

Federal Home Loan Bank of Seattle

Third Quarter 2005 Management's Discussion and Analysis

## **Forward-Looking Statements**

This report contains certain forward-looking statements that are subject to risk and uncertainty. These statements describe the expectations of the Federal Home Loan Bank of Seattle, or the Seattle Bank, regarding future events and developments, including future operating results, growth in assets, and continued success of our products. These statements include, without limitation, statements as to future expectations, beliefs, plans, strategies, objectives, events, conditions, and financial performance. The words "will," "believe," "expect," "intend," "may," "could," "should," "anticipate," and words of similar nature are intended in part to help identify forward-looking statements.

Future events are difficult to predict, and the expectations described in this report, including any forward-looking statements, are subject to risk and uncertainty that may cause actual results to differ materially from those we currently anticipate. Consequently, there is no assurance that the expected results will be achieved. Factors that may cause actual results to differ materially from those discussed in this report include, among others, the following:

- We earned net income of \$14.3 million in the third quarter of 2005 and \$10.9 million for the nine months ended September 30, 2005, which included a gain from the sale of \$1.4 billion of Mortgage Purchase Program, or MPP, government-insured mortgage loans. We anticipate reporting a net loss for the fourth quarter of 2005 due, in part, to expected one-time charges and in part to reduced net interest income compared to the third quarter. Assuming continuation of the current interest-rate environment, however, we anticipate that we will break even or earn minimal net income in 2005, and that our earnings will increase in 2006 and 2007.
- Implementation of our strategy to exit the MPP has reduced interest income and will continue to do so, particularly if we are unable to earn comparable amounts of interest income from advances.
- Although we have attempted to address the risk of changes in the interest-rate environment through our change in business focus and hedging activities, a significant drop in long-term interest rates without a similar drop in short-term interest rates could result in faster-than-expected prepayments and lower-than-expected yields on mortgage-based assets, which could contribute to lower net income or cause net losses.
- Our strategy to focus on advances will lead to reduced spreads relative to those in the MPP because advances earn lower spreads, and because we have increased our use of differential pricing to increase advances business, which will further narrow our spreads on advances due to the lower spreads we generally offer to borrowers who take out large advances or meet high-volume criteria.
- In order to encourage members to take out advances, our Board of Directors implemented a change to our capital plan that allows our members to support new advances with their outstanding membership stock, which is the stock that a member is required to hold in order to maintain its membership. One consequence of this change, however, is that our capital will not increase as a result of the increase in advances supported by membership stock. Because we must maintain a minimum capital-to-assets ratio of 4.25%, this lack of growth in capital could constrain the growth of our advances from time to time.
- Because our current advances-activity-based stock requirement generally calls for members to hold stock representing only 3.5% of the member's outstanding advances (minus the membership stock requirement), any additional purchases of capital stock for advances activity would likely not be in proportion to our minimum capital-to-assets ratio of 4.25%. Accordingly, this lack of proportionate capital growth on any new advances as compared to our required capital-to-assets ratio may also constrain the growth of our advances from time to time.

- Changes in our capital management strategies, such as the suspension of both dividends and stock repurchases that we implemented as a condition to the acceptance of our three-year business and capital management plan dated May 18, 2005, or three-year plan, by the Federal Housing Finance Board, or Finance Board, the requirement under the three-year plan that we maintain a capital-to-assets ratio that is higher than the regulatory capital-to-assets ratio requirement, and our plan to increase retained earnings over time could negatively affect members' willingness to purchase additional stock, which could result in lower than anticipated advance volumes.
- Our investment strategy to purchase consolidated obligations of other Federal Home Loan Banks, which we discontinued in October 2004, has adversely affected and will continue to adversely affect our net interest income in 2005 and 2006, with a diminishing effect on net interest income in later years. We refer to the 12 Federal Home Loan Banks as FHLBanks.
- Competition from other FHLBanks or other alternative sources of funding available to our members could reduce the demand for our advances or the interest income we receive on our advances and limit our ability to increase our advances business.
- Adverse changes in the market prices of our financial instruments, or failure to effectively hedge these instruments, could decrease our market value of equity, which we consider to be the present value of the expected net cash flows from all our assets, liabilities, and commitments.
- Failure to satisfy hedge accounting criteria under accounting principles generally accepted in the United States, or U.S. GAAP, in hedging our interest-rate risk could adversely affect our financial performance.
- Changes in investor demand for consolidated obligations or changes in our ability to participate in the issuance of consolidated obligations could affect our borrowing costs and access to funds.
- Negative changes in our credit agency ratings or ratings applicable to the Federal Home Loan Bank System (comprised of the 12 FHLBanks, the Finance Board and the Office of Finance), or the FHLBank System, could adversely impact the marketability of our consolidated obligations, products, or services.
- Regulatory or legislative changes could cause us to modify our current structure, policies, or business operations in a way that increases expenses or otherwise negatively affects our financial performance or our value to members.
- Withdrawal of one or more large members or consolidation among our members could reduce demand for our advances and, consequently, our interest income, as well as eventually reduce our capital levels.
- Changes in accounting rules or in the interpretation of existing rules could contribute to volatility in our earnings.
- Because of the joint and several liability of all FHLBanks for consolidated obligations, discussed in Note 8 to the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005, if another FHLBank were unable to make principal or interest payments on the consolidated obligations on which it was the primary obligor, we could be required by the Finance Board to make payments on behalf of the defaulting FHLBank. In addition, we could be required to make such principal or interest payments on behalf of another FHLBank even in the absence of a default if directed to do so by the Finance Board.

- Local and national economic conditions could be less favorable than expected or could have a more direct and pronounced effect on our business than expected. Changes in these conditions could adversely affect our ability to increase and maintain the quality of our earning assets.
- Events such as terrorism, natural disasters, or other catastrophic events could disrupt the financial markets where we obtain funding, our borrowers' ability to repay advances, or the value of the collateral that we hold.

These cautionary statements apply to all related forward-looking statements, wherever they appear in the report. We do not undertake to update any forward-looking statements that we make in this report or that we may make from time to time.

## **Management's Discussion and Analysis of Financial Condition and Results of Operations**

This discussion and analysis reviews our financial condition as of September 30, 2005, and December 31, 2004, and our results of operations for the three and nine months ended September 30, 2005 and 2004. This discussion should be read in conjunction with our audited financial statements and related notes for the year ended December 31, 2004, and our unaudited financial statements and related notes for the three and nine months ended September 30, 2005, included elsewhere in this report.

Operating results for the three and nine months ended September 30, 2005, are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

### **Overview**

#### **Structure and Historical Operations**

The Seattle Bank is a cooperative in which members own the stock and may receive dividends on their investments. Only federally insured depository institutions and insurance companies engaged in residential housing finance may apply for membership. All members are required to purchase stock in the Seattle Bank in amounts determined under our capital plan. The plan requires financial institutions to purchase a minimum amount of stock, which is the greater of \$500 or an amount based on their mortgage-related assets, in order to become members. Members are also subject to activity-based stock requirements, which generally require them to purchase additional stock if the amount of business they do with us increases. See Note 14 to the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005, for discussions of transactions with our members and their affiliates.

To serve the needs of our members, we have historically offered products and services through two operating segments, traditional member finance and, since 2001, the MPP. The traditional member finance segment includes advances, investments, and related funding and derivative instruments, and other fee-based member services. The MPP segment includes mortgage loans purchased for our portfolio directly from participating members and the related funding and derivative instruments. As part of the three-year plan, however, we began exiting the MPP. In August 2005, we sold a substantial portion of our MPP government-insured mortgage loans to an affiliate of one of our members.

Our principal source of financing is the issuance of consolidated obligations by the Office of Finance, a joint office of the FHLBanks created by the Finance Board, on our behalf. Although the FHLBanks are jointly and severally liable on all consolidated obligations, individual banks are primarily liable for an allocated portion of the consolidated obligations in which they participate.

Our principal source of income is net interest income, which is interest income received from our interest-earning assets less the interest expense paid on our interest-bearing liabilities. Our financial results are significantly impacted by changes in interest rates and, to a lesser extent, by U.S. economic conditions resulting from the level of interest rates.

## Trends

Beginning in 2001, we chose to emphasize acquiring mortgage loans through the MPP to achieve asset growth. In 2002, as a result of this strategic shift, we discontinued the use of differential pricing on our advances. This change in pricing policy contributed to the eventual decrease in our advance volumes because our advance rates were no longer competitive with the rates that could be obtained by our largest members elsewhere. We continued to expand our mortgage loan portfolio until the end of 2003, when, due to historically low interest rates and the complexities associated with managing a 30-year, fixed-rate, mortgage loan portfolio, we decided to limit the growth of the MPP until we could improve our operational infrastructure to better support the more complex risk profile of the MPP.

In late 2002 and early 2003, the Seattle Bank made large purchases of MPP assets and mortgage-backed securities. We funded these purchases with both callable debt and noncallable, or bullet, debt. The acquisition prices of these mortgage-based assets often exceeded par because interest rates had declined since their origination, causing them to appreciate before we purchased them. In 2003, when interest rates declined to historic lows, mortgage prepayments accelerated to a much faster pace, and we were not able to effectively match the cash flows of callable and bullet debt with the cash flows of the newly acquired mortgage-based assets. We did not refinance or retire the debt because of either the lock-out period on the callable debt or the premium that would have been required to extinguish the above market-rate debt. In addition, we did not hedge the interest-rate risk associated with the debt in part because of the cost associated with hedging. We purchased new mortgage-based assets at interest rates significantly lower than the assets they replaced, causing a decrease in net interest income or negative net interest income. Net interest income was also reduced because of the increased premium amortization that had to be recognized when the above-par MPP mortgage loans and mortgage-backed securities were prepaid more quickly than expected.

The faster-than-expected prepayments of existing mortgage-based assets, the decrease in new advances because of the noncompetitive rates, and our internal limits on acquiring MPP mortgage loans caused us to generate excess cash. We had to either reinvest our excess cash in higher-yield investments in order to produce a higher return on capital or return it to our members by repurchasing their stock. Our members had historically received dividends at favorable rates – for example, ranging from 6.88% in 2001 to 5.15% in 2003 – and preferred to retain their stock in order to continue to receive attractive dividends. Seeking to earn additional interest income to continue paying dividends at close to historical rates, we invested our excess cash primarily in mortgage-backed securities and callable debt of government-sponsored entities, or GSEs, such as other FHLBanks, Fannie Mae, and Freddie Mac. We also significantly increased our investment portfolio in late 2003 through August 2004, primarily by acquiring the consolidated obligations of other FHLBanks. We funded most of these purchases with our own contemporaneously-issued consolidated obligations, primarily consisting of short- and long-term bullet debt, but we did not match the prepayment options and maturities of the investments we purchased with the maturities and call options of the debt issued. During 2004, short-term interest rates steadily increased and long-term interest rates did not correspondingly increase, causing a decrease in our net interest income.

These changes in interest rates also caused the market value of our investments to decline and the market value of the contemporaneously-issued long-term debt to increase. Consequently, our market value of equity declined. As of September 30, 2005, we disclosed net unrealized market value losses of approximately \$400 million, which, in accordance with U.S. GAAP, are not reflected in our September 30, 2005 financial results. For more information regarding estimated fair value, see Note 13 of the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005. Because of the net unrealized market value losses, the ratio of the market value of our equity to the book value of our equity was estimated at 82% as of September 30, 2005. As of November 30, 2005, these net unrealized market value losses remained at approximately \$400 million, with the ratio of the market value of our equity to the book value of our equity estimated at 82%. The amount of our net unrealized market value loss involves estimates of the market values of our assets, liabilities, and commitments, which we discuss in greater depth in "– Financial Condition."

During the first half of 2005, we purchased options on interest-rate swaps, or swaptions, at an approximate cost of \$80 million, as economic hedges to protect against the potential of large unrealized losses in market value of equity. We intended to use swaptions to hedge our interest-rate risk until we were able to significantly reduce this risk by restructuring our assets and liabilities. The approximately \$12.3 million of expenses associated with holding these swaptions contributed to our net loss in the first half of 2005. The expenses related to these swaptions were \$3.5 million for the quarter ended September 30, 2005. In August 2005, we sold \$1.4 billion of our MPP government-insured mortgage loans to reduce both our interest-rate risk and the immediate need to hedge with swaptions. If long-term rates should decline from current levels or rise significantly and rapidly, we might again purchase swaptions to hedge against the potential for large declines in our market value of equity.

