To Our Members

What a difference a year makes! In our 2002 annual report we identified several issues and trends that have the potential to alter the mission and structure of the Federal Home Loan Bank System by leading to consolidation. The questions we raised last year—about the growth of the mortgage purchase programs, the possibility of new securitization programs, SEC registration, and the expansion of multidistrict membership in the System—are still valid. These forces are still at work, and they still raise the long-term potential for structural alterations to the System that could change the way the Federal Home Loan Banks fulfill their housing mission. However, they are not the issues occupying center stage right now. Instead, questions of governance and regulatory oversight are in the spotlight.

Last spring an event that most observers would previously have considered extremely unlikely occurred when accounting irregularities were discovered at Freddie Mac. Even before those problems emerged, pressure had been building to reexamine the regulatory structure of both Fannie Mae and Freddie Mac. Freddie Mac's problems increased that pressure.

At the same time, others proposed that the FHLBanks be included in any regulatory restructuring proposal. They believed that if the regulatory structure of Fannie Mae and Freddie Mac was going to be strengthened to improve safety and soundness, the size and importance of the FHLBanks made it imperative that they receive the same treatment—both for enhanced safety and soundness and to prevent any perception in the market that the FHLBanks were less well regulated.

Our Board of Directors considered these ideas and concluded that if world-class regulation was appropriate for the other housing GSEs, it was also appropriate for the FHLBanks.

As ideas of reform developed, as specific proposals emerged, and as op-ed pieces proliferated, it became clear that there were many other objectives being pursued under the rubric of GSE regulatory reform. Observers each seem to see something different as they look at the housing GSEs. Some commentators question the value of the GSEs and whether there truly is any need for the capital market intermediary function. These people assert that the housing market would not be impaired by loss of access to the capital markets at agency rates through the GSEs. They urge privatization or elimination of the GSEs. Others seem to share that objective, but choose to couch their comments in terms of eliminating particular attributes of GSE status. These may include eliminating the relatively small line of credit with the U.S. Treasury that is made available to each GSE, eliminating the statutory exemptions from certain SEC registration requirements, and so forth. Others want to curb GSE activities or advantages in other ways, by restricting new product development, changing capital requirements, etc.

Clearly, any change that has a negative impact on access to the capital markets at agency rates would diminish the role and value of the GSEs and their contribution to housing. More expensive funding in the capital markets would reduce the availability of low-cost mortgage credit, as would any reduction in the amount of funding available.

It is our belief that the FHLBank System deserves a world-class regulator. At the same time, our objective is to maintain the cooperative structure of the System and to achieve our mission in the same way we do today. In other words, it is the regulatory structure that should be reformed, not the mission or structure of the System.

The stakeholders in the System are the ones to whom this issue matters the most. Borrowers from the FHLBanks want ongoing access to the advance programs. Members that originate loans for sale want viable and continually available alternatives to the traditional secondary mortgage market dominated by two giant GSEs. Housing advocates want a robust System so that the Affordable Housing Program and community investment programs will be consistently available through our financial institution members. The FHLBanks and the other GSEs are significant participants in numerous financial markets—their counterparties need, and expect to have, ongoing participation in the markets by the FHLBanks.

As is the case with most policy issues in America, if you choose to, you get to have a role in the decision. We urge you to be part of this process and to examine reform proposals closely as they are defined. You need to decide whether the particular things you find useful about the System will be there after reform, just as they are now.

Fortunately, as we move into these legislative debates, we are operating from a foundation of strength. Our membership base continues to grow, as we welcomed 31 new members in 2003. In addition, members' use of Bank products and services expanded significantly throughout the year. Seventy-nine percent of members actively used our products or services during 2003, up from 73% in 2002.

Advances outstanding grew 14% during the year, but, more importantly, we achieved our objective of being able to deliver solid returns to members in both expanding and contracting environments. We entered the year with an advances balance of $81.2 billion, which declined to $65.5 billion at one point in the third quarter, and then grew substantially through the rest of the year to end 2003 at $92.3 billion. Throughout the year, despite the rapid change in members' demand for advances, we continued to generate returns that were quite stable relative to our dividend benchmark.

The Bank's mission is to provide funding for its members. The need for funding may be driven by many factors, such as member asset growth or shrinkage, or the flow of deposits. Ultimately, the size of our balance sheet is not as important as our successful management of the Bank's balance sheet in a manner that gives us the flexibility to grow and shrink with member needs while continuing to deliver solid returns. This past year was a perfect example of why this strategy is so critical.

Another change you will notice as you read through this annual report is the growth in mortgage loans acquired through our mortgage purchase program. Mortgage loans on our balance sheet grew from $0.3 billion to $6.4 billion during the year. This program provides members with an attractive alternative to selling loans into the secondary market. It also provides the Bank with a way to diversify our revenue sources while enhancing our dividend, which allows us to continue to offer pricing on advances that is competitive with alternative funding sources for any of our members, along with an attractive dividend.

We recognize that owning long-term fixed rate mortgages also adds considerable interest rate risk to our balance sheet, a point that is regularly mentioned in the financial press. We devote considerable resources and attention to managing this risk. Last year provided a good test for those resources, as longer-term interest rates fluctuated throughout the year and led to rapid swings in prepayment rates on mortgages. In 2003, our funding and hedging strategies proved they were up to the test.

In closing, we thank the Bank's directors for their leadership and guidance. Given the significance of the issues being debated today, we are fortunate to be led by a Board of Directors that understands the dynamics of the System and appreciates the importance of its unique mission and structure. In particular, we thank our outgoing Chairman of the Board, Mary Lee Widener, and Vice Chairman of the Board, D. Tad Lowrey. Ms. Widener served as Chairman for the past ten years, and she did a remarkable job leading us through times of significant change for the Bank and the System. Mr. Lowrey served on the Board as an industry director for eight years, the last two as Vice Chairman, and also contributed greatly to our success. In addition, we would like to welcome Monte L. Miller and John F. Robinson to the Board.

We also thank the members of our Affordable Housing Advisory Council for sharing their insight into the housing and economic development needs of our region in order to make our community investment programs and services more effective. In addition, we thank the Bank's employees, who work on a daily basis to meet the needs of members, achieve the Bank's mission, and preserve the safety and soundness of the Bank.

Above all, we thank you, our members, for your business and for your investment in the Bank. The purpose and structure of the Bank only matter as long as you are in the community, working to provide the credit and other financial products your customers need, contributing to the vitality and prosperity of the regions you serve.

Timothy R. Chrisman

VICE CHAIRMAN OF THE BOARD

Robert N. Barone

CHAIRMAN OF THE BOARD

Dean Schultz

PRESIDENT AND CEO