SUMMARY: The Export-Import Bank, as a part of its continuing effort to reduce paperwork and respondent burden, invites the general public and other Federal Agencies to comment on the proposed information collection as required by the Paperwork Reduction Act of 1995.

SUPPLEMENTARY INFORMATION: This notice is soliciting comments from the public concerning the proposed collection of information to (1) evaluate whether the proposed collection is necessary for the paper performance of the functions of the agency, including whether the information will have practical utility; (2) evaluate the accuracy of the agency's estimate of the burden of the proposed information collection of information; (3) enhance the quality, utility, and clarity of the information to be collected; and minimize the burden of collection of information on those who are to respond, including through the use of appropriated automated collection techniques or other forms of information technology, e.g., permitting electronic submission of responses.

DATES: Written comments should be received on or before February 5, 2007 to be assured of consideration.

ADDRESSES: Direct all comments to David Rostker, Office of Management and Budget, Office of Information and Regulatory Affairs, NEOB, Room 10202, Washington, DC 20503 (202) 395–3897.

Titles and Form Numbers: Export-Import Bank of the United States Application for Long-Term Loan or Guarantee, EIB 95–10.

OMB Number: 3048–0013.

Type of Review: Extension of a currently approved collection.

Need and Use: The information requested enables the applicant to provide Ex-Im Bank, with the information necessary to determine eligibility for the loan and guarantee programs.

Affected Public: Business or other for-profit.

Respondents: Entities involved in the provision of financing or arranging of financing for foreign buyers of U.S. exports.

Estimated Annual Respondents: 86 (revised).

Estimated Time Per Respondent: 2.0 hours (revised).

Estimated Annual Burden: 172 hours.

Frequency of Response: When applying for a long-time preliminary or final commitment.

Dated: December 27, 2006.

Solomon Bush,

Agency Clearance Officer.

[FR Doc. 06–9978 Filed 1–4–07; 8:45 am]

BILLING CODE 6690–01–M

FEDERAL HOUSING FINANCE BOARD

[No. 2006–N–10]

Examination Rating System for the Federal Home Loan Banks and the Office of Finance

AGENCY: Federal Housing Finance Board.

ACTION: Notice.

SUMMARY: The Federal Housing Finance Board (Finance Board) is adopting an examination rating system known as the Federal Home Loan Bank Rating System (Rating System).

DATES: The Finance Board will use the Rating System for all examinations that begin after December 31, 2006.

FOR FURTHER INFORMATION CONTACT: Anthony Cornyn, Associate Director, Supervision and Examination, Office of Supervision, *cornyna@fhfb.gov* or 202–408–2522, or Kari Walter, Associate Director, Supervisory and Regulatory Policy, Office of Supervision, *walterk@fhfb.gov* or 202–408–2829. You can send regular mail to the Federal Housing Finance Board, 1625 Eye Street, NW., Washington DC 20006.

SUPPLEMENTARY INFORMATION:

I. Background

In September 2006, the Finance Board published a proposed Rating System for the Federal Home Loan Banks (Banks) and the Office of Finance (OF) in the **Federal Register** for public comment. *See* 71 FR 55181 (Sept. 21, 2006) (available at the Finance Board's Web site: *http://www.fhfb.gov/Default.aspx?Page=59&ListCategory=4#4*). The 30-day comment period closed on October 23, 2006. The Finance Board received 7 comments (the comments are available at the Finance Board's Web site: *http://www.fhfb.gov/Default.aspx?Page=93&Top=93*). Based on the comments, the Office of Supervision revised the Introduction and Overview to clarify that the composite rating will be based on the relative importance of each component as determined case-by-case within the parameters established by the Rating System. The proposal stated that the Finance Board would give special consideration to corporate governance in assigning a composite rating. Although the importance of corporate governance cannot be over-emphasized, our intent is not to weight the corporate governance component more heavily than other components. Rather than giving special consideration to any one component, examiners will use judgment and a case-by-case approach when assigning composite ratings. The Office of Supervision made no other significant changes to the Rating System as proposed.

II. The Federal Home Loan Bank Rating System

In 2005, the Office of Supervision began to provide an overall conclusion—Satisfactory, Fair, Marginal, or Unsatisfactory—as part of its Report of Examination. The Rating System, which is the next step in communicating exam results to the Banks, is a risk-focused system under which each Bank and the OF is assigned a composite rating from ''1'' to ''4'' based on an evaluation of various aspects of their operations. The composite rating of each Bank is based on an evaluation and rating of 5 key components: corporate governance, market risk, credit risk, operational risk, and financial condition and performance. The composite rating of the OF is based primarily on an evaluation of 2 components: corporate governance and operational risk. A ''1'' rating indicates the lowest degree of supervisory concern, while a ''4'' rating indicates the highest degree of supervisory concern. The composite rating is based on the ratings of the underlying components, which also are rated on a scale of ''1'' to ''4.'' The composite rating is not an arithmetic average of the component ratings. Instead, the relative importance of each component is determined case-by-case within the parameters established by the Rating System.