As a result of these historical trends and the actions we are taking to implement the three-year plan discussed below, our net income declined in 2004 and the first quarter of 2005, and we reported a net loss in the second quarter of 2005. We expect to experience a net loss for the fourth quarter of 2005, which will be due in part to expected one-time charges and in part to reduced net interest income, compared to the third quarter when we earned net income. The gain in the third quarter included a gain from the sale of \$1.4 billion of MPP government-insured mortgage loans. Assuming continuation of the current interest-rate environment, we anticipate that we will break even or earn minimal net income in 2005, and that our earnings will increase in 2006 and 2007.

### **The Finance Board Agreement; The Three-Year Business and Capital Management Plan; and Changes in Our Retained Earnings, Dividend Payment and Stock Repurchase Policies**

On December 10, 2004, we entered into an agreement with the Finance Board in connection with our 2004 examination, which we refer to as the Finance Board agreement. The Finance Board agreement required us to develop a three-year business and capital management plan and submit it to the Finance Board's Office of Supervision, and imposes certain other requirements and limitations. For example, the Finance Board agreement prohibits us from further purchases of consolidated obligations of other FHLBanks without Finance Board approval, although it does not require us to divest our investments in the consolidated obligations of other FHLBanks that we currently hold.

On April 5, 2005, we submitted our three-year business and capital management plan to the Finance Board. On May 18, 2005, the Finance Board accepted our three-year business and capital management plan, or the three-year plan, subject to our adoption of certain dividend and stock repurchase restrictions. To meet the Finance Board conditions, our Board of Directors adopted policies on May 18, 2005, (i) suspending indefinitely the declaration or payment of any dividend and providing that any future dividend declaration or payment generally may be made only after prior approval of the Director of the Office of Supervision of the Finance Board, or the OS Director, and (ii) suspending indefinitely the repurchase of any Class B(1) or Class B(2) stock, except that a limited amount of Class B(2) stock repurchases may be made after prior approval of the OS Director. These policies will be in effect until formally revoked by our Board of Directors, following approval of the OS Director. We do not expect to obtain waivers from the Finance Board for the repurchase of Class B(2) stock or otherwise repurchase capital stock for the foreseeable future. Our Board of Directors will not be seeking a waiver to declare dividends for the remainder of 2005, but may seek a waiver to declare dividends as early as 2006, provided that we are profitable.

In addition to the dividend and stock repurchase restrictions described above, the three-year plan includes the following key elements:

- changing the focus of the Seattle Bank from mortgages to advances;
- expanding the use of differential pricing to increase advance volumes;
- proposing to amend the capital plan to permit the use of membership stock to support advances;
- substantially reducing the Seattle Bank's interest-rate exposure by discontinuing the MPP and developing alternatives for ongoing management of the mortgage loan portfolio;
- implementing an active hedging program to offset the interest-rate risk inherent in our assets and liabilities;

- significantly increasing the Seattle Bank's focus on market-risk measurement, monitoring, and management;
- specifying that the Seattle Bank will provide 12-month projections to the Finance Board if retained earnings should drop below \$40 million and, if the projections should show zero retained earnings or a retained deficit in any period, provide the Finance Board with a contingency plan for avoiding or addressing the retained deficit;
- requiring a minimum capital-to-assets ratio of 4.25% until MPP asset balances have been reduced and the transition to an advances-focused bank has been completed, at which time the minimum capital-to-assets ratio will be decreased to 4.15%;
- setting a long-term retained earnings target based on the Seattle Bank's current retained earnings policy and practices; and
- proposing possible future authorization and issuance of Class A stock under our capital plan.

Our Board of Directors has directed and overseen a number of actions to change the Seattle Bank's business focus in accordance with the three-year plan. These actions include:

- changing our senior management, including the retention of a new President and Chief Executive Officer and a new Chief Operating Officer, as well as naming a new Chief Financial Officer and Chief Risk Officer;
- refocusing our strategic direction on advances;
- exiting from the MPP by no longer entering into new master commitment contracts and selling approximately \$1.4 billion of our government-insured mortgage loans;
- restructuring our finance division and creating an independent risk management division to implement more stringent risk management controls and to upgrade our market-risk management processes;
- decreasing our staff by approximately 65 positions during 2005 to reduce overall operating expenses;
- approving strategies to actively hedge our overall interest-rate risk;
- retaining consultants to advise us in developing strategy, risk management, and governance processes;
- amending our retained earnings policy to require an increase in our level of retained earnings based on specific target objectives; and
- amending our capital plan to allow our members to support their advances with their membership stock, which is stock that they are required to hold in order to maintain their membership in the Seattle Bank.

The purpose of the Finance Board agreement, the three-year plan, and the steps we have taken to change our business and policies as described above is to strengthen our risk management, capital structure, corporate governance, and capital plan. However, these measures have had or could in the future have consequences that negatively impact our business operations, results of operations, and financial condition, including the following:

- During the implementation of the three-year plan, including our exit from the MPP, our earnings are expected to continue to be negatively affected and our Board of Directors will not be seeking a waiver to declare dividends for the remainder of 2005 – although it may seek a waiver to declare dividends as early as 2006, provided that we are profitable. In addition, we expect to have limited capacity to accommodate repurchases of member stock, assuming we could obtain Finance Board approval to do so. We do not expect to request permission to make such repurchases in the foreseeable future.
- The costs associated with the use of derivative instruments to mitigate the interest-rate risk in our MPP and investment portfolios and the related liabilities will negatively impact our earnings in 2005.

- Restrictions in our capital-to-assets ratio will reduce the amount of our earning assets relative to capital, likely reducing our return on capital.
- We have incurred significant expenses, including approximately \$4.0 million in consulting fees, in order to implement the Finance Board agreement and the three-year plan.
- Our reductions in staff have resulted and will continue to result in termination-related expenses that will adversely affect our net income over the periods when the reductions occur.
- Member demand for advances and other products that would require additional investment in our stock may be limited due to the suspension of dividends and member stock repurchases.
- Due to the recent amendment to our capital plan permitting members to support their advances with their membership stock, which is designed to encourage growth of our advances business, our capital will not increase proportionately with the increase in advances, which could constrain our ability to make advances due to the capital-to-assets ratio we must maintain.
- Limits on any increase to our market, credit, or operational risk may constrain our ability to compete by introducing new products or services.

These impacts are discussed below under the captions "- Financial Condition" and "- Results of Operations for the Three and Nine Months Ended September 30, 2005 and 2004."

### **Regulatory Issues and Developments**

*Registration with Securities and Exchange Commission.* On June 23, 2004, the Finance Board adopted a regulation requiring each FHLBank to register a class of its equity securities with the Securities and Exchange Commission, or SEC, under the Securities Exchange Act of 1934, as amended, or Exchange Act. The regulation requires the Seattle Bank to have filed a registration statement with the SEC by June 30, 2005, and to ensure that the registration statement was declared effective by August 29, 2005. On June 30, 2005, we submitted to the SEC the initial public filing of our registration statement. On August 26, 2005, prior to our registration statement going effective, we withdrew our registration statement from filing with the SEC in order for us to resolve certain accounting issues with our independent registered public accountant and the SEC. As a result, we are not in compliance with the Finance Board regulation to register a class of our equity securities with the SEC by August 29, 2005. We currently intend to refile with the SEC a registration statement that includes our 2005 audited financial statements. Once our stock is registered, we will file quarterly, annual, and certain other periodic reports with the SEC pursuant to the Exchange Act, and we will comply with other applicable SEC rules and regulations. Only two of the FHLBanks met the regulatory deadline. As of the date of the posting of this report, some FHLBanks have refiled registration statements with the SEC. It is uncertain at this time what effect, if any, the delays in registration will have on the cost of FHLBank System debt, the timing of the issuance of new FHLBank System debt, or other aspects of the Seattle Bank's operations.

*Government-Sponsored Enterprise (GSE) Regulation.* Congressional scrutiny of GSEs, which include FHLBanks, has increased over recent years. Legislation that would, among other things, create a new regulator for Fannie Mae, Freddie Mac, and the FHLBanks and address other GSE reform issues was passed by the House of Representatives in October 2005 and has passed the Senate Banking Committee, but has not yet come up for a vote in the full Senate. It is impossible to predict what, if any, provisions relating to the FHLBanks and their regulation may ultimately be included and enacted in legislation, when any changes would go into effect, and what effect legislation would have on the Finance Board or the FHLBanks.

*Rating Agency Actions.* Standard & Poor's rating agency lowered the Seattle Bank's long-term rating from "AAA" to "AA+" in mid-December 2004, citing concerns about the Finance Board agreement, our lower profitability, and the impact of growing mortgage-based asset portfolios on our risk profile, as mortgage-based assets carry a higher risk compared to traditional assets. This rating was reaffirmed in April 2005; however, at the same time, Standard & Poor's changed our rating outlook from stable to negative, citing our lower profitability as a

key reason for the outlook adjustment. In mid-July 2005, Moody's reaffirmed the Seattle Bank's rating of "Aaa/P-1" and issued a stable outlook.

Individual FHLBank ratings do not necessarily impact the credit rating of the consolidated obligations issued on behalf of the FHLBanks. Currently, Moody's rates the FHLBank System's consolidated obligations "Aaa" and Standard & Poor's rates them "AAA/A-1+."

Rating agencies may, from time to time, change a rating because of various factors, including operating results or actions taken, business developments, or changes in their opinion regarding, among other things, the general outlook for a particular industry or the economy. We cannot provide assurance that Standard & Poor's, Moody's, or other rating agencies will not reduce our ratings or those of the FHLBank System or any other FHLBank in the future.

### **Financial Condition**

Our assets principally consist of our advances, investments, and mortgage loans held for portfolio. The composition of our assets changed during the first nine months of 2005 from year-end 2004, primarily reflecting our decisions to emphasize our advances, exit the MPP, and increase our short-term investments in order to fully use our capital, together with our principal payments on our investment portfolio and the MPP. During 2004, the change in the composition of our assets from year-end 2003 primarily reflected decreased advance balances and the growth of the investment portfolio. MPP growth was moderated in 2004 by the increase in prepayments on our MPP mortgage loans and by our decision in late 2003 to limit MPP purchases from large participating financial institutions until we had improved the operational infrastructure to support the more complex risk profiles associated with mortgage loans. During 2004, as advances and MPP mortgage loans were paid off, we generally invested these proceeds, along with other funds, in investment securities, increasing the investment portion of our assets.

As part of the three-year plan, we have begun exiting the MPP and have refocused our business on advances. We are using differential pricing to increase our advances activity, and our mortgage loan portfolio will continue to decrease over time as mortgage loans are paid off. In August 2005, we sold approximately \$1.4 billion of our government-insured mortgage loans to an affiliate of one of our members.

The following table summarizes our total assets by major asset classes, as of September 30, 2005, and December 31, 2004, 2003, and 2002.

	As of September 30,	As of December 31,		
	2005	2004	2003	2002
Advances .....	33.3%	31.0%	38.4%	42.9%
Investments .....	52.0	46.6	39.2	36.8
Mortgage loans held for portfolio .....	14.3	21.7	21.8	19.5
Other assets .....	<u>0.4</u>	<u>0.7</u>	<u>0.6</u>	<u>0.8</u>
Total .....	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

We obtain funding to support our business primarily through the issuance, by the Office of Finance on our behalf, of debt securities in the form of consolidated obligations. We also rely on the issuance of our equity securities to our members in connection with their membership and their utilization of our products, such as advances, and on member deposits.

We report our assets, liabilities, and commitments in accordance with U.S. GAAP, including the market value of our assets, liabilities, and commitments, which we also review for purposes of risk management. The differences between the accounting book value and market value of our assets, liabilities, and commitments are unrealized market value gains or losses. As of September 30, 2005, we had net unrealized market value losses of approximately \$400 million. Our calculation of market values involves estimates of the market value of our assets, liabilities, and commitments, which may interject imprecision into any unrealized market-value gains or losses that we report.

