Report of the Horizontal Review of Board Governance of the Federal Home Loan Banks

June 2003

Preface

The Federal Home Loan Bank Act (the "Bank Act"), as amended by the Financial Institutions Reform Recovery and Enforcement Act (FIRREA), made the Federal Housing Finance Board (the "Finance Board") responsible for the supervision and regulation of the twelve Federal Home Loan Banks (the "Banks"). The Bank Act also gave the Finance Board broad powers, including those that involved the Finance Board directly in the business affairs of the Banks. The Federal Home Loan Bank System Modernization Act of 1999 recognized that the Finance Board's authorities in those areas were inappropriate and they were in large part repealed. Consequently, stewardship responsibilities for the affairs of each Bank now rest fully with its board of directors.

The review of board governance of the Federal Home Loan Banks was designed to assist the Finance Board in directing and developing its supervisory and regulatory initiatives. The review included all twelve Banks, but not the Office of Finance. In the course of our review, we visited each of the Banks and interviewed key members of the Banks' boards and management. We also reviewed Bank documents, particularly with respect to board policies, practices, and decisions. However, these activities did not constitute an examination of the Bank. In an effort to elicit candid and full responses, we assured each of the participants that the review would not be viewed as an examination of the Bank and that the observations from our reviews would not be considered an examination report.

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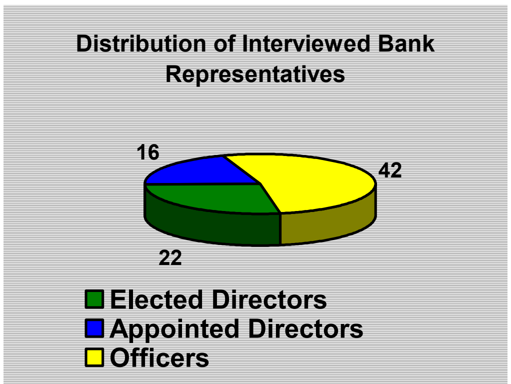
Introduction

An independent-minded, informed, and engaged board of directors is the cornerstone to the operation and mission of the Federal Home Loan Banks (the "Banks") and the Federal Home Loan Bank System (the "System"). From October 2002 through February 2003, the Federal Housing Finance Board (the "Finance Board") conducted a series of targeted reviews to assess the effectiveness of board governance at each of the 12 Federal Home Loan Banks. These reviews were aimed at enhancing our understanding of board governance at the 12 Banks and to identify practices that contribute to effective governance programs among the Banks.



Finance Board staff from the Office of Supervision and the Office of General Counsel visited each Bank to conduct the reviews. Their visits lasted one week per Bank. At each Bank, the teams completed a work program, which is reproduced in the Appendix. Senior Bank Examiners in the Office of Supervision developed the work program, which consists of two modules – an interview module and a document review module. To complete the interview module, the review team interviewed elected directors, appointed directors, and executive officers to gain their insights on board governance practices at their respective Bank. The chart at left illustrates the distribution of Bank representatives interviewed during the 12 board governance reviews. To complete the document review module, the review team examined various documents, including board and committee minutes, Bank policies and procedures, Finance Board reports of examination, and Bank risk assessment programs.

This report is in four sections. The first section summarizes the indicators and standards of board effectiveness that guided our analysis. Following that description of the indicators and standards, the second section presents our observations about board effectiveness throughout the System and our recommendations regarding steps the Banks could take to enhance board effectiveness with respect to each indicator. The observations and recommendations reflect our judgment with respect to prudent and effective practices, taking into consideration the fact that the Banks are cooperatives; they are government sponsored enterprises (GSEs); and they are constrained by statutory and regulatory requirements with respect to appointment and election of directors. The third section of the report summarizes statutory and regulatory issues that influence board governance at the twelve Banks. The final section describes areas where we anticipate further work or study by the Finance Board.

Indicators and Standards of Board Effectiveness

We reviewed board effectiveness at the twelve Federal Home Loan Banks relative to eight indicators of board effectiveness. We identified these indicators by drawing on our own experiences as financial institution supervisors and our review of literature published by domestic and international supervisory and consulting organizations that have studied board governance. The eight indicators are:

- ***Engaged Board of Directors***
- ***Skilled Senior Management***
- ***Thorough Strategic Planning***
- ***Sound Risk Management***
- ***Robust Internal Controls***
- ***Effective Audit Program***
- ***Strong Ethical Culture***
- ***Timely, Accurate, and Complete Communications***

An engaged board of directors is one in which the board is actively involved in critical discussions and decisions about Bank business strategies and in establishing risk limits. Because of the size of many of the Bank boards, we paid particular attention in our review to the involvement of a broad spectrum of board members in critical discussions and decisions reached by the board. We also reviewed the functioning of board committees, such as the governance committee, the audit committee, and the risk committee. We also reviewed the extent to which the board regularly assessed directors' training needs; the training actually provided to board members, particularly new board members; the frequency and content of board and committee meetings; the process by which committee assignments were made; and whether the board systematically obtained and analyzed director assessments of board or committee effectiveness.

Skilled senior management is critical to the effective functioning of a Bank. The board is responsible for selecting key members of the senior management team and for regularly assessing the effectiveness of the Bank's senior managers. In each review, we paid particular attention to succession planning at the Bank, the Bank's recruitment practices, and the board's oversight of the performance of senior management. We determined whether the board actively considered external and internal candidates for executive positions. We also checked to determine whether executive incentives were tied to the Bank's performance and integrated with performance relative to strategic goals.

Thorough strategic planning assists a Bank in establishing priorities, particularly with respect to business strategies and the appropriate tradeoff between risk and return. We reviewed the strategic plans and the strategic planning process at each Bank to understand the role of the board in establishing the Bank's strategic goals and objectives. We also reviewed the extent to which those goals and objectives had been integrated into the Bank's operations, particularly in establishing annual budgets. Regular strategic planning sessions with the active participation of the Bank's directors, along with metrics to track the Bank's performance relative to the strategic plan, were key elements of our assessment.

Sound risk management means measuring risk accurately, understanding the implications of that risk, and ensuring appropriate systems are in place to identify problems before they materially affect the Bank. Banking is a business of managing risks, so our intention in looking at risk management was not to discourage the Banks from accepting appropriate risks, but rather to assess the extent to which their acceptance of risk was deliberate, integrated, appropriate, and managed. In reviewing the risk management factor, we checked the involvement of the board in setting risk tolerance limits, measuring risk using multiple tools, requiring risks to be measured and reported to the board in clear and understandable ways, and employing an enterprise-wide risk management program. We reviewed the extent to which business units are responsible for identifying, assessing, and controlling risk. While we did not expect to observe board involvement in daily risk management activities, we did expect the board to establish standards for the extent to which the Bank may assume risk and the kinds of risk the Bank may assume.

Robust internal controls are necessary to effect sound risk management. Their purpose is to provide the board with a means of identifying or detecting exceptions to board approved policies or violations of law; unauthorized transactions; reporting irregularities; and waste, fraud, and abuse. Appropriate controls will vary among the Banks, based on their business strategies, their risk profile, and their risk management philosophy. Our review focused on the use of management information systems and technology to map control processes and provide timely reports of deficiencies and needed remedies. We paid particular attention to the incidence of internal control breakdowns at the Bank.

An effective audit program works in concert with a robust internal control environment to properly manage risk. An effective audit program tests and monitors internal controls and provides the board an independent assessment of the Bank's risk management and controls. Our assessment focused on the staffing, training, and independence of the internal audit staff; the quality and independence of the external auditor; and the active involvement of the board, particularly the audit committee of the board. We particularly looked for an effectively functioning board audit committee receiving thorough and independent reports from both internal and external auditors.