Under the Rating System, examiners take administration of a Bank's affordable housing and community investment activities into account in assigning component ratings for corporate governance and operational risk. Given the importance of affordable housing and community investment activities to the mission of the Bank System, the Office of Supervision may consider the need for a separate rating system or a separate ratings component to evaluate and rate the affordable housing and community investment programs of each Bank after gaining experience with the Rating System.

The Rating System is intended to serve 2 purposes. First, it is designed to reflect in a comprehensive, systematic, and consistent fashion the overall condition and performance of an institution, taking into consideration all significant financial, operational, and compliance factors addressed in the Finance Board's examination. Second, the Rating System is meant to further enhance communication and transparency between the Office of Supervision and each Bank and the OF regarding the results of the examination process.

The ratings for individual Banks and the OF will not be made public or released to other Banks, but will be supplied to the individual Banks and the OF on a confidential basis as part of the examination and supervisory process.

The Federal Home Loan Bank Rating System is attached as an Exhibit to this Notice.

Dated: December 28, 2006.

By the Federal Housing Finance Board.

John P. Kennedy,

General Counsel.

BILLING CODE 6725–01–P

FEDERAL HOME LOAN BANK RATING SYSTEM

I. Introduction and Overview

The Federal Home Loan Bank Rating System (FHLBRS) is a risk-focused rating system under which each Federal Home Loan Bank (Bank) and the Office of Finance (OF) is assigned a composite rating based on an evaluation of various aspects of its operations. Specifically, the composite rating of each Bank is based on an evaluation and rating of five key components: corporate governance, market risk, credit risk, operational risk, and financial condition and performance. The composite rating of the OF is based primarily on an evaluation of two components: corporate governance and operational risk. The administration of a Bank's affordable housing and community investment activities is taken into account under the corporate governance and operational risk components of the rating system.

Under the rating system, each Bank and the OF is assigned a composite rating from "1" to "4." A "1" rating indicates the lowest degree of supervisory concern, while a "4" rating indicates the highest degree of supervisory concern. The composite rating of each institution is based on the ratings of the underlying components, which are also rated on a scale of "1" to "4." The composite rating assigned to an institution is not an arithmetic average of the component ratings. Instead, the relative importance of each component is determined case-by-case within the parameters established by this rating system.

The ratings assigned under the FHLBRS are to be viewed within the context of the risk profiles of the Federal Home Loan Banks. For example, the rating system employs three risk categories "Low Risk," "Moderate Risk," and "High Risk" to designate the level of risk exposure of a Bank's market risk, credit risk, and operational risk. These risk levels are intended to measure risk within the context of the Federal Home Loan Banks. They are not intended to measure risk relative to risk levels of other financial institutions. In this regard, the ratings assigned under the FHLBRS should not be viewed as comparable to the ratings used by any other rating system or rating agency.

II. Composite Ratings

Composite ratings are based on a careful evaluation of an institution's corporate governance, market, credit, and operational risk, and its overall financial condition and performance. An institution will be assigned a composite rating of "1" to "4" as described below.

Composite 1 – An institution that is rated "1" is considered to be operating in a safe and sound manner in every respect. It exhibits no material deficiencies in corporate governance, risk management, or financial condition, performance, and prospects. It is in substantial compliance with laws, regulations, and supervisory guidance.

Composite 2 – An institution that is rated "2" is considered to be operating in a satisfactory or acceptable manner. It may exhibit some moderate deficiencies in corporate governance, risk management, or financial condition and performance. The institution's board of directors and senior management have demonstrated the ability and willingness to address deficiencies in a timely manner. It is in substantial compliance with laws, regulations, and supervisory guidance. ***The general policy is that examiners will monitor the correction of identified deficiencies or weaknesses through the normal supervisory process.***

Composite 3 – An institution that is rated "3" raises supervisory concern due to deficiencies in its corporate governance, risk management, or its financial condition or performance. Taken alone or in combination, these deficiencies are moderate to severe. The organization may be in substantial noncompliance with laws, regulations, or supervisory guidance. The institution's board of directors or management do not demonstrate the ability or willingness to address deficiencies. A composite "3" rated institution requires more than normal supervision. ***The general policy is that supervisory action will be taken to address identified deficiencies or weaknesses.***

Composite 4 – An institution that is rated "4" is operating in an unacceptable manner. It may exhibit serious deficiencies in corporate governance, risk management, or financial condition and performance. It may be in substantial noncompliance with laws, regulations, or supervisory guidance. It requires close supervisory attention. Institutions in this group are considered to be operating in an unsafe or unsound condition or with unsafe and unsound practices. ***The general policy is that a formal enforcement action will be taken to address identified deficiencies or weaknesses.***

III. Component Ratings

The composite rating is derived from the five component ratings that are described below. Each of the component rating descriptions provides a list of the principal evaluative factors that relate to that component. The listing of evaluative factors for each component rating is not exhaustive and is not in order of importance.

