Definitive Proxy Statement (March 3, 2008) (at: <http://www.sec.gov/Archives/edgar/data/21344/000119312508044624/ddef14a.htm>); Sun Microsystems, Inc. Schedule 14A: Definitive Proxy Statement (September 24, 2008) (at: <http://www.sec.gov/Archives/edgar/data/709519/000119312508200222/ddef14a.htm>).

<sup>53</sup> See Sarbanes Oxley Act § 407; Reg. S-K Item 407(d)(5).

would have done anything differently than management, an explanation should be made of management's position and the auditor's response.

2. If the auditor were an investor, does he believe that he would have received the information essential to a proper understanding of the company's financial performance during the reporting period?
3. Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why?<sup>54</sup>

The text of these questions has been revised and expanded slightly in the Audit Committee Reports of The Coca Cola Company and Sun Microsystems, Inc.:

1. Are there any significant accounting judgments or estimates made by management in preparing the financial statements that would have been made differently had the independent auditors themselves prepared and been responsible for the financial statements?
2. Based on the independent auditors' experience, and their knowledge of the Company, do the Company's financial statements fairly present to investors, with clarity and completeness, the Company's financial position and performance for the reporting period in accordance with generally accepted accounting principles and SEC disclosure requirements?
3. Based on the independent auditors' experience, and their knowledge of the Company, has the Company implemented internal controls and internal audit procedures that are appropriate for the Company?<sup>55</sup>
4. Are the external and internal auditors getting the support they need from management to execute their duties.<sup>56</sup>

## **VI. IMPLEMENTATION AND OTHER NEXT STEPS**

Our engagement did not include an analysis of the structure of the FHLBank system, including the Office of Finance. The issue of whether the Office of Finance and the FHLBanks are appropriately structured, however, inevitably arises when considering the implementation of our recommendations. We question whether the implementation of these recommendations within the current structure will satisfy the desire of users to have the highest-quality

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<sup>54</sup> See Turner Remarks on Audit Committees.

<sup>55</sup> Coca Cola Company Schedule 14A: Definitive Proxy Statement (March 3, 2008) (at: <http://www.sec.gov/Archives/edgar/data/21344/000119312508044624/ddef14a.htm>).

<sup>56</sup> Sun Microsystems, Inc. Schedule 14A: Definitive Proxy Statement (September 24, 2008) (at: <http://www.sec.gov/Archives/edgar/data/709519/000119312508200222/ddef14a.htm>).

disclosure—a single financial report that will allow them to fairly evaluate the business, risks, financial condition, liquidity and results of operations of the FHLBank system as a whole.

We believe the answer is no. While a thorough and conscientious effort to implement our recommendations would improve the CFR substantially, we doubt that the ultimate objective of a highest-quality, transparent, consistent, and comprehensive disclosure of material information can be achieved through a CFR prepared within the constraints of the existing structure of the FHLBanks and the Office of Finance. The present structure of the Office of Finance inherently limits the quality of the disclosures in the CFR. For instance, to provide the broad management perspective that CFR users desire, the Office of Finance must have enhanced authority to assess and make judgments about whether to discuss system-wide risks, including the potential impact on the financial stability of the system from the activities of one or more individual FHLBanks.

In addition, there currently is not uniformity of accounting policies and systems, or disclosure approaches, among the individual FHLBanks. To the contrary, from our limited review of some of the FHLBank Forms 10-K, we observed a high degree of variability in the disclosures and in the accounting policies underlying those disclosures.<sup>57</sup> As a result, the CFR frequently refers the reader to (or implicitly relies on) the individual FHLBank financial disclosures. In many cases, the reader must review multiple Forms 10-K or Forms 10-Q to obtain a complete understanding of a particular issue. These issues—particularly the absence of underlying consistency—dilute users’ confidence in the CFR.

To provide disclosure that meets users’ desire for a single report that accurately conveys the financial state of the FHLBank system, the Office of Finance, or some system-level equivalent body, must have the authority (1) to provide a subjective, system-level perspective (*i.e.*, to do more than merely combine the reports of individual FHLBanks), and (2) to require the individual FHLBanks to make the necessary changes in disclosure approaches, accounting policies, and systems.