A strong ethical culture throughout the organization is critical for its longer-term effectiveness. While robust internal controls and an effective and independent audit function can identify program deficiencies, appropriate corrective action depends on the integrity and ethical values of an organization's leadership. Although a strong ethical culture transcends policies and procedures, for purposes of our review, the existence of explicit written ethics and conflict of interest policies were key to determining whether a Bank met this standard. Our review also considered the Bank staff's understanding of and commitment to programs intended to ensure adherence to those codes and adherence to standards for the appropriate use and confidential treatment of information, including information about other employees.

Timely, accurate, and complete communications are critical to ensuring the decisions of a Bank's member institutions, including but not limited to the selection of elected directors, are informed.

The Bank's activities, furthermore, should be transparent to its members. We paid particular attention to practices designed to give the board and member institutions timely and useful information about the Bank's business strategies, financial performance, and controls. The quality of information available to the board and the Bank's membership is critical to ensuring that the Bank's business and risk management strategies serve its members and support housing finance. As such, in our review, we paid particular attention to the quality of information shared with the Bank's member institutions and the means the Banks use to facilitate access to that information.

These eight indicators are closely related. For example, an engaged board sets the strategic direction of the Bank, with a thorough understanding of the potential risks and rewards of that strategy. That board oversees the selection of key executives and ensures they are evaluated relative to the strategic plan and intermediate term goals and objectives. That board also sets expectations for timely reports from management in order to ensure that the Bank's operations are consistent with a board approved business strategy, including risk tolerances, and with the needs of the Bank's member institutions. An engaged board also ensures that it hears regularly from the internal and external auditors, and explores their findings critically and without undue influence from senior managers.

In light of the interrelationship of these eight indicators of board effectiveness, we further grouped them into three broader standards for purposes of our review of board governance. The three over-arching standards we established in reaching conclusions about board effectiveness are:

- ***Board Oversight***
- ***Risk Management***
- ***Controls***

We "mapped" the eight indicators to the three standards as shown in the table below. While this process is necessarily subjective, we identified those indicators we believed to be most important to achieving the three standards. There is, as one would expect, some overlap in the interrelationships among the indicators. Communication, however, is the one indicator common to all of the standards. The quality of information provided to the board, senior management, employees, and the member/shareholders, is critical to an effective board governance program and the operating success of the Bank.

Board Oversight	Risk Management	Controls
• Engaged Board	• Engaged Board	• Robust Internal Controls
• Skilled Senior Management	• Strategic Planning	• Effective Audit Program
• Strategic Planning	• Sound Risk Management	• Strong Ethical Culture
• Communications	• Communications	• Communications

In assessing ***Board Oversight*****,** we considered the extent to which the board was engaged, its effectiveness in assembling and evaluating a skilled management team, the extent of strategic planning, and the quality and completeness of the information available to board members to facilitate decision making. As such, in reviewing Board Oversight, we considered the elements of an engaged board, skilled senior management, thorough strategic planning, and timely, accurate, and complete communications.

In assessing ***Risk Management*,** we considered the extent to which the board communicated risk tolerance parameters to Bank management, the extent to which risk assessment was incorporated into strategic planning, and the quality and sophistication of risk management at the Bank, including risk identification, measurement, monitoring, and control. We also considered the quality of management information systems and the completeness and timeliness of risk management reports provided to the board. As such, in reviewing Risk Management, we considered the elements of thorough strategic planning, sound risk management, and timely, accurate, and complete communications.

In assessing ***Controls*,** we considered the effectiveness of the internal control environment at the Bank, the independence of the internal auditor and the internal audit process, the quality of external audits, and the integration of audit results into the board's strategic planning. We also considered the quality and completeness of the audit information provided to the board. As such, in reviewing Controls, we considered the elements of robust internal controls; effective audit program, strong ethical culture, and timely, accurate, and complete communications.

These three standards – ***Board Oversight, Risk Management, and Controls*** – form a foundation for effective board governance. We do not mean to suggest that these three standards constitute a formula for success. For example, the success of a board depends critically on the interactions among board members and between a Bank's board and its senior management. As important as we believe the indicators and standards are to promoting an environment conducive to effective board governance practices, they do not, in and of themselves guarantee success.

System Observations and Effective Practices

Overall Observations

The increasingly complex business of the Banks makes effective board governance a corporate imperative for each of them. We found strengths and weaknesses with respect to each of our eight indicators and three standards at each of the 12 Banks. Our review also suggests that the overall effectiveness of board governance varies widely among the Banks.

From our review, it appears that ***Board Oversight*** is at the heart of an effective governance program. Among the Banks our review team judged to be most effective, we always found them to have an engaged board of directors, effective selection and oversight of senior managers, and thorough strategic planning and follow through. Not to diminish the importance of ***Risk Management*** and ***Controls*,** but our review indicates that the oversight provided by the members of the board is the most critical element in determining a board's effectiveness. A substantive and effective risk management and control environment may be necessary for an effective board governance program, but together they do not appear to be sufficient (or perhaps even possible) without active board oversight. The right people on the board can make a difference. We found that the Banks with the weakest overall governance programs demonstrated weaknesses in board engagement, selection and oversight of senior management, and strategic planning. They also tended to exhibit deficiencies in their risk management function.

As described in an earlier section of this report and in additional detail in the appendix, as part of our work program, we established performance factors for each indicator for board effectiveness. We reviewed each Bank's performance against those performance factors and noted strengths and weaknesses within each indicator. Examples are listed in the following table.

Indicator	***Strong***	***Weak***
Engaged Board	➢ Established authority and responsibility ➢ Formal governance committee ➢ Periodic assessment of board effectiveness ➢ Timely distribution of materials in advance of board meetings ➢ Training for board members	➢ Infrequent meetings ➢ Management driven ➢ High turnover among directors ➢ Incomplete documentation of board deliberations and decisions ➢ Limited input on committee assignments
Senior Management	➢ Formal succession planning ➢ Plan-linked performance goals ➢ Open recruitment	➢ Inadequate succession planning ➢ Compensation not tied to performance ➢ Limited or restricted recruitment
Strategic Planning	➢ Directors surveyed on issues ➢ Performance and variance reports ➢ Board meeting or retreat devoted to strategic planning	➢ Informal planning process ➢ Performance not systematically tracked relative to strategic plan ➢ Plan not regularly updated
Risk Management	➢ Enterprise-wide program ➢ Effective use of models ➢ Forward-looking	➢ Not linked to business plan ➢ Limited use of technology
Internal Controls	➢ Control process mapping	➢ Manual systems
Audit Program	➢ Independent and objective program ➢ Commitment of resources ➢ Independent access to board ➢ Risk-based	➢ Inadequate resources ➢ Incomplete staff training/preparation ➢ High risk areas not audited annually ➢ Exceptions to audit plan not documented
Ethical Culture	➢ Comprehensive ethics policies ➢ Tracking and reporting system for conflicts of interest	➢ No policy regarding potential conflicts of interest in awarding AHP funds
Communication	➢ Monthly President's newsletter ➢ Web site for board members only	➢ Infrequent financial reporting to members

Engaged Board of Directors

An engaged board of directors is a principal component of an effective board governance program. We found many instances in which a Bank's board of directors was satisfactorily engaged. However, we found other instances in which a Bank's performance under this indicator needed improvement. Three principal areas related to board engagement that needed improvement at a number of the Banks were:

- *Knowledge, skills, and training*;
- *Information reporting*; and
- *Committee structure*.

The most common deficiency was in the knowledge and skills of directors and the training provided for them. Attention to the training needs of directors, frequency of meetings, clarity of information, and the manner in which committees are selected and function were factors we identified as needing improvement at some of the Banks. We also found that board and committee minutes often did not fully reflect discussion or dissenting views.