Corporate Governance

Good corporate governance requires the board of directors and senior management to take an active role in formulating strategy; setting goals and objectives; adopting sound risk management policies and practices; conforming to laws, regulations, and supervisory guidance; and ensuring compliance with high standards of ethics and professional conduct.

Although the board of directors is not actively involved in day-to-day operations, it must provide clear guidance to management regarding acceptable risk exposures and ensure that management has developed and implemented appropriate policies, procedures, and practices. The board, in conjunction with senior management, is expected to set risk and return objectives that are consistent with the institution's strategy and mission.

Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

An institution's corporate governance is rated based upon, but not limited to, an assessment of the following factors:

Board of Directors and Senior Management

- Whether the board is actively engaged in carrying out its duties and responsibilities, including monitoring senior management performance, providing strategic direction, establishing risk parameters, and governing the institution's affordable housing and community investment activities.
- The effectiveness of the board of directors.
- The quality, expertise, and effectiveness of management.
- Whether the board and senior management have established an operating structure that facilitates a sound risk management program.
- Management depth and the adequacy of management succession plans.
- The quality of strategic planning and the ability of management to integrate strategy with risk and return objectives.
- The overall "tone at the top," including the quality of the risk management culture and the existence of high ethical standards.
- The institution's responsiveness to supervisory criticism.

Risk Management and Controls

- The quality of risk management oversight and the soundness of risk management policies, practices, and procedures.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems.
- The quality of internal controls and the effectiveness of the internal audit and control unit(s) in identifying and communicating internal control deficiencies to management and the board.

Compliance

- Compliance with laws, regulations, supervisory guidance, and Bank policies.
- The responsiveness of the board and management to internal audit and independent auditors.
- The responsiveness of the board and management to supervisory authorities.

Assessing the Quality of Corporate Governance

The quality of corporate governance will be rated in accordance with the definitions outlined below. It is not necessary to exhibit every characteristic to be accorded a specific rating.

1. A rating of "**1**" indicates that the quality of corporate governance is strong and there are no supervisory concerns. The board and senior management are actively engaged in carrying out their duties and responsibilities, and possess and demonstrate the experience and expertise to manage the institution effectively. Strategic and operational plans have been developed with full participation by the board and serve as effective guides to management. Such plans fully incorporate the institution's affordable housing and community investment activities. Management succession is well-developed and comprehensive.

   The board and management effectively promote compliance with laws, regulations, supervisory guidance, and internal policies. Risk management policies and procedures are comprehensive and highly effective. Risk monitoring, internal control, and management information systems are comprehensive and sound. Management information reports provided to the board and senior management are timely, accurate, and comprehensive.

   Risk limits are prudent and address all significant risk exposures. The board and senior management review compliance with risk limits. Limit breaches are identified, evaluated, and corrected in a timely manner.

   Audit programs are effective. Mission-critical functions are supported by appropriate technological and human resources and contain no material control weaknesses. Any risk management and control deficiencies are minor and supervisory recommendations are addressed in a timely manner. Affordable housing and community investment activities are well-administered and exhibit no significant governance deficiencies.

2. A rating of "**2**" indicates that the quality of corporate governance is satisfactory. Risk exposures are identified and controlled in a manner that does not require more than normal supervisory attention. The board and senior management are generally effective in carrying out their duties. Strategic and operational plans have been developed with the involvement of members of the board. Such plans incorporate the institution's affordable housing and community investment activities. Management succession planning is adequately developed and comprehensive.

   The board and management promote compliance with laws, regulations, supervisory guidance, and internal policies, although some minor compliance exceptions may be noted. Risk management policies and procedures are adequate and generally effective. Risk management, internal control, and management information systems are adequate. Management information reports provided to the board and senior management are timely, accurate, and informative but some deficiencies may exist.

   Risk limits are prudent. In general, limit breaches are identified, evaluated, and corrected in a timely manner.

Audit programs are effective but may exhibit minor weaknesses. With few exceptions, mission-critical functions are fully automated and contain few control weaknesses. Risk management and control deficiencies and supervisory recommendations are generally addressed in a timely manner. Affordable housing and community investment activities are well-administered and exhibit only minor governance deficiencies.

3. A rating of **"3"** indicates that the quality of corporate governance is of supervisory concern. Risk management deficiencies are a cause for more than normal supervisory attention. The board of directors and management are not fully engaged in carrying out their duties and responsibilities and have not demonstrated the experience or expertise to manage the institution effectively. Strategic and operational plans may have been developed with little participation by the board (other than plan approval), and may be deficient in some material respect. Management succession planning is only partially developed and is not fully comprehensive.

   The board and management are not fully effective in promoting compliance with laws, regulations, supervisory guidance, and internal policies. Risk management policies and procedures contain some deficiencies. Risk management, internal control, or management information systems are deficient in some material respect. Management information reports provided to the board and senior management are untimely, inaccurate, or misleading.

