

## *Secured Credit*

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### **Introduction**

The FHLBanks are a government-sponsored enterprise with an assigned mission to further housing finance and to foster community investment. This mission is largely accomplished by providing advances to members. Member advances are the FHLBanks' oldest and primary business, and the principal form of secured credit in an FHLBank. The FHLBank provides short and long-term advances that are used by members to support mortgage lending, community investment, and other operational needs of their customers. Members may use long-term advances only to support residential housing finance and, in the case of community financial institutions, to support lending (through collateral acceptance) to small businesses, small farms, and small agricultural businesses. Since the FHLBanks are designed to serve members, advances are a low-margin business. FHLBank advance activity is generally a low-risk business as all advances are fully secured and FHLBanks typically hold or can claim collateral substantially in excess of total advances outstanding.

In accordance with Section 917.3 of Finance Board's regulations, each FHLBank must have in effect at all times a risk management policy that addresses the FHLBank's exposure to credit, operations, business, liquidity and market risk. The risk management policy should identify each of the aforementioned risks as they relate to secured credit activities, and establish standards and tolerances that can be measured and monitored. In addition, each FHLBank is required to perform, at least annually, a written risk assessment that identifies and evaluates all material risks that could adversely affect the achievement of the FHLBank's performance objectives and the satisfaction of compliance requirements. A description of the risks applicable to secured credit activities follows below.

- 1) ***Credit Risk.*** Credit risk is the potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms. This risk is mitigated with the implementation of the following practices:
  - a) Establishing an appropriate credit risk management environment that includes credit strategies, credit and collateral policies and procedures, reserve for credit losses, and other elements;
  - b) Operating under a sound credit granting process that includes the review and approval of new and existing relationships, establishment of credit and collateral limits, and other elements;
  - c) Maintaining an effective credit administration process that includes the on-going monitoring of relationships, the maintenance of information systems to monitor and measure the composition and quality of the portfolios, and other elements; and
  - d) Ensuring the maintenance of adequate controls over credit risk, including the independent and on-going assessments of the processes and controls that are

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communicated to senior management and the board of directors, segregation of duties, implementation of a monitoring process to identify and correct deviations from established policies, procedures and controls, and other elements.

- 2) ***Operational Risk (including both operations and business risk under Section 917.3 of the Finance Board regulations)***. By extending credit, an FHLBank assumes both credit risk and operational risk. Operational risk is the potential that the FHLBank could incur an unexpected loss resulting from human error, fraud, unenforceability of legal contracts, deficiencies in internal controls or information systems, or experience an adverse impact on profitability due to external factors, such as changing economic conditions, increased competition, and changes in legal or regulatory requirements. Certain of these risks may be mitigated through the segregation of key duties and the maintenance of sound credit management and administration policies and procedures, including automated systems related to these functions.

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

### **Regulatory Environment**

The primary authorities governing, or relevant to, secured credit activities of the FHLBanks are set forth below. The discussion does not address the application of authorities other than the FHLBank Act and the regulations, interpretations and issuances of the Finance Board to the FHLBanks. The examiner should ensure that the application of such authorities to an FHLBank has been considered by the FHLBank and its legal counsel.

- 1) ***Rules and Regulations of the Federal Housing Finance Board, which include the following parts and sections relevant to secured credit:***

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

Section 932.4 requires an FHLBank to maintain capital to offset its credit risk capital charge for all assets, off-balance sheet items and derivative contracts.

Part 950 of the Finance Board regulations addresses advances. Subpart A of Part 950 is a general section dealing with definitions, authorizations, and limitations. Subpart

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B addresses advances to housing associates and Subpart C deals with advances to out-of-district members and housing associates.

Part 960 of the Finance Board regulations addresses standby letters of credit (SLOC).

- 2) ***Advisory Bulletins of the Federal Housing Finance Board*** that provide supervisory guidance relating to the topic of secured credit activities are:

Advisory Bulletin 98-2, dated January 30, 1998, which offers guidance on the use of advance proceeds. The bulletin addresses prohibitions on use of advance proceeds.