Knowledge, Skills, and Training. There is room for improvement in the knowledge and skills of board members on a System-wide basis. Some Banks lack a formal assessment process to determine the training needs of new directors. In those Banks, the chairman of the board and/or the president informally assesses skills and training needs. All Banks provide new director orientation sessions, which range in duration from a few hours to two-days. In addition, most Banks provide periodic training on issues that may affect the Bank. Training normally occurs prior to board meetings or as a segment of a scheduled board meeting. Training is usually provided by Bank management and staff, although most Banks use consultants on occasion to brief directors on highly technical topics, such as derivatives.

We concluded that many directors would benefit from additional capital markets training, particularly with respect to market risk, hedging, and modeling. We found both elected and appointed directors could benefit from more training, but the training needs tended to be more acute for appointed directors. Most of the Banks are already offering some training in this area, but limited capital markets experience, director turnover, and the complexities of many capital markets transactions will continue to make this an area for focused training. While it is not necessary for each director to be technically skilled in this area, each board should have some capital markets expertise among its directors.

Information Reporting. We found the best board packages focus the directors' attention on important issues or concerns. Priorities are clear. The requested board action is identified. Relevant data and information are provided along with explanatory context. In our reviews, however, we found some board packages contained large amounts of data without explanatory comments. In our reviews, we were critical of tables and charts without accompanying narrative and of board packages that contained a vast number of documents without adequate guidance with respect to their relative importance in conducting the board's business.

At many of the Banks, communication between board meetings is informal and depends on the preference of the board and committee chairs. We found some instances of regular or more formal communications. Some notable examples include information shared by executive committees that can act on behalf of the full board, board web information portals, board newsletters, and monthly financial reporting communicated during months outside of a scheduled board meeting.

Board governance is a matter that must be dealt with actively. It is not the result of something happening, but an activity deserving and in need of management and discipline.

One Bank has established a Board Governance Committee and has plans for a Governance Unit. The Governance Unit will comprise a full-time staff dedicated to the board to strengthen oversight responsibilities and capabilities. This Bank has also developed a Director's Handbook and a directors' web "info-portal."

At another Bank, directors are asked to complete an annual survey on board and management effectiveness, board operations, and board materials.

Committee Structure. We concluded that the structure and function of board committees is satisfactory overall, but that improvements are warranted. We found the number of committees and their function to be sufficient to identify, analyze, and establish controls on the risks to which the Banks are exposed. At many of the Banks, much of the board analysis is done in committees, with the most critical committees normally being the executive or governance committee, the audit committee, and the risk committee. The number of standing committees ranged from five to eight among the Banks. We were satisfied with the number of committees and their responsibilities. However, we believe that some board committees meet too infrequently. In particular, meetings less frequently than quarterly for asset/liability, credit, finance, risk management, and audit committees are not likely to be sufficient to manage the risks attendant to their oversight responsibilities. In some cases, particularly in the case of a board's audit committee, quarterly meetings are insufficient.

In general, some of the Banks should improve the process of selecting board and committee chairpersons and assigning committee memberships. We were most concerned about the lack of transparent or inclusive selection processes. For example, at some Banks, assignment of committee memberships is at the discretion of the Chairman of the Board or elective directors, while other Banks involve senior management. Committee selection processes that rely on only one person or the recommendations of senior management may diminish the independence of directors.

We found that board meetings at all of the 12 Banks are held on a regular basis. Some boards meet about nine times throughout the year. Others meet approximately every other month, excluding special meetings for strategic planning purposes. Given the size and complexity of the Banks, we believe that meeting every other month is too infrequent.

Recommendations

Most of the 12 Federal Home Loan Banks already are taking steps to promote the engagement of their boards of directors. They can further those efforts by:

- Ensuring board packages prioritize issues and clearly identify the action requested.
- Offering additional capital markets training for directors – particularly in the areas of derivatives and hedging.
- Holding more than six board meetings a year.
- Holding more than four audit committee meetings a year.
- Promoting additional accounting or finance expertise among audit committee members.
- Using transparent and inclusive processes for selecting committee chairs and assigning committee memberships.

Effective Practices

An engaged board of directors ultimately depends on the knowledge, skills, and commitment of its members. However, certain practices may help to foster engagement. Among the practices we observed at the Banks that we believe promote engagement are:

- A secure web portal for directors, which includes board and committee minutes, previous and current board packages in their entirety, board policies, and other documents intended to provide easy access to Bank information.

- An orientation program for all new directors.

- A monthly newsletter containing relevant Bank and System information that provides directors with information and updates between scheduled meetings.

- A succinct and prioritized agenda book.

- Assignment of specific senior managers to board committees to provide support for the committees and to serve as a point of contact for directors.

- A formal governance committee.

- An annual survey of directors to identify informational and training needs.

- Self-assessments to improve board functioning and identify training opportunities.

Skilled Senior Management

Board practices for selecting and retaining ***skilled senior management*** at the Banks are generally satisfactory. Most of the Banks also have satisfactory performance management programs. However, a number of Banks should improve their succession planning, in part by adopting more formalized succession planning processes.

The Banks have varied selection and retention practices. The best practices are those at Banks where boards have engaged the services of executive search firms and/or have canvassed wide geographic areas to attract qualified candidates. The boards of some Banks, however, have done neither. Internal candidates will often warrant selection for executive management positions, but organizations of the size and complexity of the Federal Home Loan Banks, should select executive managers from as broad and diverse a pool of qualified candidates as possible.

Retention practices have been good and seem to be improving. Many of the Banks have employed consultants to conduct an analysis of management compensation. These analyses have identified factors that should be considered in assessing performance and establishing compensation, incentive programs, and longer-term benefits. Merit increases and incentive compensation are appropriately tied to goals derived from strategic and/or business plans at most of the Banks.

Some of the Banks are facing high turnover and recruitment problems for certain specialty functions, particularly in internal audit. The board of directors at Banks in which turnover is a problem and recruitment has been difficult need to reassess their compensation packages and the recruitment practices applicable to senior managers.

Many of the Banks have formal performance management programs that incorporate goals based on strategic or business plan objectives. These practices are conceptually sound when the Board explicitly considers these goals in setting executive management compensation. In practice, the results were mixed. We found that the Boards that assess the performance of the Bank president annually in writing -- whether through an *ad-hoc* committee, permanent committee, or by the chairman of the board – demonstrated the best practices in this regard.

The majority of Banks need to improve their succession planning. Those Banks with effective succession planning have devoted considerable resources to leadership continuity planning. These well-developed plans identify key management positions and analyze their probability of turnover, potential internal successors, and external recruitment strategies. The best also identify training needs for senior managers to provide opportunities for cross training and to identify and develop future leaders from within the organization. Succession planning should be improved at those Banks with no formal succession plan, an out-of-date succession plan, or a succession plan limited solely to the position of president.

Recommendations

Most of the boards are effective in selecting and retaining skilled senior managers. They can further those efforts by:

- Considering external, as well as internal, candidates when filling executive management positions.
- Ensuring executive compensation is linked to the Bank's success in meeting the board's strategic and business objectives.
- Improving their recruitment of senior managers in certain specialty functions, such as internal audit.
- Updating or formalizing succession planning.
- Expanding the scope of succession plans to include positions other than president.

Effective Practices

We observed a number of practices that effectively helped to promote ***skilled senior management***. Among them were:

- Soliciting input from all directors on the president's written performance evaluation.
- Integrating senior management's incentive compensation with the Bank's strategic plan.
- Including developmental opportunities and cross training in succession planning.
- Benchmarking studies for job responsibilities and compensation.

Thorough Strategic Planning

Thorough strategic planning is evident among many of the Banks. Some have particularly strong strategic planning programs. Even among those Banks having strong planning practices, however, performance tracking can be improved. The Banks rely too much on intermittent or *ad hoc* analysis and review of actual performance against strategic plan goals.