   Risk limits may be imprudent. Breaches to limits are not always reported, reviewed, or properly addressed.

   Audit programs exhibit weaknesses or deficiencies. Mission-critical functions of the institution are ineffective and exhibit weaknesses. Risk management and internal control deficiencies or supervisory recommendations are not being addressed in a timely manner and could adversely affect the institution's safety and soundness. Governance of affordable housing activities is deficient in some material respect.

4. A rating of **"4"** indicates that the quality of governance is unacceptable. Risk management practices warrant a high degree of supervisory attention. The board and senior management are not carrying out their duties and responsibilities or may not possess the experience or expertise to manage the institution effectively. Strategic and operational plans may have been developed without the participation of the board and may be deficient in some material respect. Management succession planning is inadequate.

   The board and management are ineffective in promoting compliance with laws, regulations, supervisory guidance, and internal policies. Risk management policies and procedures may contain serious deficiencies. Risk management, internal control, and management information systems may contain serious deficiencies. Management information reports provided to the board and senior management are frequently untimely, inaccurate, misleading, or less that fully informative.

Risk limits have not been established or are not reported, reviewed, and evaluated by board and senior management committees.

Audit programs exhibit serious weaknesses or deficiencies. Mission-critical functions of the institution rely on manual processes and exhibit significant weaknesses. Material risk management and internal control deficiencies or supervisory recommendations are not addressed in a timely manner. Unless immediate corrective action is taken, deficiencies could seriously affect the institution's safety and soundness. Governance of affordable housing and community investment activities is seriously deficient in one or more material respects.

Market Risk

Market risk is the degree to which changes in interest rates and other market risk factors can adversely affect an institution's economic capital (market value of equity) or earnings. The market risk component of the FHLBRS reflects both the level of an institution's market risk exposure and the quality of its market risk management. For Banks, the primary component of market risk is interest rate risk – the risk to the market value of equity and earnings as a result of changes in interest rates.

The market risk rating of an institution is based upon, but not limited to, an assessment of the following factors:

Level of Market Risk Exposure

- The sensitivity of the institution's earnings and market value of equity to changes in interest rates and other market risk factors.
- The sensitivity of the institution's earnings and market value of equity to changes in interest rates and other market risk factors in relation to its retained earnings and capital.

Quality of Market Risk Management

- The quality of board and senior management oversight of market risk.
- The effectiveness of risk management policies, procedures, and internal controls.
- The effectiveness of risk measurement, monitoring, and reporting systems.
- The effectiveness of the institution's hedging activities.

Assessing the Level of Market Risk Exposure

Based on the factors outlined above, examiners will assess the level of market risk of an institution, within the context of a government sponsored enterprise, as **Low**, **Moderate,** or **High** as defined below:

Low Risk – The sensitivity of the institution's market value of equity to changes in interest rates and other market risk factors is low in relation to its level of market value of equity; and the sensitivity of the institution's earnings to changes in interest rates and other market risk factors is low in relation to its retained earnings and capital. Exposure to repricing risk, basis risk, and yield curve risk is minimal. Options positions are clearly identified and well-managed.

Moderate Risk – The sensitivity of the institution's market value of equity to changes in interest rates and other market risk factors is moderate in relation to its level of market value of equity; and the sensitivity of the institution's earnings to changes in interest rates and other market risk factors is moderate in relation to retained earnings and capital. Repricing risk, basis risk, yield curve risk, and options risk are maintained at manageable levels.

High Risk – The sensitivity of the institution's market value of equity to changes in interest rates and other market risk factors is substantial in relation to its level of market value of equity; or the sensitivity of the institution's earnings to changes in interest rates and other market risk factors is substantial in relation to retained earnings and capital. Exposure may reflect substantial repricing risk, basis risk, or yield curve risk.

Assessing the Quality of Market Risk Management

Based on the factors outlined above examiners will assess the quality of market risk management as **Strong, Adequate,** or **Weak** generally as defined below. It is not necessary to exhibit every characteristic to be accorded a specific rating.

Strong – Market risk limits are comprehensive and prudent in relation to the risk to earnings and the market value of equity under a variety of plausible scenarios. Management and the board of directors have a strong understanding of the market risk exposures and their implications for the institution's earnings and capital. The risk management process is effective. Measurement tools and methods enhance decision making by providing meaningful and timely information under a variety of plausible scenarios. The quality of market risk modeling is high. Market risk models are properly documented and validated. Few, if any, risk management deficiencies exist. Management information at various levels of the organization is timely, accurate, and complete. Staff responsible for monitoring risk limits and measuring exposures is effective and independent from staff executing risk taking decisions. Risk limits are rarely breached and breaches are addressed promptly.