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

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

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

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

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

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

Advisory Bulletin 06-02, dated March 20, 2006, which provides guidance on proper validation and documentation on the use of models. Each FHLBank and the Office of Finance should have policies and procedures to ensure that its various models are appropriately documented and validated.

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

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### **3) *Article 9 (Secured Transactions) and Article 5 (Letters of Credit) of the Uniform Commercial Code (UCC).***

Article 9 of the UCC applies to any transaction which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts, the sale of any accounts or chattel paper, and security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title contract and lease or consignment intended as security.

Specific requirements that pertain to attachment and perfection of security interests, including the method of perfecting a security interest in specific types of collateral, the contents and filing of financing statements, changes in name and identity of debtors, rights and duties in connection with default, and enforcement, must be complied with in order to create and maintain a priority security interest in the collateral.

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

The UCC is a uniform nonbinding code which, to be effective in any domestic jurisdiction, must be adopted into law by that jurisdiction. As a result, there are sometimes variations in the UCC's provisions in particular jurisdictions. The FHLBanks should coordinate periodic reviews of their documents and operating practices with legal counsel to ensure compliance with current UCC requirements.

### **4) *Statements of Financial Accounting Standards (collectively, Statements of Financial Accounting Standards or individually, SFAS) adopted by the Financial Accounting Standards Board*** establish standards of financial accounting and reporting governing the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Accountants. Specific Statements of Financial Accounting Standards applicable to secured credit activities, include, but are not limited to, the following:

- a) SFAS 5, Accounting for Contingencies establishes standards of financial accounting and reporting for loss contingencies. It requires a creditor's accrual by a charge to income (and disclosure) for an estimated loss from a loss contingency if two conditions are met: (1) information available prior to the issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements; and (2) the amount of loss can be reasonably estimated.
  
- b) SFAS 114, as amended by SFAS 118, Accounting by Creditors for Impairment of a Loan, requires a creditor to recognize loan impairment through the creation of a

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credit loss reserve and a charge to bad debt expense. Loan impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. This statement is applicable to advances and to Acquired Member Advances.

- 5) *State privacy laws that require disclosures to customers of the recording of conversations to which they are a party.* Specific requirements may vary by state jurisdiction.

### **FHLBank Environment**

Within the FHLBank System, organizational structures for secured credit may vary and require coordination with other functions such as customer funding, credit underwriting/administration, collateral operations, securities safekeeping operations, and wire transfer operations, as well as with board of directors and management committees such as the credit, asset/liability, operations, information technology and risk management committees . The primary processes are set out below.

### **Customer funding**

An FHLBank's customer funding function receives the funding request from the member, housing associate or State Housing Finance Authority (SHFA) associate on recorded telephone lines, reviews loan documents that have been submitted, and enters the request into the FHLBank's advance system, which is updated with all relevant credit underwriting and collateral information. The advance system automatically checks all of the required borrowing criteria such as the amount, term, and sufficiency of collateral. Any discrepancies are noted by the system; a credit review is thereafter performed by designated credit personnel. If approved, advance proceeds are credited to the borrower's deposit account at the FHLBank.

FHLBank customer funding personnel have responsibility for the maintenance of the advance system, answering of questions on advance products, generation and distribution of confirmations, disclosures, statements to the member, housing associate or SHFA associate, maintenance of loan documents and share transaction reconciliation responsibility with accounting personnel.