Those Banks with strong strategic planning practices survey directors on strategic issues; fully analyze risks and opportunities, including systemic risk; and report on performance, particularly with an eye to explaining variances from plans. Strong planning exists at Banks that invite and obtain board input throughout the process. Weak planning processes exist at Banks that limit or marginalize board input and rely on management almost to the exclusion of the board. Several Banks conduct annual multi-day strategic planning conferences. A few of the Banks designate a specific board committee to oversee the development of the strategic plan in addition to a management committee charged with overseeing the development process. Multi-year plans, complete with scenario analyses, are representative of Banks with the strongest processes.

Most of the Federal Home Loan Banks do not use consultants for their strategic planning other than as facilitators at planning conferences. They may use technical experts to develop assumptions or to brief the board on specific issues, but not to articulate the organization's goals and objectives. Some Banks solicit input for longer-term goals and objectives from their membership through, for example, focus groups or surveys.

While there are many positives in the Banks' strategic planning activities, their performance tracking needs improvement. Most Banks review performance tracking only annually, a process that seems to be driven by regulation, which requires an annual review of strategic plans. Strategic plan performance tracking within the System is typically an infrequent and/or informal comparison of actual to *pro forma* results. The strongest programs track their performance and compare it to strategic plan goals quarterly or semiannually. Some Banks do not formally assess performance relative to strategic plan objectives. At the Banks that do, staff is generally well aware of strategic objectives, which are integrated within a functional area's performance measures.

Recommendations

Each of the 12 Federal Home Loan Banks has a strategic planning program. Some programs are very effective. All of the Banks can promote effective strategic planning by:

- Formally monitoring the Bank's actual performance relative to strategic plan goals and objectives quarterly.
- Integrating executive compensation with achievement of strategic plan goals and objectives.
- Formalizing processes to elicit strategic plan input from directors, including an annual strategic planning session with the board.

Effective Practices

We observed a number of notable practices during our reviews that promote ***thorough strategic planning***. Those practices included:

- Surveying directors concerning strategic issues.
- Holding off-site meetings of directors for the sole purpose of strategic planning.
- Conducting a comprehensive risk/reward analysis before engaging in new activities.

- Incorporating scenario analysis into strategic planning, including base-, best-, and worst-case scenarios.

- Preparing periodic board reports comparing actual performance to plan and explaining variances.

Sound Risk Management

A Bank's board should approve all significant policies relating to the management of risks throughout the institution. The board should also ensure that the Bank has in place a process for systematically identifying, measuring, monitoring, and controlling risks. The board must also ensure that it remains informed about the risks to which the Bank is exposed, that those risks are prudent in light of board-approved policies, business strategies, and risk limits.

In our review, we observed that the Banks' risk management techniques are improving, reflective of the evolution of the risk management discipline throughout the financial sector. However, further improvement is needed at most of the Banks. The effectiveness of the boards in overseeing risk management processes varies across the Banks, depending, in part on the extent to which the board has effectively established a process that ensures that management systematically brings identified risks to the board's attention. In addition, board members with risk management experience in other endeavors can significantly contribute to the effectiveness of the board's oversight of a Bank's risk management activities.

The Banks need to further their development and use of quantitative and technological risk management tools commensurate with the increasingly complex business of the Banks. Through the capital plan implementation process, most of the Banks have substantially enhanced their use of interest rate risk management models, but they will need to further enhance these tools as their mortgage portfolios and mortgage hedging activities grow in size and complexity. As the Banks expand these activities, their boards must be alert to the concomitant risk/reward tradeoff to ensure that the expansion meets the board's strategic objectives.

We found that the boards of Banks with effective risk management programs set risk tolerance limits, monitor exceptions to those limits, require that risk be reported to the board in clear and understandable ways, and employ an enterprise-wide program for risk management. Directors also approve risk policies and procedures.

Most of the Banks' boards of directors use annual risk assessments to identify, measure, monitor, and control risks. The most effective boards expect risk assessments to be more frequently than that, however. Currently, one Bank in the System conducts quarterly risk assessments, while another Bank plans to conduct risk assessments on a continual basis.

Enterprise-Wide Risk Management

Since the introduction of enterprise-wide risk analysis and management in the early 1990s, risk management has evolved rapidly. Enterprise-wide risk management has several dimensions. First, every unit has risk, even if it is only operational risk. Second, there are risks, such as reputation risk, that are enterprise-wide. Third, in order to be effective, risk ownership is critical; every risk must have an owner."

An enterprise-wide program recognizes that line and unit managers are risk managers. Enterprise-wide risk management programs call for these managers to conduct risk assessments, measure and monitor the risks, put in place controls to mitigate the risks, and identify any gaps in the controls. These "sponsors" are responsible for their own units and for contributing to the enterprise systems. They take responsibility for the whole, even though they may not be responsible for all of the parts.

One Bank has five risk teams, a chief risk officer, and an annual budget for this function. The Bank's risk management policy fully considers statutory, regulatory, and Bank compliance guidelines and the results of the annual and quarterly risk assessments are detailed and reported to the board of directors.

We found that in most of the Banks, deviations from approved risk procedures are typically identified by the internal audit function or through self-reporting by management. Many boards delegate risk oversight responsibilities to board committees. Delegating risk oversight in that way is appropriate, however, audit or risk committees at several Banks do not meet frequently enough to discharge this duty most effectively. Board audit or risk committees to whom overseeing the testing of controls for Bank-wide risks has been delegated should meet more often than four times per year.

We found that in most instances, board packages provided the necessary information for the boards to carry out their risk oversight responsibilities. However, in some instances, the board packages did not have sufficient focus to facilitate risk identification and prioritization, especially for newer board members or board members without much background in risk management. We also observed that enterprise-wide risk management programs are increasing in number within the System, but are still not in place at every Bank.

Recommendations

The Banks evidence *sound risk management* practices, but those practices can be enhanced by:

- Adopting enterprise-wide risk management.
- Considering associated risks as well as returns in assessing business strategies.
- Conducting risk assessments more frequently than annually.
- Holding board audit or risk committee meetings more frequently than quarterly.
- Enhancing the financial risk management expertise of directors.

Effective Practices

We observed at the Banks a number of practices representative of ***sound risk management*** including:

- Providing the board with detailed explanations of all exceptions to the board's established risk tolerance limits.
- Measuring interest rate risk using multiple models.
- Reporting risk measurements to the board in a timely and easy-to-understand format.
- Providing training to directors on hedging activities and on the use of derivatives.
- Including risk management in the strategic planning process.

Robust Internal Controls and Effective Audit Program

Robust internal controls allow a Bank to prevent or detect inappropriate or unauthorized transactions; exceptions to Bank policies, procedures, and risk limits; violations of laws and regulations; and procedural deficiencies resulting in unanticipated risks. Internal controls should be appropriate for the Bank's business strategies, the board's appetite for risk, and the regulatory environment within which the Bank operates.

We found the board oversight of the internal controls at most of the Banks to be satisfactory. However, many of the Banks still rely heavily on manual processes that may not be adequate given the size and complexity of Bank operations. From our interviews, we learned that managers and directors recognize they may need to increase their investment in technology to enhance their internal controls; however, those investments are still largely unfunded. Indeed, many of the significant internal control breakdowns within the System tend to be caused by human error, which can be minimized or eliminated by reducing the volume of manual transactions and using technology platforms that communicate among and between business lines and match aggregate risks.

With the advent of enterprise-wide risk management, it is becoming more prevalent for Banks to task business units with identifying all risk and risk mitigation processes within their functional area. The reports from these efforts funnel up to a risk manager, risk management committee, or internal audit department. Banks' audit committees conduct internal control monitoring. Risk management committees or risk managers oversee risk self-assessments. Institutions that conduct risk assessments more than annually are few, but noteworthy.