Adequate – Market risk limits are prudent in relation to the risk to earnings and market value of equity under a variety of plausible scenarios. Management and the board of directors have a good understanding of the key market risk exposures of the institution. The market risk management process is adequate. Measurement tools and methods may have minor deficiencies. The quality of market risk modeling is adequate. Market risk models are properly documented and validated, although some deficiencies may exist. Management information at various levels in the organization is, for the most part, timely, accurate, and complete. Staff responsible for monitoring risk limits and measuring exposures is generally effective and is independent from staff executing risk-taking decisions. Risk limits are occasionally breached but limit breaches are not serious.

Weak – Market risk limits are not prudent in relation to the risks to earnings and the market value of equity. Management and the board of directors do not understand, or have chosen to ignore, key aspects of the institution's market risk. Management does not anticipate or take timely and appropriate actions in response to market conditions. Knowledge of market risk may be concentrated in too few individuals in the organization. The market risk management process is deficient in light of the size and complexity of the institution's exposures. The quality of market risk modeling is deficient. Market risk models are not properly documented and validated. Management information at various levels in the organization exhibits significant deficiencies. Staff responsible for monitoring risk limits and measuring exposures is ineffective or is not independent from staff executing risk-taking decisions. Risk limits are not adhered to or limit breaches are not addressed promptly.

Market Risk Ratings

An institution's market risk rating is based upon an assessment of both the level of its market risk exposure and the quality of its market risk management. The following matrix will be used to combine these two factors to derive a market risk component rating.

	LEVEL OF MARKET RISK		
QUALITY OF MARKET RISK MANAGEMENT	LOW RISK	MODERATE RISK	HIGH RISK
Strong	1	1-2	2-3
Adequate	1-2	2-3	3-4
Weak	2-3	3-4	4

1. A rating of **"1"** indicates the level of market risk exposure is low and the quality of market risk management is strong. A "1" rating may be accorded in other situations where the combination of market risk and the quality of market risk management is of minimal supervisory concern. The level of earnings, capital, and retained earnings provide substantial support for the degree of market risk of the institution. Market risk is not increasing at an unacceptable or unmanageable pace.

2. A rating of **"2"** indicates the level of market risk exposure and the quality of risk management is satisfactory or acceptable. A "2" rating may be accorded in other situations where the market risk exposure of the institution is offset by strong market risk management or when the level of market risk exposure is not excessive in relation to the quality of market risk management. The level of earnings, capital, and retained earnings provide adequate support for the market risk of the institution. Market risk is not increasing at an unacceptable or unmanageable pace.

3. A rating of **"3"** indicates the level of market risk exposure is of supervisory concern and is not mitigated by the quality of market risk management. Risk management practices may need to be improved or risk exposures may need to be reduced. The level of earnings, capital, and retained earnings may be marginal in relation to market risk exposures.

4. A rating of **"4"** indicates the combination of the level of market risk exposure and the quality of market risk management is unacceptable. A rating of "4" may be accorded in other situations where the market risk of the institution is a significant supervisory concern. Market risk management practices must be significantly improved, or market risk exposure must be significantly reduced, or both. The level of earnings, capital, and retained earnings do not adequately support market risk exposures.

Credit Risk

The credit risk rating reflects the level and direction of credit risk exposures and the quality of credit risk management. Investments, acquired member assets, derivatives, off-balance sheet items, and other assets are primary sources of credit risk. The credit risk rating of an institution is based upon, but not limited to, an assessment of the following factors:

Level of Credit Risk Exposure

- The level and trend of nonperforming and non-accrual assets.
- The overall quality and diversification of the advance, investment and acquired member assets portfolios.
- The volume and nature of credit documentation exceptions.

Quality of Credit Risk Management

- The quality of credit review performed by the board of directors and senior management.
- The quality and effectiveness of credit risk management policies and procedures.
- The quality and effectiveness of credit underwriting policies and procedures.
- The quality, timeliness, and effectiveness of collateral valuation and testing procedures.
- The quality of the methodologies for evaluating and maintaining reserves for credit losses.
- The quality of the institution's credit risk self-assessment and internal risk rating processes.
- The quality of credit information systems.

Assessing the Level of Credit Risk Exposure

Based on the factors outlined above, examiners will assess the level of credit risk of an institution, within the context of a government sponsored enterprise, as **Low**, **Moderate,** or **High** as defined below. It is not necessary to exhibit every characteristic to be accorded a specific rating.

Low Risk – Exposure to loss of earnings or capital is minimal. Credit exposures reflect conservative underwriting policies and practices. Exceptions or overrides to sound underwriting standards pose minimal risk. Portfolio diversification is sound and risk of loss from concentrations is minimal. Portfolio growth presents no concerns. The volume of troubled credits is low relative to capital and can be resolved in the normal course of business.

Moderate Risk – Exposure to loss of earnings or capital does not materially affect financial condition. Credit exposures reflect acceptable underwriting policies and practices. Exceptions or overrides to sound underwriting standards may exist, but do not pose significant risk. Exposure does not reflect significant concentrations. The volume of troubled credits does not pose undue risk relative to capital.