### **Credit underwriting/administration**

An FHLBank's credit underwriting/administration function is responsible for managing the performance and quality of the advance portfolio, including:

- a) Establishing credit and collateral policies that address underwriting guidelines for the evaluation and monitoring of the borrower and collateral, maximum portfolio

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- exposures for specific types of concentrations, limits and standards for the approval of credit, eligible collateral, collateral valuation, collateral “haircuts,” compliance with federal and state requirements (such as the UCC and state predatory lending laws) and periodic reporting to the FHLBank’s credit committee and board of directors.
- b) Coordinating the periodic review of loan and letter of credit documents with the FHLBank’s legal counsel and perfecting the FHLBank’s security interest in the underlying collateral.
  - c) Performing the initial review, approval and on-going monitoring of credit availability and credit maintenance levels of borrowers and overall credit risk profile of the FHLBank. This is performed by evaluating various factors relating to the borrower’s business, financial condition and posted collateral including, but are not limited to, the following:
    - (1) Borrower’s business profile;
    - (2) Total outstanding obligations to the FHLBank;
    - (3) Adequacy of qualifying collateral;
    - (4) Results of regulatory examinations and annual audited financial statements;
    - (5) Adequacy and stability of capital position;
    - (6) Net income and prospects for future earnings;
    - (7) Trends in operating ratios such as return on assets, net interest margin, efficiency, and liquidity;
    - (8) Quality and composition of assets; and
    - (9) Interest rate risk management.

These evaluations include the analysis of financial data and credit scoring derived from financial reports periodically filed by members with their regulators. The review of credit scores, examination reports, audited financial reports, and other information assists in the determination of the borrower’s credit lines, collateral lien or pledge status, frequency of reviews by the FHLBank’s credit committee, performance of on-site collateral verifications, and timely identification and classification of potential problem relationships.

### **Collateral operations**

The primary duties and responsibilities customarily assigned to an FHLBank’s collateral operations function are:

- a) Receipt and safekeeping of collateral in delivery status and the conduct of verifications for collateral in blanket and specific listing lien status;
- b) Valuation of the collateral and coordination with FHLBank’s securities safekeeping operations function for securities pledged as collateral;

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- c) Filing of UCC-1 financing statements; and
- d) Receipt of credit committee information to permit adjustment of collateral maintenance and/or haircut requirements, as well as the maintenance of the collateral system.

Advances and standby letters of credit are secured using the following methods:

- a) Blanket lien-the blanket lien is used for the most creditworthy borrowers and is the most cost effective method of securing the FHLBank's advance because it requires fewer personnel resources to administer. Required collateral haircuts are the most severe when a blanket lien is employed.
- b) Specific listing-specific listing of collateral enables the FHLBank to estimate the market value of the listed collateral and requires a less severe haircut than would be required for collateral pledged using a blanket lien.
- c) Delivery-the FHLBank has possession of the collateral. The FHLBank's securities safekeeping department generally maintains custody of the notes or securities.

Depending on the risk identified with the borrower and type of collateral, valuations are performed of financial data derived from financial reports periodically filed by members with their regulators, as well as interim reports, using vendor software. In addition, periodic on-site reviews and/or the review of independent collateral verifications are performed with respect to members, housing associates or SHFA associates, as the case may be, to determine the accuracy of the collateral information that is reported.

### **Securities safekeeping operations**

An FHLBank's securities safekeeping operations function generally has responsibility for the control of securities that are pledged as collateral, including the review, receipt and release of, and accounting for, principal and interest payments received. The close coordination of the activities of this function with those of the FHLBank's collateral operations function is necessary to ensure timely and accurate valuation of the collateral.

### **Wire transfer operations**

An FHLBank's wire transfer operations function generally has responsibility for the control of disbursements and payments received from the members and housing associates. The coordination of the activities of this function with those of the FHLBank's credit function is necessary to identify relationships that require monitoring or additional approvals.

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### *Management committees*

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

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

- (1) Approval of extensions of credit in accordance with delegated authorization;
- (2) Monitoring of asset quality, composition, trends and risk diversification in the portfolios; and
- (3) Monitoring of compliance with credit and collateral policies, including the identification and reporting of exceptions, and the review of the adequacy of the reserve for credit losses.

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

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



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

### **Risks Associated with Secured Credit Activities**

An FHLBank's primary risks relating to secured credit activities are set forth below.