To determine market values, our valuation policy requires us to use outside pricing sources, when such prices are available from active dealers in the specific securities being valued. We estimate prices for our advances and derivative products using an internal model because outside pricing sources for these instruments are not readily available. Because most of our financial assets, liabilities, and commitments are not actively traded, the external pricing sources that we use can only provide us with estimates of market values. Although we believe these estimates are reasonable, they do not necessarily represent the actual values that would be realized if the financial assets, liabilities, or commitments were to be sold or settled. These estimates of value are generally based on algorithms that rely on traded prices to derive prices for instruments that do not trade frequently and are commonly used to estimate the values of financial instrument portfolios. Different pricing sources may provide different market values for the same asset, liability, or commitment. These differences in market-value estimates, although small in relative value to our overall assets, liabilities, and commitments, can result in large differences in the amount of unrealized gains or losses that we report. Valuation of even actively traded instruments may be imprecise and vary among dealers.

We discuss the material changes in each of our principal categories of assets and liabilities and our capital stock in more detail below.

### **Advances**

For the nine months ended September 30, 2005, advances increased by \$2.8 billion, to \$17.7 billion, primarily as a result of our renewed emphasis on our advances business. New advances totaled \$58.1 billion, while maturing advances totaled \$55.2 billion during this period. This compares favorably to the nine months of 2004, when advance levels fell \$3.7 billion as new advances totaled \$31.3 billion and maturing advances totaled \$35.0 billion. The increase in our advances balance at September 30, 2005, continues the reversal of a trend in year-over-year declines described below. The increase in advances during the nine months of 2005 was primarily attributable to advances made to our larger members and to our increased use of differential pricing.

For the year ended December 31, 2004, advances decreased \$4.8 billion to \$14.9 billion, due primarily to the maturity and nonrenewal of approximately \$5.3 billion of advances held by two large members. We believe these nonrenewals occurred primarily because large members, which we consider to be institutions with assets of \$3.0 billion and greater, generally have access to a broad range of alternative funding sources at competitive rates and because we discontinued differential pricing in 2002. During 2004, the alternative funding sources became more competitive, and these members selected lower-cost alternatives, including other FHLBanks.

The decline in advance balances at December 31, 2004 was a continuation of the year-over-year declines we reported at December 31, 2003 and 2002. We experienced a smaller decline in 2003 than in 2004 because reductions in the advance balances of our larger members were partially offset by growth in advances to our smaller members. Although aggregate advance balances for our small- and mid-size members remained more stable compared to those of large members over the two-year period ended December 31, 2004, balances for our small- and mid-size members declined during 2004 as other funding markets became increasingly competitive for all customers. Our advance balances at December 31, 2003, declined from 2002 levels due in part to a member merger and the prepayment of the acquired member's advances, as well as the maturity and nonrenewal of advances held by two large members.

As of September 30, 2005, and December 31, 2004 and 2003, five members held approximately 57%, 49%, and 61% of our outstanding advances. Two of these members had advances totaling approximately 37% (one with 23% and another with 14%) of our outstanding advances as of September 30, 2005, compared to two members with approximately 30% (one with 19% and another with 11%) of our outstanding advances as of December 31, 2004, and approximately 42% (one with 31% and another with 11%) as of December 31, 2003. No other borrower held over 10% of our outstanding advances as of September 30, 2005, and December 31, 2004 and 2003. Because a large concentration of our advances is held by only a few members, changes in their borrowing decisions may cause volatility in the amount of our advances outstanding. As we refocus our business on our advances, we expect that the concentration of advances with our largest borrowers will increase, potentially increasing the volatility in the amount of our advances outstanding.

Approximately 44% of the advance portfolio had a remaining term to maturity of less than one year as of September 30, 2005, compared to approximately 43% as of December 31, 2004, and 50% as of December 31, 2003. The decrease in advances with a remaining term to maturity of less than one year between year-end 2004 and 2003 reflected a significant decrease in advances to our two largest members because our rates were not competitive. The total weighted-average interest rate on our advance portfolio as of September 30, 2005, was 4.07%, compared to 3.70% as of December 31, 2004 and 2.95% as of December 31, 2003.

From December 31, 2003 to September 30, 2005, short-term interest rates increased substantially, while, in general, long-term interest rates modestly declined. As a result, the weighted-average interest rates on our advances with maturities of less than one year increased faster than the weighted-average interest rates on advances with maturities of one year or more. See Note 7 of the notes to our audited financial statements for the years ended December 31, 2004, and Note 5 of the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005, for additional information on advances.

The following table summarizes our advance portfolio by remaining term to maturity and weighted average interest rate as of September 30, 2005, and December 31, 2004 and 2003.

Year of Maturity	As of September 30, 2005		As of December 31,			
	Amount	Weighted Average Interest Rate %	2004		2003	
			Amount	Weighted Average Interest Rate %	Amount	Weighted Average Interest Rate %
			(in thousands)			
Due in one year or less .....	\$ 7,810,126	3.86	\$ 6,335,455	2.76	\$ 9,779,304	1.81
Due after one year through two years.....	1,831,687	3.65	2,530,054	3.96	3,087,950	2.81
Due after two years through three years.....	3,457,185	4.10	1,194,583	3.70	1,858,332	4.40
Due after three years through four years .....	955,479	4.21	1,179,267	4.70	913,428	3.71
Due after four years through five years .....	1,017,781	4.71	955,193	4.13	988,318	4.94
Thereafter .....	<u>2,587,235</u>	4.67	<u>2,564,484</u>	5.13	<u>2,774,709</u>	5.18
Total par value .....	17,659,493	4.07	14,759,036	3.70	19,402,041	2.95
Discounts on advances .....	(4,952)		(3,070)		(2,812)	
Unamortized commitment fees .....	(1,034)		(976)		(1,027)	
Discount on Affordable Housing Program advances.....	(368)		(417)		(480)	
Derivative hedging adjustments .....	<u>24,187</u>		<u>142,526</u>		<u>254,844</u>	
Total.....	<u>\$ 17,677,326</u>		<u>\$ 14,897,099</u>		<u>\$ 19,652,566</u>	

The percentage of variable-rate advances as a portion of our total advances as of September 30, 2005, was essentially unchanged at 21%, compared to 20% as of December 31, 2004. Of advances originated during the nine months ended September 30, 2005, and outstanding on that date, 36% of the advances were variable-rate advances. Between December 31, 2004 and 2003, the composition of our advances by interest-rate payment terms changed. Variable-rate advances, which appeal primarily to our large customers, declined in volume by approximately 59% as of December 31, 2004, from December 31, 2003. This was largely a result of the maturity and nonrenewal of variable-rate advances held by two large members. Variable-rate advances also declined as a percentage of the overall advance portfolio in 2003 from 2002, also largely due to the maturity and nonrenewal of advances held by these large members.

The following table summarizes our advance portfolio by interest-rate payment terms as of September 30, 2005, and December 31, 2004, 2003, and 2002.

Interest-Rate Payment Terms	As of September 30,	As of December 31,		
	2005	2004	2003	2002
Fixed-rate.....	78.8%	80.1%	63.3%	59.9%
Variable-rate .....	<u>21.2</u>	<u>19.9</u>	<u>36.7</u>	<u>40.1</u>
Total.....	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

*Member Demand for Advances.* Many factors affect the demand for advances, including changes in interest rates and changes in member funding needs. Members regularly evaluate financing options relative to our advances offerings. In a low interest-rate environment, members typically have had less need for advances because their consumer depositors generally maintained larger demand and term deposit account balances. While most members continue to obtain their advances from us through our advance window pricing, which offers advances to all members at the same rates, members can obtain lower-cost advances by using our other pricing alternatives, which impose additional conditions. These other pricing alternatives include: (1) auction funding, through which borrowers can generally save five basis points or more, but which is offered only two times per week; and (2) differential pricing, through which a member can obtain lower advance rates on large transactions, as set within parameters established by our Asset and Liability Management Committee under authority delegated by our Chief Executive Officer and overseen by the Board of Directors. As we pursue more advances, we expect to increase the use of differential pricing to increase advance volume. For the nine months ended September 30, 2005, differentially-priced advances accounted for 41% of advances made, compared to less than 2% for the year ended December 31, 2004. Window- and auction-priced advances accounted for 48% and 11% of the advances made for the nine months ended September 30, 2005, compared to 73% and 25% of advances made for the year ended December 31, 2004.

We believe that the use of differential pricing will give us greater flexibility to compete with regard to rates for more advances business. In practice, this means that rates on advances may be lower for some members than for others in order to be competitive with lower rates available to those members that have alternative funding sources. In general, our larger members have more alternative funding sources and are able to access funding at lower rates than our smaller members. For example, some large members maintain memberships with several FHLBanks through affiliates and can select their advances from any of the FHLBanks in which they or their affiliates are members. Each FHLBank offers advance products that may have different repayment terms, collateral terms, or spreads to prevailing market rates such as LIBOR. These institutions can select among the different FHLBanks in which they or their affiliates are members to obtain more favorable terms. We believe that competition among FHLBanks contributed to the decrease in our advances in 2004 and 2003, as larger members borrowed advances from other FHLBanks that offered better rates. We anticipate the use of differential pricing will increase our advance volume in the future and that the increased volume will compensate for any reduction in overall yield due to differential pricing. We are currently reviewing the adequacy of our disclosure to members of the terms under which they may qualify for differential pricing.

Finally, demand for advances may be affected by whether we pay dividends on the stock our members are required to purchase in connection with such advances and any applicable restrictions on their ability to have that stock redeemed or repurchased by us. Consequently, demand for advances, particularly those that require new stock purchases, could decline as a result of our action to suspend the declaration or payment of dividends and to suspend the repurchases of all capital stock prior to the end of the statutory five-year redemption period for FHLBank stock, without in each case prior approval of the OS Director. Our large members, in particular, may factor into their overall cost assessment our current dividend restrictions and the suspension of stock repurchases in their decisions whether to borrow from us. Our Board of Directors will not be seeking a waiver to declare dividends for the remainder of 2005, but may seek a waiver to declare dividends as early as 2006, provided that we are profitable. Also for the foreseeable future, we do not expect to repurchase shares of capital stock prior to the end of the statutory five-year redemption period. See "- Overview."

In response to this concern, in June 2005, the Board of Directors implemented a change to our capital plan that allows our members to support new advances with their outstanding membership stock, which is stock that a member is required to hold in order to maintain its membership. Previously, under the capital plan, members were required to purchase activity-based stock, in addition to their membership requirement, in order to take out advances. Under the amended capital plan, the Board of Directors authorized the use of membership stock to satisfy the members' advances stock purchase requirement after all excess Class B(1) and Class B(2) stock has been used to allow members to access more advances funding. This change effectively allows members access to additional advances, making borrowing more attractive to our members, especially those with large membership stock balances. One consequence of this change, however, is that our capital will not increase as a result of the increase in

advances supported by membership stock. Because we must maintain a minimum capital-to-assets ratio of 4.25%, this lack of growth in capital could constrain the growth of our advances from time to time.

In addition, because our current advances-activity-based stock requirement generally calls for members to hold stock representing only 3.5% of the member's outstanding advances (minus the membership stock requirement), any additional purchases of capital stock for advances activity would likely not be in proportion to our minimum capital-to-assets ratio of 4.25%. Accordingly, this lack of proportionate capital growth on any new advances as compared to our required capital-to-assets ratio may also constrain the growth of our advances from time to time.

Refer to "-- Capital Resources and Liquidity -- Capital Resources," for more information.

*Credit Risk.* Our credit risk from advances is concentrated in commercial banks and savings institutions. As of September 30, 2005, and December 31, 2004, we had advances of \$6.6 billion and \$4.5 billion outstanding to two member institutions, which represented 37.4% and 30.2% of our total advances outstanding. We held sufficient collateral to cover the advances to these institutions, and, as a result, we do not expect to incur any credit losses on these advances. As of September 30, 2005, we had \$42.5 million of outstanding advances to two borrowers that we classified as substandard. These advances are fully collateralized with high-grade, marketable securities, and rights to proceeds from mortgage loans. Because the borrowers continue to pay according to contractual requirements, and because of our collateral position, we continue to accrue interest and do not expect to incur any credit losses on these advances.

While we have never experienced a credit loss on an advance to a member, the expanded range of eligible collateral permitted for community financial institutions and our extension of credit to entities, such as insurance companies, that are not covered by the Federal Deposit Insurance Corporation, or FDIC, present more credit risk to us. We have policies and procedures in place to appropriately manage these types of credit risk, including requirements for physical possession or control of pledged collateral, restrictions on borrowing, specific review of each advance request, and regular verifications of the collateral. Accordingly, we have not provided any allowances for losses on advances.