High Risk – Exposure to loss of earnings or capital is material. Credit exposures reflect aggressive underwriting policies and practices. A large volume of substantive exceptions or overrides to sound underwriting standards exists. Exposure reflects significant concentrations. Portfolio growth, including products or sectors within the portfolio, is aggressive. The volume of troubled credits may be large relative to capital.

Assessing the Quality of Credit Risk Management

Based on the factors outlined above examiners will assess the quality of credit risk management as **Strong**, **Adequate,** or **Weak** generally as defined below:

Strong – The credit policy function comprehensively defines risk tolerances, concentrations, responsibilities, and accountabilities. All credit policies are communicated effectively throughout the organization. The credit culture, including compensation, strikes an appropriate balance between marketing and credit considerations. The credit granting process is extensively defined, well understood, and adhered to consistently. Credit analysis is thorough and timely. Credit risk measurement and monitoring systems are comprehensive and allow management to implement appropriate actions in response to changes in asset quality and market conditions. The quality of credit risk modeling is high. Credit risk models are properly documented and validated.

Information processes are appropriate for the volume and complexity of activity and any weaknesses are minor, with little potential for any adverse impact to earnings or capital. Credit administration is effective. Management identifies and actively manages portfolio risk. The loss reserve methodology is well-defined, objective, and clearly supports adequacy of current reserve levels. Credit personnel possess extensive technical and managerial expertise. Internal controls are comprehensive and effective. The stature, quality, and independence of the credit risk review function are appropriate and highly effective.

Adequate – The credit policy function satisfactorily defines risk tolerances, concentrations, responsibilities, and accountabilities. In general, credit policies are communicated effectively throughout the organization. Credit analysis is adequate. Credit risk measurement and monitoring systems are satisfactory. The quality of credit risk modeling is adequate. Credit risk models are documented and validated, although some deficiencies may exist.

Credit information processes are adequate for the volume and complexity of activity. Credit reports may contain minor weaknesses. Weaknesses in information processes are not so significant that they lead to poor credit decisions. The internal credit-grading system accurately stratifies portfolio quality. Credit administration is adequate. Management identifies and monitors portfolio risk. Credit risk diversification is adequate. The loss reserve methodology is satisfactory and the loss reserve is sufficient to cover inherent losses. Credit personnel possess requisite technical and managerial expertise. Key internal controls are effective. The stature, quality, and independence of the credit risk review function are appropriate and effective.

Weak – The credit policy function may not effectively define risk tolerances, concentrations, responsibilities, and/or accountabilities. Credit policies are not effectively communicated. The credit culture, including compensation, overemphasizes marketing relative to credit considerations. The credit granting process is not well-defined or not well understood. Credit analysis is insufficient relative to the risk. Credit risk measurement and monitoring systems may not permit management to implement timely and appropriate actions in response to changes in asset quality or market conditions. The quality of credit risk modeling is deficient. Credit risk models are not properly documented and validated.

Credit information processes are inappropriate for the volume and complexity of activity. Credit reports are inaccurate, untimely, or incomplete. Weaknesses in information processes can lead management to poor credit decisions. The internal credit-grading system does not accurately stratify the portfolio's quality. Credit administration is ineffective. Management is unable to identify and monitor portfolio risk. Credit risk diversification is inadequate. The loss reserve methodology is flawed or the loss reserve is insufficient to cover inherent credit losses. Credit personnel lack requisite technical and managerial expertise. Key internal controls may be absent or ineffective. The stature, quality, or independence of the credit risk review function is inappropriate or ineffective.

Credit Risk Ratings

An institution's credit risk rating is based upon an assessment of both the level of credit risk exposure and the quality of its credit risk management. The following matrix will be used to combine these two factors to derive a credit risk component rating.

	LEVEL OF CREDIT RISK		
QUALITY OF CREDIT RISK MANAGEMENT	LOW RISK	MODERATE RISK	HIGH RISK
Strong	1	1-2	2-3
Adequate	1-2	2-3	3-4
Weak	2-3	3-4	4

1. A rating of **"1"** indicates the level of credit risk exposure is low and the quality of credit risk management is strong. A "1" rating may be accorded in other situations where the combination of credit risk and credit risk management is of minimal supervisory concern. The level of earnings, capital, and retained earnings provide substantial support for the degree of credit risk of the institution. Credit risk is not increasing at an unacceptable or unmanageable pace.

2. A rating of **"2"** indicates the level of credit risk exposure and the quality of risk management is satisfactory or acceptable. A "2" rating may be accorded in other situations where the credit risk exposure of the institution is offset by strong credit risk management or when the level of credit risk exposure is not excessive in relation to the quality of credit risk management. The level of earnings, capital, and retained earnings provide adequate support for the credit risk of the institution. Credit risk is not increasing at an unacceptable or unmanageable pace.