All of the Banks have functioning audit committees that establish and approve internal and external audit programs, adopt audit committee charters, and approve charters for directors of audit committees. Audit committees receive all audit reports and review them as appropriate. At most of the Banks, exceptions to internal controls are reported to the board in a timely manner. Some Banks have senior management affirm at each board meeting that the investment and credit activities comply with appropriate regulations and policies.

Control Process Mapping

Many companies have adopted quality control programs to improve customer service and other business functions. Over the years, these programs, whether known as *Zero Defects* or the most recent and most popular *Six Sigma*™, have had in common the objectives of improving performance or eliminating error or variance. Those objectives are achieved by defining opportunities, measuring process control performance, analyzing the root cause of poor performance, and improving performance by eliminating variability.

One effective tool of a quality control process is process mapping. That is, displaying visually, through flow charts, each step in a process. This process mapping, thus, represents a flow of activities that transforms a set of inputs into a set of predetermined outputs. A company or unit can then identify critical control points, measure the level of risk at those points, and develop control procedures to limit or eliminate risk or error.

Some of the Banks have initiated and are implementing control process mapping as part of their risk management and control functions to aid in risk assessment and control.

At many of the Banks, however, audit committees meet too infrequently, some meeting only quarterly. This seems to be the case throughout the System and continues despite employee and management turnover, complex or risky business activities, or internal control breakdowns. Generally, we did not find that audit committees had increased the frequency of regular meetings in response to increased risk.

An ***effective internal audit program*** is the primary method the Banks' boards use to independently assess the adequacy of the Bank's control environment. Audit programs throughout the Federal Home Loan Banks are well structured and appropriate in scope. Annual risk assessments focus on high-risk areas along with a sample of lower risk areas. We found that in some cases, exceptions to such an audit strategy were not satisfactorily documented or planned audit frequencies were not adequate. The weakest audit programs lack full independence and are understaffed or inadequately skilled.

Among the Federal Home Loan Banks, generally we found that the directors of internal audit report to the audit committee, and the audit committees conduct the annual performance evaluation for the director of internal audit. Both practices are appropriate. However, we found at least one instance in which the Bank president regularly attended audit committee meetings and was involved in assessing the performance of the internal auditor. Those practices compromise the independence of the internal audit function.

In some Banks, internal audit for the areas of capital markets and/or information technology are outsourced, because of a lack of in-house expertise. We also observed some instances in which a Bank's internal audit department was inadequately staffed or staffed with individuals without proper qualifications. Excessive turnover was a problem in a few cases, as was a failure on the part of the board's audit committee to approve exceptions to high-risk audit plans.

According to interviewed Bank representatives, Banks depend less on the external auditors to assess the adequacy of the control environment because they believe that the external auditors often rely on the work of the internal audit function. If that is the case, the boards can enhance the quality of the audit function by taking steps to ensure that external auditors are working independently of internal auditors.

Recommendations

Internal controls and audit effectiveness among the Federal Home Loan Banks can be enhanced by:

- Allocating additional resources to control and audit functions.
- Making greater use of technology.
- Increasing the frequency of board audit committee meetings.
- Ensuring high-risk areas are audited at least annually.
- Limiting the extent to which external auditors rely on internal audit findings.
- Ensuring the board, not management, controls the selection, retention, and evaluation of the internal audit director and the internal audit staff.

Effective Practices

During our review, we observed a number of effective practices that promote ***robust internal controls*** and ***effective audit programs***. They include:

- Ensuring the Internal Audit Director meets periodically with the board or its audit committee in executive session regarding the effectiveness of the internal control system.

- Timely reporting of internal control deficiencies to the board.

- Assessing and mapping control processes at the business unit level.

- Auditing high-risk audit areas at least annually.

Strong Ethical Culture

The framework for a ***strong ethical culture*** exists across the System. Collectively known as codes of conduct, all boards of directors of the Banks have instituted programs ensuring ethical conduct, confidentiality of information, and employee treatment and safety. The boards of all of the Banks have established similar frameworks for promoting ethical conduct. Policies governing workplace conduct, such as disclosure of confidential information, treatment of coworkers, workplace safety, sexual harassment, and acceptance of gifts are common. Boards have adopted conflict of interest policies that require directors to disclose and resolve conflicts, and to maintain compliance with regulations. Attestation or certification of receipt and compliance are also common. One general observation is a need for better tracking and reporting of directors' interests to assist in avoiding conflicts. Along these lines, the development of policies and procedures with respect to potential conflicts of interest in Affordable Housing Programs would improve these programs.

Many of the Banks implement policies and practices that go beyond the codes of conduct and conflict of interest policies to create work environments that promote a positive ethical culture. Expectations are very clear, although there is not always a system in place that goes beyond reporting of a conflict. Such a system would provide operating units with a list of director interests to aid in preventing potential conflicts. Interviewed representatives from Banks with such programs believe that infractions are handled fairly and consistently. Emphasis and value are placed on integrity, fairness, diversity, and a favorable environment in which to work.

Recommendations

Programs to promote an ethical culture can be further enhanced by:

- Implementing improved systems for tracking and reporting directors' interests.
- Developing policies and procedures to guard against conflicts of interest in the award of AHP grants.

Effective Practices

- New directors receive ethics training as part of their orientation program.
- The Bank's General Counsel provides ongoing training to directors, management and staff.
- Directors, officers, and employees are reminded of instances that may constitute conflicts of interest or inappropriate conduct in the workplace.

Timely, Accurate, and Complete Communications

All of the Banks have developed ***timely, accurate, and complete communication*** practices to convey information about the Bank, its products, and its financial performance to member institutions. Periodic financial reporting and membership communication exist at all of the Banks. Notable practices include a monthly president's newsletter to member/shareholders and web sites dedicated to board or member communications.

All of the Banks publish periodic financial reports to its membership in addition to financial reports submitted to the Office of Finance. Most of the Banks publish quarterly and annual reports, but a few Banks publish only semi-annual and annual reports. The reports contain extensive information and satisfy many, but not all, SEC standards. For example, published reports do not generally include detailed management description and analysis of the Bank's financial performance. They do not generally include information regarding senior management, volume of related party transactions, and organizational structures. Some Banks, however, include biographical information on directors and senior management.

Most of the Banks communicate regularly with their member institutions. Bank websites are the common distribution channel for information related to issues and announcements. Banks also publish newsletters for their membership and hold periodic regional shareholder meetings.

Recommendations

The Banks have many programs in place to communicate with their members, but those programs can be further enhanced by:

- Providing enhanced disclosures to members at least quarterly.
- Disclosing additional information regarding senior management and organizational structure.

Effective Practices

We observed a number of notable practices that contributed to *timely, accurate, and complete communications* to members including:

- A monthly President's letter to the membership.

- Informative websites.

Statutory and Regulatory Issues

The structure of the Federal Home Loan Bank System and the rules regarding board size, selection, and composition are factors that complicate the application of generally accepted board governance standards to the Federal Home Loan Banks. For example, statutory and regulatory provisions govern the selection of the Banks' directors, determine the size and composition of boards, restrict the potential for directors as well as Bank managers and staff to influence the election of directors, set board terms, and govern director compensation. Section 7 of the Federal Home Loan Bank Act (the "Bank Act") and Parts 915, 917, and 918 of the Finance Board regulations address board size, board composition, the selection of board members, directors' terms, and director compensation.

Section 7 of the Federal Home Loan Bank Act

- Section 7(a) of the Bank Act provides that the board of directors at each of the Banks shall have a minimum of 14 directors – ***eight elective directorships*** and ***six appointive directorships***. Elective directorships are filled through an annual election of members. Appointive directorships are filled through appointments annually by the board of directors of the Finance Board.