As a practical matter, *consolidation* in some form of the financial reporting and structure of the FHLBanks would be the best way to create the necessary authority, accountability and consistency among the individual FHLBanks. The reasons for consolidation are many. First,

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<sup>57</sup> We also observed a need for the individual FHLBanks to take more responsibility and accountability over the development of combined disclosures in the CFR, particularly the narrative disclosures.

consolidation necessarily would drive uniformity of systems and accounting policies. Second, it would establish accountability with specific individuals. Third, debt investors, as previously mentioned, look to the FHLBank system as a whole because of the joint and several liability associated with that debt. Finally, consolidation offers a more efficient and certain path to achieving the level of internal controls review and assessment that current CFR users expect.

The regulatory, legislative, organizational, accounting, operational, and resource implications of consolidation were beyond the scope of our engagement, as was a consideration of the operational benefits of the current decentralized structure. We strongly recommend that the Office of Finance, along with the individual FHLBanks, begin a dialogue among themselves and interested parties, including the regulator and possibly Congress, to consider consolidation or some alternative structure that can satisfy the objectives and principles set forth in this report. This dialogue is imperative in light of the joint-and-several liability of the consolidated debt, the recent events in the financial markets, and the desire of CFR users for more transparent, consistent, and comprehensive reporting.<sup>58</sup>

We do not make this recommendation lightly or naively. The FHLBank system has a long institutional history, many stakeholders, and a unique and complicated corporate and regulatory structure. We are fully aware that the issue of centralization or decentralization has been the source of recurring discussions within and outside of the FHLBank system over the years and that prior efforts aimed at centralizing authority have been unsuccessful. Our recommendation for further consideration of consolidation derives directly from our review of the FHLBank system's current financial reporting system, our observations about its shortcomings, and the recommended principles that would allow this system and its reports to meet the objectives of its users.

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<sup>58</sup> We are not suggesting that the individual FHLBank SEC reports be eliminated as part of such a consolidation. Our view is that the individual FHLBank SEC reports could only be eliminated if a new structure provided assurance that all interested parties, such as members, creditors, transaction counterparties and the like, could obtain adequate, transparent, and comprehensive disclosure about the individual FHLBanks' operations through a consolidated report and other avenues for disclosure.

## APPENDIX A

### **Proposed guiding principles used when preparing any FHLBanks system-level financial report:**

In light of the public mission of the FHLBanks, their importance to the safety and soundness of the overall United States financial system and their government sponsorship, the Office of Finance and the individual FHLBanks should strive to set the highest standards in providing meaningful and transparent disclosure in their system-level financial reports, whether combined or consolidated (“System Financial Reports”).

The guiding principles to be used when preparing the System Financial Reports are as follows:

1. **Objective:** The System Financial Reports should be prepared with the overarching objective of providing transparent, meaningful, timely, comprehensive and accurate information that will enable report users to understand and to evaluate the business, risk profile, financial condition, liquidity and results of operations of the FHLBank system as a whole.

To be transparent, disclosure must meet the fundamental qualitative characteristics of comprehensiveness, relevance and timeliness, reliability, comparability (across institutions and over time), and materiality.

2. **Report Users:** Users of the System Financial Reports include any person who has an interest in understanding the operations, performance, and financial condition of the FHLBank system on a combined basis. At a minimum, report users include:

- Investors in FHLBanks consolidated debt obligations,
- FHLBank members,
- Congress,
- Government agencies and regulators (including the FHFA, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the SEC),
- Rating agencies and financial analysts,
- Counterparties and creditors, and
- U.S. taxpayers.

Report users will typically have similar interests, so disclosure of information relevant to debt investors and FHLBank members should generally meet the needs of other users.

3. **Clarity:** The System Financial Reports should be written in “plain English” following the SEC’s rules and guidance for writing prospectuses and periodic reports.
  - The System Financial Reports should provide comprehensive, material information for all 12 FHLBanks. Users should not need to look to individual FHLBank reports for material information.