## Investments

We maintain a portfolio of short-term investments for liquidity purposes and a portfolio of long-term investments, primarily mortgage-backed securities and agency investments, with the intention of increasing returns on our capital. During the third quarter of 2005, we increased our short-term investments in order to fully use our capital and fund advances. As we refocus our business on advances, however, we plan to decrease the portion of our total assets comprising our investment portfolio.

The following table summarizes our investments, both short-and long-term, as of September 30, 2005, and December 31, 2004, 2003, and 2002.

	As of September 30,	As of December 31,		
	2005	2004	2003	2002
	(in thousands)			
<b>Short-Term Investments</b>				
Federal funds sold.....	\$ 7,985,000	\$ 1,679,500	\$ 2,506,500	\$ 3,649,500
Other.....	<u>1,857,200</u>	<u>200,000</u>	<u>870,000</u>	<u>915,000</u>
Total short-term investments .....	<u>\$ 9,842,200</u>	<u>\$ 1,879,500</u>	<u>\$ 3,376,500</u>	<u>\$ 4,564,500</u>
<b>Long-Term Investments</b>				
Commercial paper.....	\$ 24,760	\$	\$	\$
Consolidated obligations of other FHLBanks.....	6,524,940	8,025,248	3,500,000	159,993
Mortgage-backed securities .....	6,568,015	6,932,029	7,245,569	6,481,668
Other U.S. agency obligations .....	244,286	344,033	937,778	1,021,613
Government-sponsored enterprise obligations.....	4,314,746	5,213,122	4,946,273	4,856,343
State or local housing agency obligations.....	<u>18,146</u>	<u>29,100</u>	<u>41,273</u>	<u>87,000</u>
Total long-term investments .....	<u>\$17,694,893</u>	<u>\$20,543,532</u>	<u>\$16,670,893</u>	<u>\$12,606,617</u>

During the nine months ended September 30, 2005, we increased our balance of short-term investments by \$8.0 billion, with the majority of this increase occurring during the third quarter. During this period, we implemented a strategy of managing our business to a capital-to-assets ratio of 4.30% in order to fully use our capital and fund advances. We invested primarily in federal funds sold and allowed our holdings of long-term investments to decrease by over \$2.8 billion compared to December 31, 2004, in order to meet anticipated demand for advances. In 2004 and 2003, the demand for advances and the volume of our MPP purchases declined. As a result, we increased our long-term investments during 2004 and 2003, primarily in consolidated obligations of other FHLBanks.

*Consolidated Obligations Bonds of Other FHLBanks.* Our investment in other FHLBanks' consolidated obligation bonds as of September 30, 2005, decreased by \$1.5 billion from December 31, 2004, primarily due to maturities of and calls on the consolidated obligation bonds. Our investment in other FHLBanks' consolidated obligation bonds increased \$4.5 billion during the year ended December 31, 2004 and \$3.3 billion during the year ended December 31, 2003.

In 2004 and 2003, we purchased consolidated obligations of other FHLBanks with funds received primarily from the issuance of consolidated obligations on which we are the primary obligor. By issuing debt with differing maturities and payment terms from the investments we were contemporaneously purchasing, we attempted to earn a favorable spread over our cost of funding on these investments. For example, we may have purchased a five-year callable bond investment that paid a favorable interest rate due in part to the call premium, and contemporaneously issued a combination of six-month and 15-year bullet debt instruments at an average interest rate for the combined issued debt below the interest rate on the callable bond investment. Nearly 90% of the aggregate amount of the consolidated obligations of other FHLBanks that we purchased was callable, but the debt issued contemporaneously was largely noncallable. During 2004, short-term interest rates increased, and as the short-term instruments issued contemporaneously with the purchase of the callable bond investments matured, we replaced them with new debt at higher interest rates, increasing the cost of our overall funding for these investments and reducing the initial favorable spreads.

In addition, of the \$9.0 billion in callable debt of other FHLBanks that we purchased in 2004 and 2003, \$2.5 billion were called prior to maturity and \$1.0 billion matured as of September 30, 2005. In contrast, we were unable to call the long-term bullet debt that had been issued contemporaneously with the bond investment that was called, and continue to carry that debt at rates that, in some cases, are above our current cost for issuing such debt. We are unable to reasonably allocate all of the debt issuances that may have been used to fund the purchase of consolidated obligations of other FHLBanks to the purchased debt in order to calculate the actual spreads that resulted from this investment strategy. However, due to the market factors that significantly increased our borrowing cost in replacement of the short-term debt that funded those investments, and the loss of the favorable interest rate on the portion of the callable debt that was actually called, we believe that any favorable spreads we may have generated at the inception of this strategy are now mostly negative. Accordingly, this investment strategy has contributed to the approximately \$400 million in unrealized market value losses that we reported as of September 30, 2005. The amount of these unrealized losses involves estimates of the market values of our assets, liabilities, and commitments, which we discuss in greater depth above.

In 2004 and during late 2003, we also accumulated excess cash due to the maturity and nonrenewal of advances and the prepayment of mortgage-based assets. Because demand for advances decreased during the year and demand for MPP products grew more slowly than we anticipated, we generated more cash than we were able to redeploy into new advances and the purchase of MPP mortgage loans. As we had reached the limits on our ability to invest in the debt or mortgage-backed securities of Fannie Mae and Freddie Mac, we invested in the consolidated obligations of other FHLBanks because there was no limit on such investments and because we believed that they offered an attractive return relative to their credit characteristics.

We believed at the time of each purchase of a consolidated obligation on which another FHLBank is the primary obligor that the purchase complied with applicable Finance Board regulations. However, during October and November 2004, Finance Board staff expressed their view that our purchases of such consolidated obligations did not represent an appropriate investment strategy for the Seattle Bank. In November 2004, the Finance Board

informed us that those purchases represented an apparent violation of a Finance Board regulation. As a result, our Board of Directors prohibited further purchases of consolidated obligations on which another FHLBank is the primary obligor, which prohibition was reiterated in the Finance Board agreement. In March 2005, the Finance Board issued a regulatory interpretation of the Finance Board regulation to make it clear that it prohibits a FHLBank from purchasing any consolidated obligation as part of the consolidated obligation's initial issuance, either directly from the Office of Finance or indirectly through an underwriter.

The Finance Board agreement does not require us to divest the investments in the consolidated obligations of other FHLBanks that we currently hold. For additional discussion of the agreement with the Finance Board, see "– Overview."

*Mortgage-Backed Securities.* The decrease in our investment in mortgage-backed securities between September 30, 2005 and December 31, 2004 was due to maturities and principal payments. Finance Board regulations limit each FHLBank's investment in mortgage-backed securities, at the time a security is purchased, to 300% of a bank's capital. Our investment in mortgage-backed securities represented 289%, 320%, 295%, and 272% of our total capital as of September 30, 2005, and December 31, 2004, 2003, and 2002. Although the percentage of investments in these mortgage-backed securities to our total capital was greater than 300% as of December 31, 2004, we were in compliance with the regulation due to the level of our capital at the time of each of our purchases of the securities. Our investment in mortgage-backed securities as of September 30, 2005, and December 31, 2004, 2003, and 2002, included \$1.1 billion, \$1.4 billion, \$2.0 billion, and \$1.6 billion in Freddie Mac mortgage-backed securities and \$1.2 billion, \$1.4 billion, \$1.7 billion, and \$0.8 billion of investments in Fannie Mae mortgage-backed securities. The remaining investment in mortgage-backed securities is rated "AAA" (or its equivalent) by a nationally recognized statistical rating organization, or NRSRO, such as Moody's and Standard & Poor's.

As of September 30, 2005, and December 31, 2004 and 2003, we held \$10.7 billion, \$1.4 billion, and \$97.2 million in held-to-maturity investments with unrealized losses of \$228.9 million, \$52.8 million, and \$1.3 million that had been in an unrealized loss position for over 12 months. Based on the creditworthiness of the issuers and underlying collateral, we believe that these unrealized losses represent temporary impairments. See Note 4 of the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005 for tables summarizing the held-to-maturity securities with unrealized losses as of September 30, 2005 and December 31, 2004.

*Other U.S. Agency Obligations.* Our investments in other U.S. agency obligations consist primarily of debt securities of Ginnie Mae and other government agencies whose debt is guaranteed, directly or indirectly, by the U.S. government. As of September 30, 2005, our investments in other U.S. agency obligations declined by 29.0%, to \$244.3 million, from December 31, 2004, primarily as a result of principal payments we received since December 31, 2004. These investments decreased by \$593.7 million as of December 31, 2004, compared to December 31, 2003, principally due to maturity of securities during 2004. The balance of these investments remained essentially unchanged as of December 31, 2003, compared to December 31, 2002.

*Government-Sponsored Enterprises.* Our investments in GSEs, excluding our investments in other FHLBanks, consist primarily of unsecured debt securities of Fannie Mae and Freddie Mac. These securities are not guaranteed, directly or indirectly, by the U.S. government. Fannie Mae securities totaled \$2.3 billion, \$2.5 billion, \$2.3 billion, and \$2.2 billion and Freddie Mac securities totaled \$1.7 billion, \$2.5 billion, \$2.4 billion, and \$2.4 billion, as of September 30, 2005, and December 31, 2004, 2003, and 2002. These securities represented 14.6%, 21.9%, 23.2%, and 26.5% of total investments as of such dates. The decline between September 30, 2005 and December 31, 2004 primarily represents maturities of certain of these investments since December 31, 2004. Finance Board regulations limit our investments in the debt of any one GSE to the lower of 100% of our capital or the capital of the GSE, with the exception of the investment in other FHLBank consolidated obligations, in which we can no longer invest without Finance Board approval.

## Mortgage Loans Held for Portfolio

The balance of our mortgage loans held for portfolio consisted of \$7.1 billion, \$8.1 billion, \$8.6 billion, and \$6.5 billion in conventional mortgage loans and \$417.3 million, \$2.3 billion, \$2.5 billion, and \$2.4 billion in government-insured mortgage loans as of September 30, 2005, and December 31, 2004, 2003, and 2002. During the first nine months of 2005, we received principal payments of \$1.5 billion and purchased only \$85.9 million in mortgage loans. In August 2005, we also sold \$1.4 billion of MPP government-insured mortgage loans to an affiliate of one of our members. In September 2005, after determining the disposition of the mortgage loans had reduced our interest-rate risk profile, we reclassified the remaining approximately \$400 million of the unsold mortgage loans as held for portfolio. During the time the mortgage loans were classified as held for sale, they were measured at the lower of cost or market value. We realized a gain of \$7.0 million on the sale of these mortgage loans. We also incurred an unrealized loss of \$1.1 million, which was reported in other income (loss), when we reclassified the unsold mortgage loans as held for portfolio. As previously indicated in "– Overview – The Finance Board Agreement; The Three-Year Business and Capital Management Plan; and Changes in Our Retained Earnings, Dividend Payment and Stock Repurchase Policies," we are exiting the MPP in order to lower the Seattle Bank's overall interest-rate risk profile and to reduce our operating costs. We are no longer entering into new master commitment contracts and have closed out open contracts.

We purchased approximately 88% of our mortgage loan portfolio as of September 30, 2005 from one participating member and over 95% from three participating members. The following table summarizes the activity and other information related to our mortgage loan portfolio as of September 30, 2005, and December 31, 2004, 2003, and 2002.

	As of September 30, 2005	As of December 31,		
		2004	2003	2002
		(dollars in thousands)		
Mortgage loan par balance at beginning of the year .....	\$10,375,000	\$11,081,180	\$ 8,955,893	\$ 1,719,738
Purchases .....	85,613	1,561,652	6,637,593	8,023,346
Maturities and sale .....	<u>(2,935,041)</u>	<u>(2,267,832)</u>	<u>(4,512,306)</u>	<u>(787,191)</u>
Mortgage loan par balance at period end .....	<u>\$ 7,525,572</u>	<u>\$10,375,000</u>	<u>\$11,081,180</u>	<u>\$ 8,955,893</u>
Mortgage loan net premium balance at beginning of the year .....	\$ 70,876	\$ 90,337	\$ 155,996	\$ 8,728
Net premium (discount) on purchases .....	761	20,572	(27,771)	155,244
Net premium amortization* .....	<u>(35,721)</u>	<u>(40,033)</u>	<u>(37,888)</u>	<u>(7,976)</u>
Mortgage loan net premium balance at period end ...	<u>\$ 35,916</u>	<u>\$ 70,876</u>	<u>\$ 90,337</u>	<u>\$ 155,996</u>
Premium balance as a percent of mortgage loans par amounts .....	0.48%	0.68%	0.82%	1.74%
Average FICO score** at origination .....	744	743	743	742
Average loan-to-value ratio at origination .....	65.08%	65.22%	72.00%	73.00%

\* Included in net premium amortization as of September 30, 2005 is unrealized loss of \$1.1 million recognized on the transfer of \$400 million of government-insured loans from held for sale to held for portfolio.