3. A rating of **"3"** indicates the level of credit risk exposure is of supervisory concern and is not mitigated by the quality of credit risk management. Risk management practices may need to be improved or risk exposures may need to be reduced. The level of earnings, capital, and retained earnings may be marginal in relation to credit risk exposures.

4. A rating of **"4"** indicates the combination of the level of credit risk exposure and the quality of credit risk management is unacceptable. A rating of "4" may be accorded in other situations where the credit risk of the institution is a significant supervisory concern. Credit risk management practices must be significantly improved, or credit risk exposure must be significantly reduced, or both. The level of earnings, capital, and retained earnings do not adequately support credit risk exposures.

Operational Risk

Operational risk is the risk of possible losses resulting from inadequate or failed internal processes, people, and systems or from external events. Operational risk includes possible losses from internal or external fraud, improper employment practices, inadequate workplace safety, improper business and accounting practices, fiduciary breaches, misrepresentations, unauthorized trading activities, damage to physical assets, business disruption and system failures, and execution, delivery, and process management failures. The assessment of operational risk includes evaluating reputation risks. The operational risk component rating of the FHLBRS reflects both the level of an institution's operational risk exposure and the quality of its operational risk management.

The operational risk of an institution is rated based upon, but not limited to, an assessment of the following factors:

Level of Operational Risk Exposure

- The level and frequency of losses resulting from inadequate or failed internal processes or systems, fraud or human error, or from external events.

- The severity and frequency of accounting, financial, and regulatory reporting errors.
- Whether the institution's operational risk losses are increasing, decreasing, or stable.
- The degree to which processes are automated to minimize error.
- The level of operational risk arising from the administration of the institution's principal lines of business and its affordable housing and community investment activities.

Quality of Operational Risk Management

- Whether appropriate policies, procedures, and systems are in place to measure, manage, and control operational risk.
- Whether operational risks are being effectively measured, monitored, and controlled.
- The quality of policies and procedures in place to ensure secure, efficient, and effective information and data processing.
- The quality of contingency and business continuity planning.
- The quality of the institution's operational risk reports.
- The effectiveness of processes for identifying and controlling risk to business activities.
- The quality of the institution's operational risk self-assessment including whether key operational risks in all products, activities, processes, and systems have been clearly identified.
- The quality of operational risk management in the administration of the institution's affordable housing and community investment activities.

Assessing the Level of Operational Risk Exposure

Based on the factors outlined above, examiners will assess the level of operational risk of an institution, within the context of a government sponsored enterprise, as **Low**, **Moderate**, or **High** generally as defined below:

Low Risk – The institution has no history or only a limited history of operational losses. The number or magnitude of loss events is low. Operational control weaknesses (*e.g.,* violations of law, regulations, or Bank policy) are identified in a timely manner, usually by management, and typically are detected during the phase of developing or refining a process. Control systems are well documented and an adequate audit trail exists for testing of controls. The internal audit department, outside auditors/consultants, and/or examiners do not routinely identify substantive operational risks that are not adequately controlled. The internal audit function at a minimum is considered acceptable. The risk to earnings and capital is low.

Moderate Risk – The institution has had operational losses but the number or magnitude of losses is not considered substantial. Operational control weaknesses are sometimes not identified in a timely manner and management may not typically identify the control weaknesses. Control systems may be inadequately documented. There may be some issues with regard to adequate testing of controls. The internal audit department may sometimes identify substantive operational risks that are not adequately controlled. The internal audit function, at a minimum, is considered acceptable. The risk to earnings and capital is low, but there is increased concern that a material loss event could occur due to operational risk.

High Risk – The institution has experienced significant operational losses or material control deficiencies. The number or magnitude of loss events may be high. Operational control weaknesses are often not identified in a timely manner and management rarely may identify the control weaknesses. Control systems may not be adequately documented. There are concerns regarding adequate testing of controls. The internal audit department may often identify substantive operational risks that are not adequately controlled or timely addressed. The internal audit function may not be adequate. The risk to earnings and capital may be low to moderate, but there is significant concern that a material loss event could occur due to operational risk.

Assessing the Quality of Operational Risk Management

Based on the factors outlined above, examiners will assess the quality of operational risk management as **Strong**, **Adequate,** or **Weak** as defined below. It is not necessary to exhibit every characteristic to be accorded a specific rating.

Strong – Operational risk controls are comprehensive and highly effective. Systems are automated and managed to minimize errors. Management has considered unusual events and abnormal control failures in developing the internal control framework. There is a strong understanding of operational risks within and across various functions or departments. The risk management process is effective and proactive. Management routinely works to identify possible control weaknesses and implement controls. Management periodically tests key controls. Internal audit rarely finds deficiencies in operational controls. Information security systems allow for the identification of control breaches; adequately protect mission-critical data; and may use industry best practices in doing so. Internal audit is effective.

Adequate – Operational risk controls are adequate and generally effective. There is a good understanding of operational risks within and across various functions or departments. The risk management process is adequate. Some control weaknesses may occasionally be identified. Information security systems monitor control breaches and adequately protect mission-critical data. Internal audit is at least adequate.