#### ***1) Lack of Sound Corporate Governance (Board of Directors and Senior Management Oversight)***

- a) Key risks and controls are not adequately identified, assessed, and monitored.
- b) Information technology is not aligned with the FHLBank's goals and strategies.
- c) Exceptions to credit and collateral policies are not properly reviewed and reported to senior management and the board of directors.
- d) The FHLBank's financial performance and compliance with established goals, policies, procedures, accounting and regulatory requirements are not properly reviewed and monitored due to inadequate, inaccurate and/or untimely reporting to the board of directors and senior management.
- e) Internal control weaknesses potentially affecting financial reporting have not been adequately identified, assessed and disclosed.
- f) Duties, responsibilities, and staff expertise, including segregation of operational and control functions, are not adequately defined.
- g) Background criminal and credit investigations are not performed as to personnel responsible for advance, credit and collateral prior to their retention. Periodic credit investigations are not performed with respect to such staff and mandatory leave policies have not been established or monitored.
- h) Duties, responsibilities, and liabilities are not adequately addressed with outside service providers and vendors.
- i) Losses due to errors and fraud are not effectively mitigated through insurance or other means.
- j) A business continuity plan has not been developed and tested.
- k) Independent audit coverage and testing is limited; auditors are inexperienced or lack the technical expertise to test the control environment.

#### ***2) Credit Risk***

- a) Inadequate credit and collateral policies, procedures and internal controls exist to manage and monitor the overall credit risk profile of the FHLBank.
- b) The borrower's creditworthiness and collateral capacity are not being analyzed and monitored. Requests for advances may be in excess of eligible collateral. Inadequate monitoring of the borrower could result in the conversion/sale of collateral without the knowledge or consent of the FHLBank.

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- c) Inadequate collateral valuations and liquidation procedures could result in losses in the event of credit deterioration and default.
- d) Inadequate procedures to identify and classify problem relationships could result in deficiencies in the reserve for credit losses.
- e) Customer deposit overdrafts are not monitored and minimized.
- f) Potential external factors such as economic downturns, natural disasters, etc. are not adequately identified or accounted for that may adversely affect the recoverability of advances extended by an FHLBank.

### **3) *Operational Risk***

- a) Management information systems do not adequately meet the needs of the FHLBank's lines of business resulting in the use of various manual processes and workarounds which can result in errors and misstated financial results.
- b) Lack of technical expertise and experience may imperil the continuation of operations in the event of key personnel turnover or absences.
- c) Legal documents are incomplete, missing, unenforceable, not in compliance with federal and state requirements or otherwise inadequate to protect the FHLBank's interests, resulting in the failure to provide a perfectible security interest. In addition, the FHLBank's lien may not be perfected and/or may be allowed to expire.
- d) Loan documents held by a third-party custodian could be lost, stolen or destroyed or may not adequately identify the FHLBank as the party for whose benefit the custodian is acting.
- e) Unauthorized or erroneous advances, collateral and standby letter of credit information may be entered into the advance, credit and collateral systems.
- f) Published rate and product information that is provided to the members and housing associates may be inaccurate or outdated.
- g) Legal documents and data cannot be readily recreated and/or required tasks performed in the event of a disaster.
- h) SAS 70 reviews are not obtained, or alternative methods not performed, to obtain assurances on the outside service provider's internal control environment.
- i) Economic downturns, natural disasters or other external factors are not adequately identified or accounted for that may adversely affect the recoverability of advances extended by an FHLBank.
- j) Member consolidations, competition, adverse legislation, judicial decisions, or other external factors result in reduced FHLBank membership or advance activity.
- k) Insurance coverage had not been evaluated and obtained to mitigate the FHLBank's risks and exposure.
- l) Procedures that pertain to the destruction and retention of records have not been established or followed.
- m) Noncompliance with federal or and state requirements that relate to predatory lending result in potential civil liabilities and a tarnished reputation in the market place.

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### **Specific Risk Controls Related to Secured Credit Activities**

An FHLBank's controls relating to its secured credit activities are set forth below.

#### ***1) Credit and Collateral Administration***

The development and maintenance of sound and effective credit and collateral administration are critical elements in the identification, management and monitoring of the risk exposures associated with secured credit activities.