\*\* The Fair Isaac Company, or FICO, score is a standardized credit score used as an indicator of consumer financial responsibility, based on credit history.

## Derivative Assets and Liabilities

As of September 30, 2005, and December 31, 2004, 2003, and 2002, we held derivative assets of \$8.8 million, \$24.5 million, \$45.8 million, and \$77.5 million and derivative liabilities of \$229.3 million, \$274.8 million, \$306.5 million, and \$322.4 million. The changes in these balances reflect the effect of interest-rate changes on the fair value of our derivatives, as well as expirations and terminations of outstanding and entry into new interest-rate exchange agreements between December 31, 2004 and December 31, 2002. We record all derivative financial instruments in the Statements of Condition at fair value, with changes in the fair value reported in earnings.

We have traditionally used derivatives to hedge advances, mortgage loan commitments under our MPP, MPP mortgage loans, consolidated obligations, and intermediary swaps for members. The principal derivative instruments we use are interest-rate exchange agreements such as interest-rate swaps, caps, forward contracts, and swaptions. We classify these types of interest-rate exchange agreements as derivative assets or liabilities according to the net fair value of the derivatives by counterparty, when appropriate under individual master netting agreements. Subject to a master netting agreement, if the net fair value of the derivatives by counterparty is positive, the net fair value is reported as an asset, and if negative, the net fair value is reported as a liability. Changes in the fair value of interest-rate exchange agreements are recorded directly through earnings.

As of September 30, 2005, the notional amount of interest-rate exchange agreements decreased by \$470.7 million, to \$15.4 billion, compared to December 31, 2004. This decrease was primarily related to a decline in swaptions used to protect against the potential of large unrealized losses in market value of equity. For the year ended December 31, 2004, the notional amount of interest-rate exchange agreements hedging our assets and liabilities declined by \$1.7 billion, to \$15.8 billion. This decrease was primarily related to our reduction of our hedges of fixed-rate consolidated obligations. This hedged debt generally financed variable-rate advances, which also declined as a result of a change in larger member demand for advances. The notional amount of interest-rate exchange agreements decreased by \$1.2 billion, to \$17.5 billion, as of December 31, 2003, compared to December 31, 2002. This decrease was primarily due to declines in the notional amount of outstanding mortgage delivery commitments, which are considered derivatives. Notional amounts are used to calculate the periodic amounts to be received and paid under interest-rate exchange agreements and generally do not represent actual amounts to be exchanged or directly reflect our exposure to credit risk. Notional amounts are not recorded as assets or liabilities in our Statements of Condition. For additional information, see "– Summary of Critical Accounting Estimates – Derivatives and Hedging" and "– Quantitative and Qualitative Disclosures About Market Risk."

The total notional amount of intermediary swaps decreased by \$168 million, to \$688.8 million, as of September 30, 2005, compared to December 31, 2004, and declined by \$278 million, to \$856.8 million, as of December 31, 2004, compared to December 31, 2003, and declined by \$851 million as of December 31, 2003, compared to December 31, 2002. As of September 30, 2005, \$221.0 million of the total notional amount outstanding on intermediary swaps was related to member intermediary swaps, a decline of \$400 million from the December 31, 2004 amount. Due to low transaction volumes, we discontinued offering member intermediary swaps as a standard product in 2004. Our smaller members generally did not have the infrastructure required to utilize and manage the interest-rate exposure associated with interest-rate swaps and our larger members were able to directly access the swap market. Although we have discontinued entering into new member intermediary swaps, we will maintain our existing transactions until maturity. We also enter into swap transactions that are deemed to be intermediary swaps to offset swap transactions that were previously in hedge relationships where the hedged item has been terminated. The notional amount of these intermediary swap transactions increased by \$232 million, to \$467.8 million, as of September 30, 2005, from December 31, 2004.

### **Consolidated Obligations and Other Funding Sources**

Our principal liabilities are the consolidated obligation notes and bonds issued on our behalf by the Office of Finance, and to a significantly lesser degree, a variety of other funding sources such as our member deposits. Although we are jointly and severally liable for all consolidated obligations issued by the Office of Finance on behalf of all of the FHLBanks, we report only the portion of consolidated obligations issued on our behalf for which we are the primary obligor. Standard and Poor's downgraded the Seattle Bank and some other FHLBanks in 2004. See "– Overview – Recent Rating Agency Actions."

*Consolidated Obligation Discount Notes.* Our allocated portion of the FHLBank System's combined consolidated obligation discount notes outstanding was \$12.9 billion, \$2.8 billion, \$6.6 billion, and \$10.4 billion as of September 30, 2005, and December 31, 2004, 2003, and 2002. Consolidated obligation discount notes represented 26.4%, 6.4%, 14.2%, and 25.1% of our outstanding consolidated obligations as of September 30, 2005, and December 31, 2004, 2003, and 2002. Discount notes are primarily used to finance short-term advances and short-term investments. The balance of discount notes increased \$10.1 billion as of September 30, 2005 from December 31, 2004, largely because we used them to fund \$8.0 billion in additional short-term investments we

made to fully use our capital and fund advances. In 2004, both short-term advances and short-term investments declined, resulting in less need for consolidated obligation discount notes. In 2003, the reduction in the use of consolidated obligation discount notes was primarily due to their higher cost relative to the issuance of consolidated obligation bonds with associated interest-rate exchange agreements.

*Consolidated Obligation Bonds.* Our allocated portion of the FHLBank System's combined consolidated obligation bonds outstanding was \$35.8 billion, \$41.3 billion, \$39.9 billion, and \$31.1 billion as of September 30, 2005, and December 31, 2004, 2003, and 2002. Consolidated obligation bonds represented 73.6% of our total outstanding consolidated obligations as of September 30, 2005, compared to 93.6% as of December 31, 2004, 85.8% as of December 31, 2003, and 74.9% as of December 31, 2002. The percent decrease in our consolidated obligation bonds as of September 30, 2005, compared to December 31, 2004, was the result of declines in our funding of the MPP and long-term investments during the first nine months of 2005. The percent increase in our consolidated obligation bonds from 2002 to 2004 was directly related to the growth of the MPP and increased investments. During this same period, we issued more consolidated obligation bonds and fewer consolidated obligation discount notes to better match the longer-term mortgages.

We seek to manage our consolidated obligation portfolio by matching the anticipated cash flows of our debt to the anticipated cash flows of our assets. The cash flows of mortgage-based assets are dependent largely on the prepayment behavior of borrowers. When interest rates rise, and all other factors remain unchanged, borrowers (and issuers of callable investments) tend to refinance their debts more slowly than originally anticipated, while when interest rates fall, borrowers (and issuers of callable investments) tend to refinance their debts more rapidly than originally anticipated. We use a combination of bullet and callable debt to attempt to match the anticipated cash flows of our mortgage-based assets and callable investments, using a variety of prepayment scenarios.

With callable debt, we have the option to repay the obligation, without penalty, prior to the contractual maturity date of the debt obligation, while with bullet debt we repay the obligation at maturity. Our callable debt is predominantly fixed-rate debt that may be used to fund our mortgage-based assets or that may be swapped to LIBOR and used to fund variable-rate advances and investments. In a falling interest-rate environment, the swap counterparty typically exercises its call option on the swap and we, in turn, call the debt. To the extent we continue to have variable-rate advances or investments, or other short-term-to-maturity assets, we replace the called debt with new callable debt that is swapped to LIBOR. This strategy is typically less expensive than borrowing through the issuance of discount notes; however, we must still use discount notes because this callable-debt strategy is not practical for funding overnight investments.

During the first nine months of 2005, we extinguished \$100 million of long-term, fixed-rate bullet debt with a weighted interest rate of 5.38%. This extinguishment resulted in a loss of \$3.0 million on the consolidated obligation bonds, which was partially offset by fees charged on prepaid advances and gains on the termination of swaption contracts. We continue to review our consolidated obligation portfolio for opportunities to lower our interest expense and better match the duration of our liabilities to that of our assets.

Our callable debt declined by \$438.4 million, to \$16.6 billion, as of September 30, 2005, compared to December 31, 2004, due to our repayment of debt. We continue to classify our debt as callable even after the last call date has passed. Our callable debt declined by \$1.2 billion in 2004, to \$17.0 billion as of December 31, 2004, compared to 2003, and increased by \$4.8 billion in 2003, compared to 2002. The decline in 2004 was a result of declining advances balances and our limitations placed on the MPP. The decline also reflected our desire to generate more favorable spreads between our interest expense and our interest income by issuing noncallable fixed-rate debt at lower interest rates. The increase in 2003 was a result of our attempt to mitigate the options embedded in the growing MPP portfolio. During 2004 and 2003, our variable-rate advances declined by \$4.2 billion and \$785.5 million, thereby reducing the need for swapped debt.

*Other Funding Sources.* Deposits are a source of funds that gives members a liquid, low-risk investment. We offer demand and term deposit programs to our members and to other eligible depositors. There is no requirement for members or other eligible depositors to maintain balances with us, and, as a result, these balances fluctuate. With the exception of an increase as of the end of the third quarter of 2005, deposits have declined since

2002, primarily because our members have chosen other alternatives for investing excess funds. Deposits totaled \$1.1 billion, \$1.0 billion, \$1.3 billion, and \$1.8 billion as of September 30, 2005, and December 31, 2004, 2003, and 2002. Demand deposits comprised the largest percentage of deposits, representing 92.9%, 85.6%, 85.5%, and 88.0% of deposits, as of September 30, 2005, and December 31, 2004, 2003, and 2002.

### **Other Liabilities**

Other liabilities increased by \$105.2 million, to \$127.8 million, as of September 30, 2005, compared to December 31, 2004. This increase resulted from our increased investment in federal funds sold in order to fully use our available capital within our capital limits. Because federal funds sold may take one to two days to settle, we had more federal funds sold pending settlement as of September 30, 2005 than as of December 31, 2004. Excluding the term federal funds sold pending settlement, other liabilities increased by \$5.2 million during the nine months of 2005. Other liabilities as of September 30, 2005 also included \$15.5 million in MPP lender risk account balances, as well as other miscellaneous liabilities. Other liabilities decreased by \$112.3 million, to \$22.6 million, as of December 31, 2004, compared to December 31, 2003, and decreased by \$110.0 million as of December 31, 2003, compared to December 31, 2002. Other liabilities primarily included \$0, \$119.9 million, and \$237.5 million of securities purchased but not settled for the years ended December 31, 2004, 2003, and 2002.

### **Capital Resources and Liquidity**

Our capital resources consist of capital stock held by our members and retained earnings. The amount of our capital resources does not take into account our joint and several liability for the consolidated obligations of other FHLBanks. See Note 8 of the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005. Our principal sources of liquidity are the proceeds from the issuance of consolidated obligations and our short-term investments.

### **Capital Resources**

Our capital resources increased 5.2% to \$2.2 billion, as of September 30, 2005, from December 31, 2004, after decreasing by 14.4% as of December 31, 2004, compared to December 31, 2003, and increasing by 3.1% as of December 31, 2003, compared to December 31, 2002. The changes between December 31, 2004 and 2002 were driven by changes in both the amount of our capital stock and the amount of our retained earnings.