- The System Financial Reports should provide sufficient explanations of complex topics, including those that require significant financial industry or accounting knowledge, in a manner that enables report users to understand the disclosure.
  - The System Financial Reports should provide concise and meaningful descriptions of the combined operations, cash flows, liquidity and financial position of the FHLBanks, and the material differences in the twelve FHLBanks' business, operations and financial condition.
  - The System Financial Reports should attempt to report all related information in one location. When such disclosure is not feasible, the System Financial Reports should provide clear links to related information to enable the reader to easily locate it.
  - The System Financial Reports should include a detailed table of contents and a glossary that defines relevant industry terms and acronyms. The use of acronyms and industry jargon should be limited.
4. **System-wide Perspective:** The System Financial Reports should be written from a system-wide perspective to enable users to evaluate and analyze the FHLBank system as a whole. If centralized management is not in effect, System Financial Reports should specifically address the impact of the absence of centralized management.
  5. **Management Perspective:** The System Financial Reports should provide disclosure that allows readers to see the FHLBanks on a system-wide basis as if through the eyes of centralized management. If centralized management is not actually in effect, appropriate disclosure controls and procedures should exist to facilitate development of disclosures *as if* such management were in place, and disclosure should address the impact of the absence of centralized management.
  6. **Comprehensive Material Information:** The System Financial Reports should be prepared in accordance with all applicable SEC rules and regulations, including Regulations S-K and S-X, generally accepted accounting principles (GAAP), and the underlying literature published by the SEC and accounting standards bodies. The System Financial Reports should include all information that would be material to the reasonable investor, even if not required by a specific rule, and regardless of whether such information is included in the SEC filings of any of the individual FHLBanks.

The System Financial Report should include the following points:

- Critical accounting and disclosure policies and practices, and their application, should be consistent and comparable among the individual FHLBanks. The current differences in accounting and disclosures should be eliminated. The System Financial Reports should fully describe any remaining differences to the extent relevant and material, while applying, at a minimum, Statement of Financial Accounting Standards No. 131 (As Amended), *Disclosures about Segments of an Enterprise and Related Information*.
- When quantitative information is disclosed, sufficient narrative discussion should be provided for the reader to fully understand the material aspects of the quantitative information.

- The System Financial Reports should discuss known trends, risks, demands, commitments, events or uncertainties that are reasonably likely to have a material effect on the FHLBank system's operations and financial condition, including liquidity, capital, credit ratings and ability to issue and repay consolidated obligations.
  - The System Financial Reports should discuss unusual or infrequent events or transactions or significant economic changes that materially affected the reported results and, in each case, the extent to which such results were so affected.
  - To the extent material, System Financial Reports should discuss matters that may impact future operations and had not previously, as well as matters that currently impact reported operations but are not expected to do so in the future.
  - The financial statements and disclosures should reflect the underlying economics of the FHLBanks' operations and transactions.
7. **Internal Controls Over Financial Reporting.** The Office of Finance should voluntarily maintain internal accounting and disclosure controls over financial reporting that comply with Sections 302 and 404 of the Sarbanes-Oxley Act of 2002, as implemented in the securities laws and the rules of the SEC and the Public Company Accounting Oversight Board.
8. **Transparency and Accountability in Disclosure Process.** The Office of Finance and the FHLBanks should use disclosure processes that are transparent to their regulators, the Office of Finance Board of Directors and Audit Committee, and other interested parties. Both the Office of Finance and the individual FHLBanks should have responsibility and accountability for the content of System Financial Reports.
- Each FHLBank should be responsible and accountable for providing timely, complete and accurate individual financial information, and work cooperatively with the Office of Finance to develop System Financial Reports.
  - The combined disclosures should be coordinated with, but not controlled by, the individual FHLBanks' disclosures in their respective SEC periodic filings.
  - The Office of Finance and the FHLBanks should develop a process by which the individual FHLBanks provide a certification of the System Financial Report to the Office of Finance, and the Office of Finance Chief Executive Officer and Chief Accounting Officer provide a certification of the System Financial Report. The process for, and content of, the certifications should be similar to the process under Section 302 of the Sarbanes-Oxley Act and implementing SEC rules, with modifications as necessary to fit the structure of the Office of Finance.