- With regard to Districts with five or more states, Section 7(a) of the Bank Act authorizes the Finance Board to increase the number of elective directorships up to 13 and to increase the number of appointive directorships up to three-fourths of the number of elective directorships.

- Section 7(b) of the Bank Act requires that each elective directorship be designated as representing the members located in a particular state and sets forth the standards by which votes are allocated among members in that state.

- Section 7(c) of the Bank Act requires the Finance Board to allocate the elective directorships of each Bank among the states in the approximate ratio of the amount of Bank stock that the members in each state were required to own as of the end of the prior year. The Finance Board conducts the annual allocation of directorships in accordance with a mathematical formula known as the method of equal proportions.

- Section 7(c) of the Bank Act also includes a grandfather provision, which requires that each state must have at least as many elective directorships as it had on December 31, 1960. If the allocation of eight seats results in a state having fewer than the number established by the grandfather provision, the Finance Board must create additional elective directorships, to ensure that the state maintains the number it is entitled to receive under the grandfather provision.

- Section 7(d) establishes a term of three years for each director, whether elected or appointed. The terms are staggered to promote continuity on the boards. On April 9, 2003, the House of Representatives adopted an amendment to its proposed "Financial Institutions Regulatory Relief Act of 2003." That amendment would extend from three years to four years the term of Bank directors. While we cannot predict the prospects for passage of that or any similar provision, any change to the structure, term, or size of Bank boards would likely carry with it changes to board governance practices.

- Section 7(i) of the Bank Act limits the annual salary of Bank directors to $25,000 in the case of the chairperson, $20,000 in the case of the vice chairperson, and $15,000 in the case of all other board members.

Director and senior manager interviews conducted during our reviews yielded some common concerns arising from statutory and regulatory requirements that are not within the full control of the Banks. These statutory and regulatory factors influence certain practices and decisions of the Banks' boards of directors. While the managers and directors often advocated that the Finance Board work for revisions to applicable statutory or regulatory provisions, the discussion in this paper is not intended to advocate specific action on those matters. Rather, its purpose is to record significant statutory or regulatory matters raised in interviews and to identify the relevant statutory or regulatory provisions that govern these matters.

Achieving the best possible board governance practices for the Banks would require a comprehensive review of applicable laws and regulations. Particular attention would need to be given to whether changes in these laws and regulations would advance the safety and soundness, the housing finance mission, or capital access of the Federal Home Loan Banks. Given the relationship among the regulatory and statutory provisions regarding Bank directors, changes to those provisions should be considered jointly rather than individually. Comprehensive changes to the Bank Act or the associated regulations are likely to be more effective than piecemeal changes to isolated statutory or regulatory provisions.

Election and Appointment Process

A number of directors and managers questioned the statutory and regulatory standards governing the election and appointment of directors. Their concerns ranged from the rules governing the election of directors, restrictions on Bank management's role in the election process, and the selection of appointed directors.

Some directors expressed concern that the formula for determining the number of votes that a member may cast for any one elective directorship position favors the smaller members and disadvantages the larger members. The formula limits the number of votes to the average number of shares of Bank stock required to be held by all members located in a state as of the record date. Large members' influence in the election is significantly diluted. Of the directors who commented on this issue, a majority expressed the opinion that the voting formula should be "more balanced" between smaller and larger members.

Section 915.5 Determination of Member Votes

Section 915.5 is promulgated pursuant to Section 7(b) of the Act. It implements the statutorily prescribed formula for determining the number of votes that any one member may cast for any one elective directorship. The formula limits the number of votes to the average number of shares of Bank stock that are required to be held by all members located in that state as of the record date.

Large bank representation on the Banks boards is limited throughout the system. That limited participation may be attributed, in part, to these provisions.

Under the current election process, bank directors, officers, and employees are also prohibited from representing the Bank in supporting the nomination or election of any particular individual for an elective directorship. They may not take any action to influence votes for a directorship. Some interviewees felt that this restriction might be contrary to the principle of effective board governance. Their argument is that the prohibition prevents certain informed individuals – Bank directors, managers, and employees – from advocating on behalf of director candidates who may have the best skill sets to oversee a Bank's activities. This point was particularly significant with respect to candidates, often from larger institutions, with substantive interest rate risk management experience or expertise.

Section 915.9 Prohibition on Actions to Influence Director Elections

Section 915.9 restricts the powers for advocating and nominating directors by prohibiting Bank directors, officers, and employees from representing the Bank in supporting the nomination or election of a particular individual for an elective directorship, or to take any action to influence votes for a directorship. Sound governance practices include reviewing and recommending, on as broad a scale as possible, potential board members, determining how many directorships to fill, and with what skills.

The selection of appointed directors by the Finance Board was also criticized. A majority of directors and senior managers interviewed expressed dissatisfaction with the appointment process. While acknowledging that newly elected, as well as appointed, directors often lack critical skills, many of those interviewed expressed particular concerns about the absence of banking and financial risk management experience among appointed directors. As a result, many felt that appointed directors require more time to gain proficiency in financial matters than do elected directors. To enhance board governance of the Banks, the Finance Board is exploring regulatory options with respect to, among other things, experience and expertise requirements for appointed directors.

Other managers and directors believed that historically the appointment process has been too slow, with some appointive directorships remaining vacant too long. They indicated that, as a result, at times appointments do not necessarily coincide with scheduled director training or orientation. While those concerns may have been warranted in the past, appointments during 2002 and 2003 were completed in a timely manner to coincide with new director orientation programs sponsored by the Finance Board.

Section 915.10 Selection of Appointed Directors

Section 915.10 implements the statutory provisions in section 7(a) of the Bank Act governing appointive directorships. Under these provisions, the board of directors of the Federal Housing Finance Board selects all appointed directors.

Board Size

The size of Bank boards ranges from 14 to19 directors. The number of elected directors ranges from eight to eleven among the Banks. The number of elected directors allocated among the states in a Bank's district is determined annually by the Finance Board based on the number of required shares of Bank stock held by the members in each state as of December 31 of the preceding calendar year. The number of appointed directors ranges from six to eight and may be up to 75 percent of the number of elected directors.

These formulas result in some relatively large boards that some directors said were unwieldy when scheduling meetings, discussing issues, and obtaining consensus. On balance, most directors said that they would not want their board to grow in size, but they did not indicate that the current size was too big. Those that did believe the boards have become too large suggested appropriate sizes in the range of 10 to 14 board members. No one advocated further increases in board size. Up to a point, board sizes can be reduced by eliminating directorships established at the discretion of the Finance Board. Beyond that, reductions below 14 directorships would require statutory change.

Section 915.3 Director Elections

This section implements the statutory requirements regarding board size in section 7(a) of the Bank Act. The number of elected directors is based on the number of shares of Bank required stock held by the members in each state at the end of the preceding calendar year. The statute establishes eight elected directors in Banks with fewer than five states. It permits the number of elected directors to range from 8 to 13 in Banks with five or more states. The number of appointed directors is six in districts with fewer than five states and may be no larger than 75 percent of the number of elected directors in districts with more than five states. In Banks with fewer than five states, the statute establishes eight elective and six appointive directorships.

Subject to statutory grandfather provisions, the Finance Board could limit the number of elective and appointive directorships to eight and six respectively by eliminating discretionary seats. However, reducing the size of a Bank's board of directors below 14 would require a statutory change. Changing the method of allocating directorships among the states – such as allocating directorships based on the number of members in each state – would also require a statutory change.

In response to the relatively large boards, all of the Banks make use of committees to conduct substantive board work. However, the full board remains ultimately responsible for the decisions it makes or that board committees make on the board's behalf. Therefore, the boards must ensure that committee charters clearly establish the committee's functions and responsibilities and that board functions are not overlooked or neglected.