Weak – Operational risk controls are inadequate or ineffective. Responsible officials do not appear to have a good understanding of the operational risks that impact their areas. The risk management process is ineffective. Management may rely too heavily on internal audit to identify control weaknesses and to implement controls. Management rarely tests key controls. Material control weaknesses may exist. Information security systems may be deficient and may not notify management of control breakdowns or protect mission-critical data. Internal audit may be inadequate.

Operational Risk Ratings

An institution's operational risk rating is a combination of the level of its operational risk exposure and the quality of its operational risk management. The following matrix will be used to combine these two factors to derive an operational risk rating.

	LEVEL OF OPERATIONAL RISK		
QUALITY OF OPERATIONAL RISK MANAGEMENT	LOW RISK	MODERATE RISK	HIGH RISK
Strong	1	1-2	2-3
Adequate	1-2	2-3	3-4
Weak	2-3	3-4	4

1. A rating of **"1"** indicates the level of operational risk exposure is low and the quality of operational risk management is strong. A "1" rating may be accorded in other situations where the combination of operational risk and operational risk management is of minimal supervisory concern. The level of earnings, capital, and retained earnings provide substantial support for the degree of operational risk of the institution. Operational risk is not increasing at an unacceptable or unmanageable pace.

2. A rating of **"2"** indicates the level of operational risk exposure and the quality of risk management are satisfactory or acceptable. A "2" rating may be accorded in other situations where the operational risk exposure of the institution is offset by strong operational risk management or when the level of operational risk exposure is not excessive in relation to the quality of operational risk management. The level of earnings, capital, and retained earnings provide adequate support for the operational risk of the institution. Operational risk is not increasing at an unacceptable or unmanageable pace.

3. A rating of **"3"** is accorded when the level of operational risk exposure is a supervisory concern and is not mitigated by the quality of operational risk management. Risk management practices may need to be improved or risk exposures may need to be reduced given the quality of risk management. The level of earnings, capital, or retained earnings may be marginal in relation to operational risk exposures.

4. A rating of **"4"** indicates the combination of the level of operational risk exposure and the quality of operational risk management is unacceptable. A rating of "4" may be accorded in other situations where the operational risk of the institution is a significant supervisory concern. Operational risk management practices must be significantly improved, or operational risk exposure must be significantly reduced, or both. The level of earnings, capital, and retained earnings do not adequately support operational risk exposures.

Condition and Performance

An institution's condition and performance rating is based upon an assessment of key financial condition and performance factors that are not directly addressed under the market, credit, and operational risk components of the rating system. Because an institution's financial condition and performance is inextricably linked to its market, credit, and operational risk exposures, there is necessarily some overlap between an institution's condition and performance rating and its ratings for market, credit, and operational risk. An institution's condition and performance should be assessed relative to both its historic condition and performance and that of other Banks. An assessment of a Bank's earnings and profitability takes into account the cooperative ownership structure of the Banks and the interplay in a cooperative between product pricing and dividends. The financial condition and performance of an institution is rated based upon, but not limited to, an assessment of the following factors:

Earnings and Profitability

- The level, trend, and stability of earnings.
- Risk-adjusted returns on assets and equity.
- Net interest margins and spreads.
- The quality of earnings.

Operating Efficiency

- Non-interest operating expenses in relation to average assets.
- The extent to which the institution is taking advantage of technological advances.

Capital and Retained Earnings

- The risk-based capital and leverage ratios.
- The relative stability of capital.
- The level of retained earnings in relation to the institution's earnings stability and future prospects.

Liquidity

- The level of liquidity instruments relative to risk exposures.
- Compliance with regulatory liquidity requirements.

Assessing Financial Condition and Performance Rating

The financial condition and performance of an institution will be rated generally in accordance with the definitions outlined below. It is not necessary to exhibit every characteristic to be accorded a specific rating.

1. A rating of **"1"** indicates that financial condition and performance of the institution is strong. Current earnings and future earnings prospects are more than sufficient to support

operations and maintain the Bank's capital, retained earnings, and dividend paying capacity. Trends of most key measures are positive.

2. A rating of **"2"** indicates that financial condition and performance of the institution is satisfactory or acceptable. Current earnings and future earnings prospects are sufficient to support operations and maintain adequate capital, retained earnings, and reasonable dividends.

3. A rating of **"3"** indicates that financial condition and performance of the institution is of supervisory concern. Earnings may not fully support operations and provide for the necessary buildup of retained earnings. Liquidity may be in violation of regulatory requirements.

4. A rating of "**4**" indicates that financial condition and performance of the institution is unacceptable. Earnings are insufficient to support operations and maintain appropriate capital and retained earnings. Institutions rated "4" may be characterized by erratic fluctuations in net income or net interest spread, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantial drop in earnings from previous years. Liquidity may be inadequate. Trends in key measures are negative.

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