#### ***2) Legal***

In connection with new or revised products, services or business prospects, FHLBank legal staff reviews applicable regulatory requirements, consultant and vendor contracts, credit and collateral documents and other FHLBank documentation to protect the FHLBank's interests.

### **Examination Guidance**

A work program for Secured Credit accompanies this narrative. What follows below are illustrative examples of attributes that should be considered by the examiner in completing the analyses required in the work program. In determining the extent of review and testing to be conducted in completing each analysis, the examiner should take into account his or her assessment of the quality and effectiveness of corporate governance, risk management, internal controls and audit coverage relating to the institution's secured credit activities.

#### ***1) Organizational structure***

- a) Assess compliance by FHLBank management and staff with the applicable laws, policies, and guidelines.
- b) Identify the key personnel and their primary duties, responsibilities and technical expertise.
- c) Evaluate the staffing and skill level, segregation of duties, and cross-training of personnel.
- d) Review coordination with other departments such as risk management, information technology, treasury and cash management, and accounting.

#### ***2) Establishment of risk tolerances and development of key policies and oversight by the board of directors. Evaluate the adequacy of senior management oversight and the risk management function for secured credit activities, which may include the following:***

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- a) Review the Risk Management Policy (RMP) for compliance with Section 917.3(b)(2) of the Finance Board regulations as it relates to secured credit. Determine what, if any, limits are established and how they are monitored.
  - b) Review the Member Products Policy (MPP) for compliance with Section 917.4(b) of the Finance Board regulations as it relates to secured credit.
  - c) Review the strategic business plan for compliance with Section 917.5(a) of the Finance Board regulations as it relates to secured credit. Determine the status of goals and objectives and how these are monitored.
  - d) Evaluate the reporting to the board of directors of RMP and MPP exceptions/waivers and periodic reporting to the board on the status of the strategic business plan goals and objectives as it relates to secured credit.
  - e) Review the asset review and classification practices for compliance with AB 01-8. Specifically, review the frequency of the classifications, reporting to management and the board of directors, the assets classified less than satisfactory, and the corrective actions taken to resolve problem assets.
  - f) Review the Anti-Predatory Lending Policy for compliance with AB 05-08. Specifically, determine the status of the member certifications, as well as, the FHLBank's ongoing compliance verification activities.
  - g) Review relevant board of directors committee structure and delegated authorities.
  - h) Review relevant management committee structure and delegated authorities.
- 3) ***Key FHLBank policies and procedures, which may include those relating to the following:***

### **Advances**

- a) Determine how advances applications are accepted (fax, telephone, and secured website) and processed. Evaluate the controls and the trends.
- b) Review advances applications and agreements and determine if they have been reviewed by the FHLBank's legal counsel and approved by the board of directors as required under Section 950.2 of the Finance Board regulations.
- c) Determine if all advances are fully secured pursuant to Section 950.2(c) of the Finance Board regulations. If not, evaluate the collateral deficiencies, monitoring, reporting, and corrective actions.
- d) Determine the controls and application of the long-term advances proxy test contained in Section 950.3 of the Finance Board regulations. Evaluate any instances of non-compliance and the reasons for these.
- e) Determine if the FHLBank has established limitations on advances for any members under Section 950.4(a) of the Finance Board regulations. If so, evaluate the reasons for the limitations and how they are monitored.
- f) Determine if the FHLBank has any advances outstanding to capital deficient members. Evaluate compliance with Sections 950.4(b), (c), and (d) of the Finance Board regulations.
- g) Review the terms and conditions for advances and determine compliance with Section 950.5 of the Finance Board regulations. Specifically, determine how the