## **APPENDIX B**

### **Primary reference sources:**

- Financial Accounting Standards Board Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51*
- Statement of Financial Accounting Concepts No. 1 (As Amended), *Objectives of Financial Reporting by Business Enterprises*
- Statement of Financial Accounting Concepts No. 2 (As Amended), *Qualitative Characteristics of Accounting Information*
- Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*
- Statement of Federal Financial Accounting Concepts No. 4, *Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government*
- The SEC's various releases on MD&A, including Release No. 33-8350 (December 29, 2003), Release No. 33-8056 (January 22, 2002), Release No. 33-6835 (May 18, 1989), and Securities Act Release No. 6349 (September 29, 1981)
- Basle Committee on Banking Supervision, *Enhancing Bank Transparency* (September 1998)
- Working Group On Public Disclosure, letter from Walter V. Shipley to The Honorable Laurence H. Meyer (January 11, 2001)
- The Council of Institutional Investors, *Corporate Governance Policies*
- SEC Release No. 33-7919, *Revision of the Commission's Auditor Independence Requirements* (February 2, 2001)
- *Audit Committees: A Roadmap for Establishing Accountability*, Remarks of SEC Chief Accountant Lynn Turner at Seminar on Corporate Accountability, Scottsdale, Arizona, (March 10, 2001)
- *Restoring Trust: Report to The Hon. Jed S. Rakoff, The United States District Court For the Southern District of New York, On Corporate Governance For The Future of MCI, Inc.*, prepared by Richard C. Breeden, Corporate Monitor (August 2003).
- *Audit Committee Workshop 2008: What Audit Committee Members & Those Who Advise Them Need to Know Now*, Practising Law Institute Course Handbook (July 9, 2008)
- The AICPA Audit Committee Toolkit -- Public Companies (2008)

- Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999)
- *Guide for Audit Committees Under Federal Securities Laws*, CCH Incorporated (Third Edition, 2005)
- *Effective Audit Committees in the Ever Changing Marketplace*, BDO Seidman, LLP (2008)
- SEC Release No. 33-8220, *Standards Relating to Listed Company Audit Committees* (April 25, 2003)
- SEC Release No. 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence* (May 6, 2003)
- SEC Staff Accounting Bulletin No. 99, *Materiality* (August 12, 1999)
- SEC Division of Corporation Finance, *Filing Review Process* (January 2009) (at: <http://www.sec.gov/divisions/corpfin/cffilingreview.htm>)
- SEC Office of Chief Accountant, *Guidance for Consulting with the Office of the Chief Accountant* (August 2008) (at: <http://www.sec.gov/info/accountants/ocasubguidance.htm>)

## **APPENDIX C**

### **FHFA views regarding principles:**

1. Regarding potential users of the CFR, go through the exercise articulated in FASB Concepts Statement No. 1. The potential users should be more than just the investors in the consolidated debt obligations.
2. Have a transparent development and materiality assessment process during CFR drafting so that the Office of Finance understands how and why the individual FHLBanks made certain disclosure and information decisions.
3. Reiterate the current CFR principle about the individual FHLBanks being responsible for providing timely and accurate information. The point here is the individual FHLBanks need to fully understand that they are involved in two levels of critical disclosure: their Forms 10-K and Forms 10-Q, but also the system-level disclosure at the Office of Finance level.
4. There should be cooperation between the FHLBanks to prepare the CFR, and veto power by any individual FHLBank over CFR disclosures is inconsistent with this. There is a joint and several guarantee on FHLBanks consolidated debt—the CFR should similarly reflect a joint effort to disclose material information.
5. Regarding internal controls, there should be some Sarbanes-Oxley-like process at the Office of Finance.
6. The CFR as a general matter should be comparable to the disclosures of its industry peers, such as other large financial institutions like Fannie Mae, Freddie Mac, and JPMorgan Chase.

Source: February 10, 2009 meeting with various representatives of the FHFA; February 19, 2009 telephone call with David R. Poston, FHFA, Office of the Chief Accountant.