Compensation

Director compensation is limited by statute. When the statute became effective in 2000, most directors' annual compensation was reduced. Many, but not all, interviewed directors voiced negative reactions to the compensation limits. Opposition to the compensation cap was philosophical for some, who stated that the boards, not statute, should establish director compensation. In addition, some directors stated that the reduced compensation was incongruent with the responsibility and potential liability attendant to the oversight of a Bank.

While none of the interviewed directors stated they were motivated to serve because of the compensation, some acknowledged that the compensation limits caused a small minority of directors to miss board meetings. This situation most typically occurred in the past when a director reached the compensation cap before all board meetings had been held for the year. Banks responded by reducing the number of annual meetings. Meeting frequency has been an issue for some Banks. Other Banks have resumed more frequent meetings because their meetings tended to last too long when their meetings were infrequent.

Interestingly, when asked their opinion regarding an appropriate amount of compensation, directors stated compensation should be $25 to $50 thousand per year, only about $10 to $35 thousand a year higher than the current cap.

Part 918 – Bank Director Compensation and Expenses

Part 918 limits director compensation pursuant to Section 7(i) of the Bank Act. When limits were imposed in 2000, most directors' annual compensation was reduced. The compensation limit may have had the unintended consequence of reducing meeting frequency or increasing absences from meetings. Eliminating or changing the compensation limit would require a statutory change.

Training and Proficiency

Interviewed directors stated that it takes six to 24 months to understand the operations of the Bank. They said that elective directors' time to proficiency is at the lower end of the range, while appointive directors, who come to the position with different experience, generally take longer to feel comfortable as directors. All Banks have responded to this issue with orientation sessions for new directors, and most provide ongoing training for all directors. Many expressed satisfaction with the Finance Board's conference for new directors.

The complexity of the Banks' operations and the attendant risk management practices are new to many directors, both elected and appointed. Despite training and management presentations at board meetings, market risk management is an area in which directors acknowledged their skills need improvement. Some directors stated that by the time they felt comfortable with the financial operations of the bank, their first term was over. Ongoing training occupies a significant amount of time during board meetings, time that otherwise could be used to oversee the affairs of the Bank.

Director Turnover

Many of the directors believe that turnover of the board is disruptive to board management, committee operations, and succession and continuity plans. There are several reasons for high turnover, including unsuccessful reelection attempts, term limitations, directors choosing not to run for reelection, non-reappointments, and the requirement that one-third of the seats on each board must be up for election or reappointment each year. When these factors converge, high director turnover is a result. It is not unusual for over 50 percent of the directorate to have less than two years experience. This level of turnover creates the need for additional training and places greater responsibilities on remaining directors to oversee the operations, in particular the risk management processes, of the Bank.

Considerations for Future Work

The review provided an opportunity for the Finance Board to focus on its supervisory responsibilities with respect to board governance of the Banks. Observations during the review lead to a suggestion regarding the sufficiency of examination procedures. Recommended action in regard to examination procedures is presented below. Further, it would be beneficial for the Finance Board to provide Bank directors with a guide on board governance based on this review and the effective practices found.

Examination Procedures

Board governance is reviewed during annual examinations of the Banks. The examination review is organized according to a work program entitled *Board of Director and Management Oversight*. The examination procedures are supplemented by more focused reviews as warranted. Complementing the *Board of Director and Management Oversight* work program are examination procedures that address internal controls, internal audit, and external audit. Each of these examination modules has a separate work program to guide the examination process. The examination procedures are for the most part comprehensive, but will be enhanced with the addition of the following to fully address all eight of the board governance indicators.

- Interview at least three directors during the examination, both elective and appointive directors. Current practice is to have a discussion with only the Chairman.

- Assess succession planning.

- Assess strategic planning, including how goals and objectives become integrated into Bank operations.

- Determine if the Bank surveys director's skills to identify training needs.

- Evaluate the effectiveness of communications and the process to ensure appropriate disclosure.

Director Guidance

A director's booklet on board governance will be prepared based on the observations and results of this review. The booklet will be distributed to directors across the System and placed on the Finance Board's external website.

Issues for Regulatory or Statutory Review

The structure of the Federal Home Loan Bank System and the rules regarding board size, selection, and composition are factors that complicate adherence to generally accepted board governance standards for the Banks. Achieving the best possible board governance practices for the Banks requires a comprehensive review of the laws and regulations that underpin the contextual issues described in this report. Among the areas that regulatory or statutory changes could address are:

- Board size,
- Allocation of directorships among states,
- Allocation of votes among member banks,
- Board terms,
- Expertise in financial markets and housing finance, and
- Director compensation.

Appendix

Appendix

Board Governance Work Program

Horizontal Review of Board Governance at the Federal Home Loan Banks

Introduction

The Finance Board established the following eight major categories of activities and conduct that are referred to as the core indicators of board governance.

- Engaged Board of Directors
- Skilled Senior Management
- Thorough Strategic Planning
- Sound Risk Management
- Robust Internal Controls
- Effective Audit Program
- Strong Ethical Culture
- Timely, Accurate and Complete Communications

Methodology

This work program describes the methodology for reviewing board governance at the Federal Home Loan Banks ("Banks"). It identifies the boards' activities and conduct within the framework of the eight core indicators.

The work program is comprised of two modules. The first module consists of interviews of directors and senior managers to determine what they do and how they do it. The intention is to conduct interviews of the Chairman of the Board, Vice Chairman of the Board, Chairman of the Audit Committee, President, General Counsel, and the Director of Audit. The second module is a review of Bank records to determine the extent to which governance is documented. Bank records to be reviewed include board and committee minutes, committee charters, board packages, and director training programs. These records should reflect, and provide examiners with a better understanding of, directors' diligence, care, loyalty, and adherence to regulatory guidelines. A summary of observations will be developed from the two modules.

MODULE 1

Director and Officer Interview Questions

The following questions are designed to assist in determining the specific activities and conduct in which the directors and officers engage that are representative of corporate governance. The questions are organized within the framework of the eight indicators and will undoubtedly lead to further discussions. Most questions are targeted to board members. However, the opinions of senior managers regarding these questions are a key component of this work program.

Introduce the program to each interviewee. Discuss the scope of the review and that it is informational, not an audit or examination. No ratings will be given. We are seeking their opinions on how they are doing in each of these categories.

Engaged Board of Directors

For new directors, how does the board determine their familiarity with accounting and business concepts? How does the board determine what training is necessary for new directors in order to achieve a level of "working familiarity" with basic finance and accounting practices?

How many times per year does the full board meet? How do directors remain engaged in oversight activities between board meetings? Does the board have a dedicated staff to support them or do individual directors have or use dedicated staff? Does the board have outside counsel, independent accountants, or other consultants?

Is your board the right size? Do the directors bring the necessary skills and abilities to the table in a group small enough to act cohesively? Are there enough members to fill all necessary committees?

How is membership decided for board committees, such as the audit committee, ALCO, *etc.*?

What typically motivates someone to want to serve as a director? How does the compensation cap fit into the picture?

Skilled Senior Management

How does the board ensure that it attracts and retains qualified managers?

How do you assess the performance of the President and Senior Management? What performance criteria are used within the performance plan?

What selection criteria are considered when selecting a new President or senior manager? What skills do you consider most important?

How are performance targets linked to the Bank strategy, both long and short term?

Describe the Bank's management succession plan/policy/analysis for top managers?

Thorough Strategic Planning

Describe the strategic planning process.

What roles do consultants, advisory committees, and member banks have in the strategic planning process?

How does the board track the Bank's performance compared to the plan?

How would you describe the Bank's success in implementing the current plan?

Sound Risk Management

How do you perceive the Bank's risk-taking appetite; conservative, moderate, or aggressive? Why?

What is the process for identifying various risks, including emerging risks and risks associated with new products such as MPP or MPF?

What are the major risk factors that the board reviews, *e.g.*, IRR, credit risk, market risk, liquidity risk, business risk, and operations risk?