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- FHLBank prices its advances and evaluate who has authority for pricing advances. With putable and convertible advances, review the disclosures provided to members.
- h) Determine if the FHLBank uses differential pricing of advances. If so, evaluate compliance with Section 950.5(b)(2) of the Finance Board regulations.
  - i) Review the FHLBank's fees for compliance with Section 950.6 of the Finance Board regulations. Specifically, determine if any prepayment fees have been waived and evaluate the reasons for such actions.
  - j) Review the new advances/product development process. Specifically, determine if the process is guided by a comprehensive vetting policy involving all appropriate departments and is driven by overall membership needs.
  - k) Review any new advances/products for compliance with applicable policies and regulations. Determine the impact of the new products.
  - l) Review departmental policies and procedures and determine if they are current, relevant, sufficiently detailed, and consistent with the FHLBank's policies and regulations.
  - m) Determine if any intradistrict transfer of advances has occurred. If so, evaluate compliance with Section 950.12 of the Finance Board regulations.
  - n) Determine the FHLBank's practices regarding advances upon termination of membership. Evaluate compliance with Section 950.15 of the Finance Board regulations.
  - o) Determine if the FHLBank has any advances to housing associates. If so, evaluate compliance with Section 950.17 of the Finance Board regulations.
  - p) Determine if the FHLBank has any advances outstanding to out-of-district members. If so, evaluate compliance Section 950.25 of the Finance Board regulations.
  - q) Review advances concentrations with members and product types. Determine trends and analyze factors mitigating risk.

### **Standby Letters of Credit**

- a) Review the purposes that the FHLBank issues or confirms SLOC for compliance with Section 960.2(a) of the Finance Board regulations.
- b) Determine if all SLOCs are fully secured pursuant to Section 960.2(b) of the Finance Board regulations. If not, evaluate the collateral deficiencies, monitoring, reporting, and corrective actions.
- c) Review the SLOC fees for compliance with Section 917.4(b) of the Finance Board regulations.
- d) Determine if any draws on SLOC have occurred. If so, and repayment was financed with an advance, determine compliance with Section 960.4 of the Finance Board regulations.
- e) Review departmental policies and procedures and determine if they are current, relevant, sufficiently detailed, and consistent with FHLBank policies and regulations.

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### **Collateral**

- a) Evaluate the collateral types accepted for compliance with Sections 950.7(a) and (b) of the Finance Board regulations.
- b) Review security or collateral agreements and determine if they have been reviewed by the FHLBank's legal counsel and approved by the board of directors as required under Section 950.2 of the Finance Board regulations.
- c) Determine if the FHLBank has perfected its lien by filing a UCC-1 on all borrowers regardless of collateral status. Determine if there are any conflicting UCC-1 lien filings between the FHLBank and other lender(s). Review and assess FHLBank management's actions to remedy any conflicting lien issues.
- d) Determine if the FHLBank uses a vendor or completes the filings internally. Evaluate the UCC-1 renewal and follow-up processes and internal controls.
- e) Review the FHLBank's practices for accepting collateral pledged by affiliates of members. Specifically, determine compliance with Section 950.7(g) of the Finance Board regulations.
- f) Review the FHLBank's practices for using third party custodians. Specifically, are third party custodians used for securities, mortgages, and/or other collateral? Evaluate the agreements and controls regarding member access to collateral.
- g) Review the FHLBank's collateral verification policies and procedures and determine compliance with Section 950.9(b) of the Finance Board regulations. Specifically, evaluate how the verifications are performed, the frequency of the verifications, and the overall adequacy of the verification process.
- h) Review the FHLBank's collateral valuation policies and procedures and determine compliance with Section 950.10 of the Finance Board regulations. Specifically, evaluate the use of book value and market value, and/or methodology, the frequency of the valuations, and the overall adequacy of the valuation process.
- i) Determine the market value pricing programs or software used to periodically value the pledged loans and securities. Analyze staff experience and knowledge, policies, procedures, periodic testing and validation, and guidance and standards for using the valuation models or pricing software to determine market and/or lendable collateral values. As needed, test market values of securities collateral obtained from external third party pricing services.
- j) Review the subprime and high loan-to-value identification process for compliance with AB 99-15 and AB 07-01. Specifically, determine how the FHLBank identifies these loans, particularly with the blanket status members. Evaluate the use of quarterly certifications and/or the onsite collateral verification process regarding subprime collateral.
- k) Determine how the FHLBank identifies and excludes potential predatory loan collateral in compliance with AB 05-08, particularly with the blanket status members. Evaluate the use of quarterly certifications and/or the onsite collateral verification process regarding potential predatory collateral.