*Class B Stock.* The Seattle Bank's capital plan authorizes two classes of Class B stock, B(1) and B(2), each of which has a par value of \$100. Each class of stock can be issued, redeemed, and repurchased only at par value. Class B(1) stock represents the stock that members are required to hold based on minimum membership requirements, the volume of their business activity with us, and, in some instances, a certain amount of excess stock that a member is allowed to hold that exceeds the stock required for membership or business activity. Class B(2) stock represents stock that a member is no longer required to hold, generally as a result of a decline in its activity with us, that exceeds the amount of allowable excess Class B(1) stock. Both classes of B stock are redeemable five years after: (1) written notice from the member; (2) consolidation or merger of two members; or (3) withdrawal or termination of membership. All stock redemptions are subject to restrictions set forth in the FHLBank Act, Finance Board regulations, and our capital plan. Historically we have elected to repurchase stock that was subject to redemption prior to the expiration of the five-year notice period. However, as further described below, our Board of Directors has adopted limitations on our ability to repurchase capital stock from members. See Note 9 of the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005, for additional information on capital requirements.

Changes in our Class B stock reflect changes in the number of our members, the volume of our members' activity with us, and the repurchases of our Class B stock that occur in any period. For example, if a member reduces its outstanding advances, the related portion of its Class B(1) stock becomes excess and is eligible to be redeemed, subject to limitations. If the member's investment in Class B(1) stock exceeds the maximum allowed investment in Class B(1) stock, then the amount in excess of the maximum amount, is periodically converted to Class B(2) stock. Conversely, if a member does not have excess Class B(1) stock but does have Class B(2) stock, the

member's Class B(2) stock can be converted to Class B(1) stock to support the member's activity stock requirement if the member increases its activity with us. If that member chooses not to hold its excess Class B(1) or Class B(2) stock, it may request a redemption which, when effected, will reduce the amount of Class B(1) and Class B(2) stock outstanding.

As of September 30, 2005, Class B(1) stock increased by \$28.7 million compared to December 31, 2004, primarily due to the May 2005 reissuance of Class B(1) stock as discussed below, offset by transfers of excess Class B(1) to Class B(2) stock. Class B(2) stock increased by \$77.0 million, to \$131.2 million as of September 30, 2005, compared to December 31, 2004. We repurchased \$10.8 million in Class B(2) stock prior to the Finance Board's acceptance of the three-year plan in May 2005. As of December 31, 2004, Class B(1) stock decreased by \$312.4 million, to \$2.0 billion, compared to \$2.3 billion as of December 31, 2003, primarily because of our repurchase from two members of Class B(1) stock as further discussed below. Class B(2) stock decreased by \$59.2 million, to \$54.2 million, as of December 31, 2004, compared to December 31, 2003, primarily because of our repurchase from one member as further discussed below. In 2003, Class B(1) stock increased by \$193.9 million, to \$2.3 billion, as members increased their stock holdings to comply with activity-based stock requirements. Class B(2) stock declined in 2002, as members converted their Class B(2) stock to Class B(1) to satisfy their activity-based stock requirements.

As of September 30, 2005, we had \$141.7 million and \$9.6 million in Class B(1) and Class B(2) stock redemption requests outstanding from members, compared to \$63.3 million and \$413,400 in Class B(1) and Class B(2) redemption requests as of December 31, 2004. Of the redemption requests as of September 30, 2005, \$65.7 million relates to the requests of ten members to withdraw from membership.

In October 2004, we repurchased \$107.7 million of Class B(1) stock and \$229.5 million of Class B(2) stock. Of these repurchases, \$81.6 million of Class B(1) stock was repurchased from two members, Bank of Hawaii and Washington Federal Savings, and all of the Class B(2) stock was repurchased from a third member, Washington Mutual Bank. Of the Washington Federal Savings repurchases, approximately \$8.2 million was repurchased pursuant to a standing Class B(1) stock repurchase order that had been in effect since March 2004. Each of these three institutions had executives serving on our Board of Directors. Following the practices then in effect, employees of the Seattle Bank responsible for processing redemption requests reviewed our capital requirements and determined that repurchasing Class B(1) stock and Class B(2) stock in these amounts would not affect our compliance with our minimum capital requirements. Based on this determination, we processed these redemption requests, and we repurchased the stock from the members.

In mid-November 2004, the Seattle Bank commenced discussions with the Office of Supervision of the Finance Board regarding the content of the written agreement that was announced in December 2004. See "– Overview – The Finance Board Agreement; The Three-Year Business and Capital Management Plan; and Changes in our Retained Earnings, Dividend Payment and Stock Repurchase Policies." In order to avoid any appearance of impropriety regarding any request for redemption of stock by a member institution with an executive who serves as a director of the Seattle Bank, the Board of Directors adopted a policy requiring each director affiliated with a member institution to ensure that his affiliated member institution refrain from making any redemption request regarding the Seattle Bank's stock until the content of the Finance Board agreement was publicly disclosed. Administrative staff at the Seattle Bank were also instructed to review all requests for redemption of the Seattle Bank's stock from member institutions that were affiliated with directors and to notify the director regarding any redemption request from his affiliated institution before accepting the request.

In early December 2004, to support prudent capital management, our Board of Directors also decided to impose limits on member stock repurchases until the three-year business and capital management plan was accepted by the Finance Board. Under both the FHLBank Act and our capital plan, our stock is redeemable after a five-year notice period, but we may repurchase stock earlier, at our discretion, as long as we remain in compliance with any relevant Finance Board regulations or policies of the Board of Directors, including minimum capital requirements and internal minimum capital-to-assets ratios. Until December 2004, we generally voluntarily repurchased member stock within one month after receipt of a member's redemption request. However, under the new stock repurchase

policy, between early December 2004 and the acceptance of the three-year plan by the Finance Board on May 18, 2005, our Board of Directors' repurchase policy provided that:

- we would not repurchase any Class B(1) stock, and
- we would repurchase Class B(2) stock solely at our discretion and only if our capital-to-assets ratio exceeded 4.40% after the repurchase.

In mid-December 2004, following the Finance Board's public announcement that it had entered into a written agreement with us, the Seattle Bank received a letter from a member bank: (1) requesting that the Board of Directors of the Seattle Bank consider reversing the repurchases of stock of member institutions with executives serving on the Board of Directors that occurred in October 2004, and (2) questioning whether the institutions requesting redemption possessed material nonpublic information about the Seattle Bank at the time they requested redemption. In response to the letter, the Board of Directors formed an independent review committee consisting of directors who were not affiliated with any member bank, who then retained independent counsel. The committee was authorized to review and investigate the circumstances surrounding the redemption requests and to make appropriate recommendations to the Board of Directors regarding whether the Seattle Bank should take any action with respect to the redemption requests and subsequent repurchases.

In February 2005, to avoid any appearance of impropriety regarding any request for redemption of stock by a member institution with an executive who serves as a director of the Seattle Bank, the Board of Directors again adopted a policy covering such redemption requests. The new policy required that, until the content of the three-year business and capital management plan was publicly announced or otherwise made available to member institutions, any request for redemption of stock by an institution with an executive who served as a director of the Seattle Bank would be submitted to the Board of Directors for consideration.

Prior to the March 31 and April 1, 2005 meetings of the Board of Directors, the independent review committee provided a report to the Board of Directors on its investigation of the circumstances surrounding the October 2004 redemption requests and its initial recommendations. At the meetings, the Board of Directors considered the independent review committee's report, as well as information provided by the affected members, and then directed the independent review committee to consider additional facts, to conduct further analyses, and to report back to the Board of Directors.

The independent review committee then submitted a final report, which was considered by the Board of Directors at a special meeting on May 6, 2005. At that meeting, the Board of Directors found that, although the actions of two of the directors, Allan Landon, Chairman, President and Chief Executive Officer of Bank of Hawaii, and Roy Whitehead, Vice Chairman, President and Chief Executive Officer of Washington Federal Savings, were undertaken without a conscious motivation to harm anyone and with the intention of benefiting the Seattle Bank, there was the appearance of impropriety with respect to stock repurchase requests of \$25.4 million in Class B(1) stock from Bank of Hawaii and \$48.0 million in Class B(1) stock from Washington Federal Savings. This finding did not apply to the approximately \$8.2 million of Class B(1) stock repurchased from Washington Federal Savings pursuant to its March 2004 standing order. In addition, the Board of Directors found that these directors failed to comply with a rule requiring the disclosure of conflicts of interest by a director by failing to make disclosure to the Board of Directors of their institutions' planned redemptions. The Board of Directors further concluded that there was no wrongdoing, policy violation, or appearance of impropriety regarding the repurchase of Class B(2) stock from Washington Mutual Bank.

Bank of Hawaii, Washington Federal Savings, Mr. Landon, and Mr. Whitehead informed the Seattle Bank that they disagree with the Board of Directors' conclusions and have denied any wrongdoing in connection with the October 2004 redemption requests and repurchases. At the request of the Seattle Bank's Board of Directors, and in complete settlement of the matter, Bank of Hawaii, Washington Federal Savings, Mr. Landon, and Mr. Whitehead entered into agreements with the Seattle Bank effective May 12, 2005, pursuant to which: (a) Bank of Hawaii and Washington Federal Savings agreed to restore the stock repurchased in October 2004 (reduced by \$834,300 of Class B(1) stock purchased by Washington Federal Savings on April 29, 2005 and excluding the approximately \$8.2 million of Class B(1) stock repurchased from Washington Federal Savings pursuant to its March 2004 standing

order), and (b) Mr. Landon and Mr. Whitehead resigned as directors of the Seattle Bank. On May 18, 2005, Bank of Hawaii and Washington Federal Savings restored the stock repurchased by the Seattle Bank in October 2004.

On May 18, 2005, the Finance Board accepted the three-year plan, subject to our adoption of certain dividend and stock repurchase restrictions. To meet the Finance Board conditions, our Board of Directors adopted policies on May 18, 2005:

- suspending indefinitely the declaration or payment of any dividend and providing that any future dividend declaration or payment may be made only after prior approval of the OS Director, and
- suspending indefinitely the repurchase of any Class B(1) or Class B(2) stock, except that a limited amount of Class B(2) stock repurchases may be made after prior approval of the OS Director.

These policies will be in effect until formally revoked by our Board of Directors, following approval of the OS Director. Our Board of Directors will not be seeking a waiver to declare dividends for the remainder of 2005, but may seek a waiver to declare dividends as early as 2006, provided that we are profitable. We do not expect to obtain waivers from the Finance Board for the repurchase of Class B(2) stock for the foreseeable future. Also for the foreseeable future, we do not expect to repurchase shares of capital stock prior to the end of the statutory five-year redemption period.

On May 20, 2005, because the February 2005 policy relating to redemption requests by member institutions with an executive on the Seattle Bank's Board of Directors had expired upon the Finance Board's acceptance of the three-year plan and in order to avoid any appearance of impropriety regarding any request for redemption of stock by such institutions, the Board of Directors adopted a new policy covering such redemption requests. The new policy requires that, until the policy is revoked by the Board of Directors, the Seattle Bank will not accept any stock redemption request from any member that has an officer or director that serves as a director of the Seattle Bank, unless the redemption request is first approved by our Board of Directors.

In June 2005, the Board of Directors implemented a change to our capital plan that allows our members to use their outstanding membership stock, which is stock that a member is required to hold in order to maintain its membership, to support advances. Under the previous capital plan, members were required to purchase additional stock, in addition to their membership requirement, in order to take out advances. Under the amended capital plan, the Board of Directors authorized the use of membership stock to satisfy the members' advances stock purchase requirement after all excess Class B(1) and Class B(2) stock has been used to allow members to access more advances funding.

*Retained Earnings and Dividends.* In general, our retained earnings represent our net income after the payment of any dividends to our members. Our net income decreased substantially for the nine months ended September 30, 2005, compared to the same period in 2004, and decreased in each of the years ended December 31, 2004, 2003, and 2002. Since 1986, the Seattle Bank has only declared dividends in the form of capital stock, except for immaterial cash payments relating to dividends on fractional lots, or shares of stock of a member that cannot be grouped into lots of 100 shares. The table below summarizes the amount of dividends declared and the resulting stock issued by the Seattle Bank, and the amount of the stock issued as dividends that we repurchased from member institutions during the first nine months of 2005 and in each of the previous three years.