Who is the senior manager responsible for risk oversight or board governance? Has the board adopted a Governance Policy?

How is the board involved in the policy and procedure development process?

How do you become aware of exceptions to policies and procedures?

Robust Internal Control

Internal control is the bank system/process to safeguard assets. It includes checks and balances including delegations of authority, dual controls, accounting controls, reliability of records, and compliance with laws and regulations.

How are internal controls assessed and how does the board become aware of deficiencies and recommendations?

What is your sense of how effective your internal controls are and why?

Does the board review internal control evaluations conducted by management, auditors, and examiners? What system is in place to monitor management's actions for internal control recommendations?

Do the board and its representatives have complete access to Bank records?

Describe Bank policies/procedures that assist in preventing, deterring, and detecting breaches of internal control (*e.g.*, pre-employment criminal background investigation, vacation policies, rotation of duty policies, frequency of obtaining employee credit reports, and reporting of policy overrides/exceptions)?

How are breakdowns in internal control presented to the board of directors?

Effective Audit Program

Describe the Bank's internal and external audit programs, and your opinion of their effectiveness.

Are you satisfied with the performance of the Audit Committee, its composition, and its aggregate skill level? Why or why not?

Describe the process for selecting an external auditor. What is the engagement process?

Describe the presentation process of internal and external auditor reports and findings to the Audit Committee?

Strong Ethical Culture

How would you describe the ethical culture of the Bank regarding conflicts of interest, compliance with laws and regulations, and corporate governance?

How does the Bank ensure that the board and employees have reviewed the Bank's conflict of interest and code of conduct policies?

How does the Bank identify potential conflicts of interest for directors and senior management? Is the process annual and ongoing? Who is responsible for maintaining board member potential conflicts of interest? Do the procedures differ for elective directors and public interest directors?

What is the Bank's policy with respect to avoiding conflicts of interest in AHP funding stemming from family or business relationships that directors may have with entities involved in AHP projects and other community development initiatives.

Timely, Accurate and Complete Communication

What time frames have been established by the board for disclosure of quarterly and annual results to member banks?

How does the bank disclose incentive structures of the bank, including executive compensation and bonuses; the extent of transactions with related parties; and the ownership of the Bank to member banks?

Other

What changes have you made to improve board governance in the last twelve months? (particularly in the light of corporate problems at Enron, WorldCom, and others)

What do you consider best practices for board governance at your Bank?

What changes would you recommend to the FHFB *vis-à-vis* governance regulations?

MODULE 2

Bank Records Review

Review Bank records to determine the extent to which governance activities and conduct are documented. Be alert for examples of director diligence and prudence, such as becoming better informed, exercising independent judgment, asking questions, and avoiding conflicts of interest. Review board and committee minutes, board packages, board training materials, and relevant policies. In addition, look for confirmation of answers to interview questions.

Discretion should be used in determining the necessity in completing and answering all questions. The purpose of this module is to assist the examiner in collecting information regarding board governance. The module does not require an answer to each question.

Engaged Board of Directors

Determine how often the board of directors meets, the reports that are provided, and the key areas that are routinely reviewed.

If a written position description for directors is available, determine how it was developed.

Determine what training is available to directors.

Determine committee types, charters, and composition meeting frequency.

Determine the frequency of presentation of committee work to the BOD.

Look for evidence that directors feel free to speak their minds and to pursue issues to their appropriate conclusions.

Skilled Senior Management

Review the minutes of the performance evaluation committee and compensation committee, if applicable.

How is compensation determined and performance measured?

Are there any special programs or emphasis on reducing turnover and retaining qualified personnel?

Is there a succession plan/policy that covers key management positions?

Determine the receptivity to examiner and auditor recommendations.

Thorough Strategic Planning

Determine how the board documents the discussions and results of the strategic planning process.

Identify attendees of strategic planning meetings. In addition to board members, who else attends these meetings, *e.g*., management, consultants, *etc.*?

Has the board delegated the strategic planning responsibility to a committee, *e.g*., strategy committee, finance committee, or executive committee?

Are the committee's results presented and discussed with the full board?

What performance measures does the board employ to measure and evaluate the strategy's success in subsequent years after developing the strategy? How are these performance measures communicated to management?

Consider how the board:

- assesses internal and external factors that could prevent the Bank from executing its strategies
- determines resources, *i.e*., human capital, funding, and capital, needed to execute strategies
- analyzes market competitors when developing strategic plans
- considers the political and economic environment when developing strategic plans
- includes member banks in developing strategies
- communicates its strategic plan to member banks
- assesses the implementation of its strategic plan
- uses action plans or milestones to monitor the accomplishments of strategic plans
- assigns probabilities of success or risks *vis-à-vis* the strategic plan

Sound Risk Management

How far in advance are board-meeting packages provided to board members?

What committees are tasked with risk assessment? How often do the committees meet?

Review the minutes of the committees involved with Risk Management and evaluate their effectiveness in identifying and managing various risks, and communicating to the full board.

What role does Legal Counsel perform in risk management, *e.g*., new product review?

How are exceptions to policies and procedures identified by and approved by the board?

How does the board track the volume of exceptions to policies and procedures?

How has the board used outside third parties in the development and review of policies and procedures?

How often does the board review the budget?

How does the board compare actual performance against objectives? Does the board use a variance report with month-end, YTD, and year-ago financial statements, with attendant ratios?

Does the board perform peer analyses?

List policies adopted by the board?

Robust Internal Control

Determine the extent to which the board is involved and aware of internal control by reviewing the board and committee minutes. What goals and objectives has the board established for internal control (*e.g.*, management oversight, dual control, rotation of duties, internal control reviews, risk assessments, and frequency and scope of internal control audits)?

What is the process for monitor management's actions on auditor and examiner internal control recommendations and concerns?

How does the Bank reimburse directors for their stipends and expenses?

Does the Bank allow board members to use district Bank credit cards? What system is in place to monitor usage?

Effective Audit Program

Determine composition and activities of the Audit Committee through review of the charter, committee minutes, board minutes and discussions with management.

Determine if there is a formal internal audit schedule in place to direct audit activities.

Determine if the Bank maintains internal audit records, such as work papers, which have been approved and reviewed by audit management.

Does the internal audit department submit formal reports to the board of directors or the appropriate committee?

Describe the content of an internal audit report. Does the report assign a rating, include a general statement regarding internal control, and identify material weaknesses or other unsatisfactory matters?

Does the board or committee support the audit staff in resolving audit matters?

Do the audit reports include a summary of the effectiveness of controls in the department or function?

Does the audit committee review the external auditors engagement letter?

How are the external audits' results provided to the audit committee?

Does the external auditor examine, attest to, and report separately on, the assertion of management concerning the Bank's internal control structure and procedures for financial reporting?

Who is responsible for reviewing the performance and compensation level of the internal auditor?

Strong Ethical Culture

Review policies governing codes of conduct and conflicts of interest.

Does the Bank have a written code of conduct? For example, does it provide guidance on such topics as employee privacy, workplace safety, political contributions, computer data/security, gifts, EEO, and sexual harassment?

If there are codes of conduct infractions, are they handled firmly and consistently?

Is turnover a problem and can it be traced to the organizational culture?

Are conflicts of interest clearly reported and handled appropriately?

Transparent Disclosure

Information on the following questions may be obtained from annual and quarterly reports developed by the Banks or at the Banks web page.

How does the bank disclose board structure, including size, qualifications, and committees to member banks?

How does the bank disclose to member banks senior management structure, including responsibilities, reporting lines, qualifications, and experience?

How does the bank disclose organizational structure, including lines of business structure?

Does the annual report discuss risk management systems, business goal and strategies, board assessment of business climate and risks, corporate governance practices, and material claims and court cases?

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