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- l) Review departmental policies and procedures and determine if they are current, relevant, sufficiently detailed, and consistent with the FHLBank policies and regulations.
- m) Review the collateral liquidation plan and determine if it is current, relevant, sufficiently detailed, and consistent with FHLBank policies and regulations.
- n) Review collateral concentrations with pledge types. Determine trends and analyze the factors mitigating risk for the non-traditional collateral types.

### **Monitoring**

- a) Review the ongoing analysis and monitoring of members' financial condition and performance. Identify the sources and adequacy of information used such as call report data, FIRE data, regulatory websites and examination reports, NRSRO ratings, and stock prices and trends. Assess the reporting to board of directors and management.
- b) Determine if the FHLBank uses an internal credit review and/or model/scoring program for members. Evaluate the adequacy of the process including the use of a watch list and reporting to the board and management.
- c) Determine if the FHLBank uses a watch list to identify and monitor members exhibiting higher than normal risk. Evaluate the adequacy of the credit criteria, financial analysis and reporting mechanisms that are used by the FHLBank's board of directors, senior management, and board and management committees to identify, manage and monitor troubled, financially weakened, problem and/or adversely classified member.
- d) Review departmental policies and procedures and determine if they are current, relevant, sufficiently detailed, and consistent with the FHLBank policies and regulations.

#### ***4) Risk assessment under Part 917 and internal control evaluation under SARBOX***

- a) Evaluate the effectiveness of the annual risk assessment and determine if it reasonably identifies and evaluates all material risks, both quantitative and qualitative aspects, of the secured credit activities. Investigate any actions plans arising from the assessment and check corrective actions.
- b) Evaluate the effectiveness of the evaluations conducted pursuant to SARBOX that identify the key risks and controls pertaining to financial reporting and evaluate potential fraud, and procedures implemented to periodically attest to the adequacy of the control environment.

#### ***5) Internal audit, external audit, and outside consultants reports***

- a) Evaluate the adequacy of the scope, testing, and workpapers completed by internal audit and determine the status of corrective actions for findings.
- b) Evaluate the adequacy of the scope and testing completed by external audit and determine the status of corrective actions for findings.

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- c) Evaluate the adequacy of the objectives and scopes of reviews performed by outside consultants and determine the status of management's actions regarding recommendations.
- d) Review the corrective actions taken in response internal and external audit findings.
- e) Review the actions taken in response to consultant recommendations.

### **6) *Information technology and controls***

Identify and assess the automated and manual systems and applicable controls for processing transactions for advances, SLOC, collateral, and members, including:

- a) Authorized users;
- b) Authorized functions for each user;
- c) Utilization of spreadsheets;
- d) Credit risk and/or collateral valuation models; and
- e) Business continuity and recovery.

### **7) *Identification and evaluation of controls and significant changes to the activity or function***

- a) Evaluate workflow and processes as well as controls, including the level and direction of risk and the quality of risk management; and
- b) Evaluate any significant changes that have been implemented since the last examination or are being considered that may affect the FHLBank's risk profile such as management, systems, key personnel, products, regulatory requirements and processing.

### **8) *Testing***

Conduct testing as appropriate. The scope of testing should be based on the preliminary review of governance, risk management, internal controls and audit coverage. Specific examples include, but are not limited to the following:

#### **Advances**

- a) Review a sample of advances for authorization, pricing, disclosure, recording, and disbursement. The sample should include a variety of advance types, as well as, some that are differentially priced.
- b) Review a sample of account reconciliations to the FHLBank's general ledger for advances, standby letters of credit and/or loan commitments as of the examination date. Determine if outstanding reconciling items are supported and cleared and/or written off in a timely manner.
- c) Check a sample of advances limits calculations for accuracy.
- d) Evaluate the adequacy and accuracy of reports used by management and the



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board of directors.