	<u>For the Nine Months Ended September 30,</u>	<u>For the Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions, except percentages)			
Stock issued as dividends .....	\$ 8.7	\$ 64.2	\$ 123.1	\$ 145.1
Stock issued as dividends, and repurchased.....	0.0	15.3	24.5	23.4
Percentage of stock issued as dividends and repurchased.....	0.0%	23.7%	19.9%	16.3%

In November 2004, the Seattle Bank's Board of Directors adopted a new dividend policy regarding the declaration and payment of dividends, which became effective for the fourth quarter of 2004. Under the new policy, dividend declarations, if any, during a quarter are based on the earnings of the previous quarter. In the first quarter of 2005, we declared and paid a member dividend based on average capital stock outstanding and earnings for the fourth quarter of 2004, subject to our then current capital requirements, retained earnings policy, and dividend limits. Under the old policy, the Board of Directors declared a dividend prior to the end of a quarter, based on a projection of earnings for the quarter. As a result of this policy change, members did not receive a dividend during the fourth quarter of 2004.

On May 18, 2005, as a condition to the Finance Board's acceptance of the three-year plan, our Board of Directors adopted a resolution suspending indefinitely dividends on all classes of our capital stock, without prior approval of the OS Director. As a result of this resolution and lower net income expectations, our Board of Directors will not be seeking a waiver to declare dividends for the third quarter of 2005 or for the remainder of 2005, but may seek a waiver to declare dividends as early as 2006, provided that we are profitable. In addition, under the three-year plan, we will give priority to increasing retained earnings over payment of dividends until we have transitioned from a mortgage-focused to an advances-focused bank. If we were permitted to declare and pay dividends, we would still be limited to paying dividends no greater than 50% of current period earnings under the Finance Board agreement.

The Finance Board issued guidance in 2003 calling for each FHLBank to assess, at least annually, the adequacy of its retained earnings in light of alternative future financial and economic scenarios, including parallel and non-parallel interest-rate shifts, changes in the basis relationship between different yield curves, and changes in the credit quality of the FHLBank's assets. Each FHLBank's board of directors is expected to adopt a retained earnings policy that includes a target level of retained earnings, as well as a plan that will enable the FHLBank to reach the target level of retained earnings.

In September 2004, the Seattle Bank's Board of Directors adopted a revised retained earnings policy in accordance with Finance Board guidance. Under this policy, we establish retained earnings targets each quarter, and we plan to increase the target level of retained earnings over the next three years. As of December 31, 2004, the target was set at \$89.0 million, and it was increased to \$107 million as of November 30, 2005. We reported retained earnings of \$77.9 million as of September 30, 2005, which was below our retained earnings target.

Under the terms of the three-year plan, if our retained earnings were reduced to below \$40 million, we would be required to submit 12-month projections to the Office of Supervision. If the obligation to provide the projections were triggered and those projections should show zero retained earnings or a retained deficit in any period, however, the Seattle Bank would be required to provide the Finance Board with a contingency plan for avoiding or addressing the retained deficit. Assuming continuation of the current interest-rate environment, however, we anticipate that we will break even or earn minimal net income in 2005, and that our earnings will increase in 2006 and 2007. Consequently, we believe it is unlikely that our retained earnings will be reduced to below \$40 million.

*Statutory Capital Requirements.* We are subject to three statutory capital requirements. As of September 30, 2005, and December 31, 2004 and 2003, we were in compliance with these statutory capital requirements. These requirements are as follows:

First, we are required to hold risk-based capital equal to the sum of our credit-risk requirement, market-risk requirement, and operations risk requirement, calculated in accordance with federal laws and regulations.

- Credit risk is the potential for financial loss because of the failure of a borrower or counterparty to perform on an obligation. The credit-risk requirement is determined by adding the credit-risk capital charges for assets, off-balance sheet items, and derivative contracts based on, among other things, the credit percentages assigned to each item as required by federal law and regulations.

- Market risk is the potential for financial losses due to the increase or decrease in the value or price of an asset or liability resulting from broad movements in prices, such as interest rates. The market-risk requirement is determined by adding the market value of the portfolio at risk from movements in interest-rate fluctuations that could occur during times of market stress and the amount, if any, by which the current market value of our total capital is less than 85% of the book value of our total capital. We calculate the market value of our portfolio at risk and the current market value of our total capital by using an internal model. Our modeling approach and underlying assumptions are subject to Finance Board review and approval on an ongoing basis.
- Operations risk is the potential for unexpected financial losses due to inadequate information systems, operational problems, breaches in internal controls, or fraud. The operations risk requirement is determined as a percentage of the market-risk requirement. The Finance Board has determined this risk requirement to be 30% of the sum of the credit-risk and market-risk requirements described above.

Only permanent capital, defined as retained earnings and Class B stock, can satisfy the risk-based capital requirement. Mandatorily redeemable Class B stock is included in our permanent capital based on a directive from the Finance Board. The Finance Board has the authority to require us to maintain a greater amount of permanent capital than is required by the risk-based capital requirements, as defined, but has not exercised such authority.

The following table presents our permanent capital and risk-based capital requirements as of September 30, 2005, and December 31, 2004 and 2003.

	<u>As of September 30, 2005</u>	<u>As of December 31, 2004                      2003</u>	
		(in thousands)	
<b>Permanent Capital</b>			
Class B(1) stock.....	\$ 2,001,329	\$ 1,972,594	\$ 2,285,032
Class B(2) stock.....	131,201	54,233	113,473
Mandatorily redeemable Class B stock.....	65,724	64,139	
Retained earnings.....	<u>77,904</u>	<u>75,296</u>	<u>57,177</u>
Permanent capital.....	<u>\$ 2,276,158</u>	<u>\$ 2,166,262</u>	<u>\$ 2,455,682</u>
<b>Risk-Based Capital Requirement</b>			
Credit risk.....	\$ 203,665	\$ 193,091	\$ 172,940
Market risk.....	350,402	262,821	361,599
Operations risk.....	<u>166,220</u>	<u>136,773</u>	<u>160,362</u>
Risk-based capital requirement.....	<u>\$ 720,287</u>	<u>\$ 592,685</u>	<u>\$ 694,901</u>

Second, the Gramm-Leach-Bliley Act, or GLB Act, imposes a 5% minimum leverage ratio based on total capital, which includes a 1.5 weighting factor applicable to permanent capital. A minimum leverage ratio, which is defined as total permanent capital (with permanent capital multiplied by 1.5) divided by total assets, is intended to ensure that the Seattle Bank maintains a sufficient amount of permanent capital. The GLB Act allows FHLBanks to issue Class A stock, which does not qualify as permanent capital, under their capital plans. The Seattle Bank has not yet authorized Class A stock, but the three-year plan proposes possible future issuance of Class A stock.

The following table presents our leverage ratios as of September 30, 2005, and December 31, 2004 and 2003.

	<u>As of September 30, 2005</u>	<u>As of December 31, 2004                      2003</u>	
		(dollars in thousands)	
<b>Leverage Ratio</b>			
Minimum leverage capital (5% of total assets).....	\$2,650,417	\$2,404,301	\$2,558,191
Leverage capital (includes 1.5 weighting factor applicable to permanent capital).....	3,414,237	3,249,393	3,683,523
Leverage ratio (leverage capital as a percentage of total assets).....	6.44%	6.76%	7.20%

Third, the GLB Act imposes a 4% minimum capital-to-assets ratio, defined as total capital divided by total assets, that does not include the 1.5 weighing factor applicable to permanent capital. We use the capital-to-assets ratio to monitor our use of financial leverage. Capital-to-assets ratios at or near the required minimums would indicate that we have fully used our capital resources, and capital-to-assets ratios that exceed these minimums would indicate that we had additional capacity to increase our asset base to increase earnings capacity.

Under the three-year plan, we must maintain a higher minimum regulatory capital-to-assets ratio of 4.25%. From time to time, adherence to our minimum capital-to-assets ratio may constrain our capacity to make advances to members because advances may increase our total assets without increasing our permanent capital. For example, the recent amendment to our capital plan permitting members to support their advances with their membership stock could increase our total assets through the funding of additional advances without increasing our permanent capital, as members could support advances using their already outstanding membership stock instead of purchasing additional capital stock to support the advances.

In addition, because our current advances-activity-based stock requirement generally calls for members to hold stock representing only 3.5% of the member's outstanding advances (minus the membership stock requirement), any additional purchases of capital stock for advances activity would likely not be in proportion to our minimum capital-to-assets ratio of 4.25%. Accordingly, this lack of proportionate capital growth on any new advances compared to our required capital-to-assets ratio may also constrain the growth of our advances from time to time.

The following table presents our capital-to-assets ratios as of September 30, 2005, and December 31, 2004 and 2003.

	As of September 30,	As of December 31,	
	2005	2004	2003
	(dollars in thousands)		
<b>Capital-to-Assets Ratio</b>			
Minimum permanent capital (4.25% of total assets as of June 30, 2005, 4.15% as of December 31, 2004, and 4.00% as of December 31, 2003).....	\$2,252,854	\$1,995,570	\$2,046,553
Permanent capital.....	\$2,276,158	\$2,166,262	\$2,455,682
Capital-to-assets ratio (permanent capital as a percentage of total assets) .....	4.29%	4.50%	4.80%

### Liquidity

We are required to maintain liquidity in accordance with federal laws and regulations, and policies established by our Board of Directors. In addition, in their asset and liability management planning, members may look to the Seattle Bank as a source of standby liquidity. We seek to meet our members' credit and liquidity needs, while complying with regulatory requirements and board-established policies, without maintaining excessive holdings of low-yield liquid investments or incurring unnecessarily high borrowing costs. We actively manage our liquidity to preserve stable, reliable, and cost effective sources of funds to meet all current and future normal operating financial commitments.

Our primary sources of liquidity are short-term investments and the proceeds of new consolidated obligation issuances. Secondary sources of liquidity are other short-term borrowings, including federal funds purchased, and securities sold under agreements to repurchase. Member deposits and capital are also liquidity sources. To ensure that adequate liquidity is available to meet our requirements, we monitor and forecast our future cash flows and our members' liquidity needs, and we adjust our funding and investment strategies as needed.

Federal regulations require the FHLBanks to maintain, in the aggregate, unpledged qualifying assets equal to the consolidated obligations outstanding. Qualifying assets are cash, secured advances, assets with an assessment or rating at least equivalent to the current assessment or rating of the consolidated obligations, mortgage loans or other securities of or issued by the U.S. government or its agencies, and securities that fiduciary and trust funds may invest in under the laws of the state in which the FHLBank is located.

The following table presents our compliance with this requirement as of September 30, 2005, and December 31, 2004, 2003, and 2002.

	As of September 30, 2005	As of December 31,		
		2004	2003	2002
		(in thousands)		
Outstanding debt .....	\$ 48,705,478	\$ 44,106,197	\$ 46,518,348	\$ 41,568,920
Aggregate qualifying assets .....	52,966,824	48,032,375	51,097,833	46,589,796

We maintain contingency liquidity plans designed to enable us to meet our obligations and the liquidity needs of our members in the event of operational disruptions at the Seattle Bank or the Office of Finance or short-term financial market disruptions. These include back-up funding sources in the repurchase and federal funds markets.

We monitor our liquidity position and anticipated funding requirements. In the event of a financial market disruption in which the FHLBank System is not able to issue consolidated obligations, we could pledge our held-to-maturity investment portfolio to borrow funds. Our investment portfolio includes high-quality investment securities that are readily marketable. Our long-term investments include U.S. agency obligations and mortgage-backed securities, of which almost 100% were rated "AAA" by Standard & Poor's or "Aaa" by Moody's as of September 30, 2005.

The following table presents our contractual obligations and commitments as of September 30, 2005.