### **SLOC**

- a) Sample SLOCs to assess whether the FHLBank is in compliance with policies, procedures (including those governing purpose, authorization, expiration date, and fees) and internal controls, and to assess the adequacy thereof.
- b) Evaluate the adequacy and accuracy of reports used by management and the board of directors.

### **Collateral**

- a) Investigate any collateral deficiencies and how they were or will be cured.
- b) Review a sample of members for appropriate collateral status and collateral maintenance level or “haircut.” The sample should include a variety of members including those on the watch list, the top borrowers, and those experiencing significant advance growths, those under advance limitations, those receiving policy waivers, and those receiving internal credit review/score downgrades.
- c) Review a sample of collateral in delivery status for appropriate documents and reconcile to collateral reports. The sample should include collateral from more than one member if available.
- d) Verify the accuracy of the latest collateral vault inventory.
- e) Review a sample of collateral verifications for compliance with policies and procedures and reasonableness given type, volume, and characteristics of collateral. Verify that planned adjustments were entered into the collateral system.

### **Risk Identification and Adversely Classified Credits**

Analyze a sample of recent member monitoring reports for accuracy and appropriate risk identification. Determine if internal credit scores/grades are accurate, current and reflective of the risks, and review a sample of assets classified less than satisfactory for justification.

If *significant weaknesses* exist in the FHLBank’s member risk identification, adverse classification policies and procedures, and credit and collateral monitoring, an expanded member exposure and adverse classification review should be considered. Specific examples of attributes to consider include, but are not limited to the following:

- a) Review and evaluate the analysis performed on the FHLBank’s member “Watch List.” For example, assess whether the analysis determines the cause of financial weakness, the risk exposure to the FHLBank, establishes the strategy to monitor, control and limit the risk, and if applicable, remedial action.

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- b) Perform a credit risk review and classify the member's exposure. Specific criteria to consider in developing the asset classification include, but are not limited to an evaluation of the following:
  - (1) Ability of the member to repay advances and any other extensions of credit extended by the FHLBank; and
  - (2) Ability of the member to repay advances and unsecured extensions of credit from secondary sources of income, such as collateral.
- c) Adversely classify those members' exposures that represent a significant credit risk to the FHLBank, using the following adverse classification categories:
  - (1) ***Substandard***-Member exposure classified ***Substandard*** is protected inadequately by the current net worth and paying capacity of the member, or by the collateral pledged, if any. Member exposure so classified must have a well-defined weakness or weaknesses that jeopardize the FHLBank's ability to liquidate the exposure. This level of member exposure is characterized by the distinct possibility that the FHLBank will sustain some loss if the deficiencies are not corrected.
  - (2) ***Doubtful***-Member exposure classified ***Doubtful*** has all the weaknesses inherent in those exposures classified ***Substandard*** with the added characteristic that the weaknesses make collection of liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.
  - (3) ***Loss***-Member exposure classified ***Loss*** is considered uncollectible and of such little value that the exposure's continuance as a bankable asset is not warranted. This classification does not mean that the exposure has absolutely no recovery or salvage value; rather, it is not practical or desirable to defer writing off this basically worthless asset, even though partial recovery may occur in the future.
  - (4) ***Special Mention***-A ***Special Mention*** member exposure has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the exposure or in the FHLBank's credit position at some future date. ***Special Mention*** is not adversely classified and does not expose an FHLBank to sufficient risk to warrant adverse classification.

### **9) *Assessment of Risks***

Summarize the results of the activity or function examined in a separate memorandum. The memorandum must articulate the risks and the management of

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those risks. It should also clearly and specifically describe the basis and analysis for the assessment. The memorandum should discuss the type(s) of risk (market, credit, operational); the level of the risk (low, moderate, high); the direction of the risk (stable, decreasing, increasing); and the quality of risk management (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.

### ***10) Items requiring follow-up at the next on-site visitation***

Identify key issues that have been communicated to management (written or oral) that require follow-up during the next on-site visitation.