	As of September 30, 2005				
	Payment Due by Period				
	Less than 1 Year	1 to 3 Years	3 to 5 Years	Thereafter	Total
	(in thousands)				
<b>Contractual Obligations</b>					
Consolidated obligations .....	\$ 8,479,300	\$12,341,150	\$ 5,598,300	\$ 9,591,400	\$36,010,150
Securities sold under agreement to repurchase .....	167,450				167,450
Member term deposits .....	76,603				76,603
Operating leases .....	2,155	4,536	4,861	6,662	18,214
Consolidated obligation bonds traded not settled .....	526,580				526,580
Total contractual obligations .....	<u>\$ 9,252,088</u>	<u>\$12,345,686</u>	<u>\$ 5,603,161</u>	<u>\$ 9,598,062</u>	<u>\$36,798,997</u>
<b>Other Commitments</b>					
Commitments for additional advances .....	\$ 4,634	\$ 33,833	\$	\$	\$ 38,467
Standby letters of credit .....	118,908	6,079		546	125,533
Standby bond purchase agreements .....	79,320				79,320
Unused line of credits and other commitments .....	21,000				21,000
Total other commitments .....	<u>\$ 223,862</u>	<u>\$ 39,912</u>	<u>\$</u>	<u>\$ 546</u>	<u>\$ 264,320</u>

### **Results of Operations for the Three and Nine Months Ended September 30, 2005 and 2004**

Our net income was \$14.3 million and \$10.9 million for the three and nine months ended September 30, 2005, which represented decreases of 14.8% and 83.3%, compared to the same periods in 2004. Our operating results for the three and nine months ended September 30, 2005, continued to reflect the negative effects of a flattening yield curve, due to an increase in short-term interest rates combined with a decrease in long-term interest rates since December 31, 2004. These trends continued to affect net income in two ways during the first nine months of 2005. First, we held more short-term liabilities than short-term assets, and the increase in short-term interest rates, driven by the 150 basis point increase in the federal funds rate during the first nine months of 2005, increased our short-term cost of funds more than it increased our short-term asset yields. Second, long-term interest rates continued to fall, negatively affecting the yields on our MPP assets and our long-term investment portfolio. In addition, interest-rate fluctuations during the first nine months of 2005 and expectations regarding the timing and amount of future interest-rate increases resulted in an increase in prepayment speeds on mortgage loans. These factors accelerated the premium amortization of our mortgage-based assets and negatively affected interest income

and average yields. We expect that premium amortization on our mortgage-based assets will continue to fluctuate as prepayment speed estimates and interest rates change.

As a result of the historical trends and the actions we have taken or expect to take, including those in connection with the three-year plan, which are more fully discussed in "– Overview," we anticipate that we will break even or earn minimal net income in 2005, and that our earnings will increase in 2006 and 2007.

In addition, we had a net unrealized loss in our market value of equity of approximately \$400 million as of September 30, 2005. We monitor our market value of equity for risk management purposes, but it is not reflected in our Statements of Condition. See "– Overview" and Note 13 of the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005. An unrealized loss in market value of equity will depress our net income as reported in our financial statements in future periods. The ratio of our market value of equity to our book value of equity was estimated at 81% as of September 30, 2005. We measure our market value of equity as the present value of the expected net cash flows from all our existing assets, liabilities, and commitments. The amount of our net unrealized market value loss involves estimates of the market values of our assets, liabilities, and commitments, which we discuss in greater depth in "– Financial Condition."

### Net Interest Income

Net interest income is the primary performance measure for our ongoing operations. Our net interest income consists of interest earned on advances, mortgage loans held for portfolio, and investments, less interest accrued or paid on consolidated obligations, deposits, and other borrowings. Our net interest income is affected by changes in the average balances (volume) of our interest-earning assets and interest-bearing liabilities and changes in the average yield (rate) for both the interest-earning assets and interest-bearing liabilities. These changes are influenced by economic factors or by changes in our products or services.

Interest rates are the key economic factor affecting net interest income. Beginning in 2001 and through 2003, the Federal Reserve Open Market Committee reduced its target for the federal funds rate by 550 basis points. Although the federal funds rate increased by 125 basis points during 2004 and by 150 basis points during the first nine months of 2005, the prior reductions in the federal funds rate contributed to a period of sustained, historically low interest rates, which had and continues to have a significant effect on our interest income and interest expense.

The following table presents the components of our net interest income for the three and nine months ended September 30, 2005 and 2004.

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2005	2004	% Increase (Decrease)	2005	2004	% Increase (Decrease)
	(dollars in thousands)					
Interest income.....	\$ 505,731	\$ 423,799	19.3	\$1,416,625	\$1,229,772	15.2
Interest expense.....	<u>481,627</u>	<u>386,753</u>	24.5	<u>1,335,037</u>	<u>1,108,797</u>	20.4
Net interest income.....	<u>\$ 24,104</u>	<u>\$ 37,046</u>	(34.9)	<u>\$ 81,588</u>	<u>\$ 120,975</u>	(32.6)

Both total interest income and total interest expense increased for the three and nine months ended September 30, 2005, compared to the prior periods, but net interest income decreased as a result of both a reduction in volume of our higher earning assets due to prepayments and our ownership of more short-term liabilities than short-term assets in a rising short-term interest-rate environment.

We expect that our high-cost, long-term borrowings and our low-yield investments in consolidated obligations of other FHLBanks will continue to depress our net interest income in 2005 and 2006, with a diminishing effect on net interest income in later years. In addition, the requirements of the Finance Board agreement, implementation of the three-year plan, and recent changes to our policies relating to retained earnings, dividends, and stock repurchases, could have an adverse effect on our net interest income.

*Average Balances, Interest Income and Expense, and Average Yields.* The following tables present average balances and yields, and interest income and expense of major categories of interest-earning assets and interest-bearing liabilities, for the three and nine months ended September 30, 2005 and 2004. The tables also present spreads between the average yield on total earning assets and the average cost of interest-bearing liabilities for the three and nine months ended September 30, 2005 and 2004.

	For the Three Months Ended September 30,					
	2005			2004		
	Average Balance	Interest Income / Expense	Average Yield %	Average Balance	Interest Income / Expense	Average Yield %
	(dollars in thousands)					
<b>Interest-Earning Assets</b>						
Advances .....	\$ 18,385,606	\$ 175,156	3.78	\$ 16,834,152	\$ 107,000	2.53
Investments.....	24,681,117	218,908	3.52	22,400,879	186,629	3.31
Mortgage loans held for portfolio* .....	8,708,471	111,651	5.09	10,959,591	130,161	4.72
Other interest-earning assets .....	1,630	16	3.78	2,432	9	1.34
Total interest-earning assets.....	<u>51,776,824</u>	<u>\$ 505,731</u>	3.88	<u>50,197,054</u>	<u>\$ 423,799</u>	3.36
Other assets.....	278,529			261,189		
Total assets .....	<u>\$52,055,353</u>			<u>\$50,458,243</u>		
<b>Interest-Bearing Liabilities</b>						
Consolidated obligations.....	\$47,884,548	\$ 471,577	3.91	\$46,122,222	\$ 383,175	3.31
Deposits .....	835,249	7,089	3.37	1,053,038	3,578	1.35
Mandatorily redeemable Class B stock.....	67,467					
Other borrowings.....	357,170	2,961	3.29			
Total interest-bearing liabilities .....	<u>49,144,434</u>	<u>\$ 481,627</u>	3.89	<u>47,175,260</u>	<u>\$ 386,753</u>	3.26
Other liabilities .....	704,113			809,953		
Capital .....	<u>2,206,806</u>			<u>2,473,030</u>		
Total liabilities and capital .....	<u>\$52,055,353</u>			<u>\$50,458,243</u>		
Net interest income.....		<u>\$ 24,104</u>			<u>\$ 37,046</u>	
Interest-rate spread .....			-0.01			0.10

\* Includes mortgage loans held for sale of \$952.6 million for the three months ended September 30, 2005.

	For the Nine Months Ended September 30,					
	2005			2004		
	Average Balance	Interest Income / Expense	Average Yield %	Average Balance	Interest Income / Expense	Average Yield %
	(dollars in thousands)					
<b>Interest-Earning Assets</b>						
Advances .....	\$ 17,796,354	\$ 466,957	3.51	\$ 17,928,550	\$ 314,811	2.35
Investments.....	22,277,674	595,022	3.57	20,576,394	501,550	3.26
Mortgage loans held for portfolio* .....	9,585,465	354,620	4.95	11,247,000	413,402	4.91
Other interest-earning assets .....	1,094	26	3.21	871	9	1.31
Total interest-earning assets.....	<u>49,660,587</u>	<u>\$ 1,416,625</u>	3.81	<u>49,752,815</u>	<u>\$ 1,229,772</u>	3.30
Other assets.....	286,154			268,933		
Total assets .....	<u>\$49,946,741</u>			<u>\$50,021,748</u>		
<b>Interest-Bearing Liabilities</b>						
Consolidated obligations.....	\$45,527,061	\$ 1,304,245	3.83	\$45,651,032	\$ 1,100,182	3.22
Deposits .....	788,591	16,890	2.86	1,097,382	8,612	1.05
Mandatorily redeemable Class B stock.....	223,163	(3)				
Other borrowings.....	687,841	13,905	2.70	296	3	1.19
Total interest-bearing liabilities .....	<u>47,226,656</u>	<u>\$ 1,335,037</u>	3.78	<u>46,748,710</u>	<u>\$ 1,108,797</u>	3.17
Other liabilities .....	716,815			799,405		
Capital .....	<u>2,003,270</u>			<u>2,473,633</u>		
Total liabilities and capital .....	<u>\$49,946,741</u>			<u>\$50,021,748</u>		
Net interest income.....		<u>\$ 81,588</u>			<u>\$ 120,975</u>	
Interest-rate spread .....			0.03			0.13

\* Includes mortgage loans held for sale of \$321.0 million for the nine months ended September 30, 2005.

Average balances of the major categories of our interest-earning assets and interest-bearing liabilities have changed as we have refocused our business on advances. Since the yield on advances is lower than the yield on mortgage loans held for portfolio, we expect a negative impact on net interest income as our MPP loans are paid off and replaced with lower-yield assets. In August 2005, we completed the sale of \$1.4 billion of these mortgage loans to an affiliate of one of our members. We expect to continue to increase the use of differential pricing to increase our advance volumes, which should offset any net reduction in advance interest income resulting from reduced interest rates charged on some advances. For the three and nine months ended September 30, 2005, differentially-priced advances contributed \$59.2 million and \$102.0 million to advance interest income.

For the three months ended September 30, 2005, the composition of our interest-earning assets changed significantly from that of the same period in 2004, with the average balance of mortgage loans held for portfolio declining significantly and the average balance of our advances and investments increasing. The reduction in mortgage loans held for portfolio reflected our decision to exit the MPP and discontinue purchasing new loans. The increase in advances largely reflected the increased use of differential pricing during the third quarter of 2005, while the increase in investments reflected our decision to use our capital near the 4.25% capital-to-assets ratio limit to maximize interest income.

For the nine months ended September 30, 2005, average balances of mortgage loans held for portfolio decreased significantly, while the average balances of our investments increased significantly, compared to the same period in 2004. The reduction in mortgage loans held for portfolio reflected our decision to exit the MPP. The increase in investments reflected our decision to use our capital near the 4.25% capital-to-assets ratio limit to maximize interest income.

The general increase in interest rates between December 31, 2003, and September 30, 2005, led to increased yields on our interest-earning assets and increased interest income during the three and nine months ended September 30, 2005, compared to the same periods of 2004. However, for the three and nine months ended September 30, 2005, compared to the same periods in 2004, we also experienced a larger increase in the average cost of our interest-bearing liabilities that compressed our interest-rate spread and decreased our net interest income. The compression of our interest-rate spread resulted from a combination of a 150 basis point increase in short-term interest rates during the first nine months of 2005 and our holding more short-term liabilities than short-term assets. This combination caused our interest expense to increase more than our interest income, which depressed net interest income. In addition, the declining yield on our mortgage loans held for portfolio further depressed net interest income. Accordingly, interest-rate spread declined by 11 basis points and 10 basis points to negative 1 basis points and 3 basis points for the three and nine months ended September 30, 2005.

*Changes in Volume and Rate.* The following table separates the two principal components of the changes in our net interest income – interest income and interest expense – identifying the amounts due to changes in the volume of interest-earning assets and interest-bearing liabilities and changes in the average interest rate, for the three and nine months ended September 30, 2005 and 2004.

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2005 vs. 2004			2005 vs. 2004		
	Volume*	Rate*	Total	Volume*	Rate*	Total
	Increase (Decrease)			Increase (Decrease)		
	(dollars in millions)					
<b>Interest Income</b>						
Advances.....	\$ 10.6	\$ 58.0	\$ 68.6	\$ (2.3)	\$ 155.1	\$ 152.8
Investments .....	19.8	12.5	32.3	43.3	50.2	93.5
Mortgage loans held for portfolio.....	<u>(28.3)</u>	<u>9.8</u>	<u>(18.5)</u>	<u>(61.5)</u>	<u>2.7</u>	<u>(58.8)</u>
Total interest income .....	<u>2.1</u>	<u>80.3</u>	<u>82.4</u>	<u>(20.5)</u>	<u>208.0</u>	<u>187.5</u>
<b>Interest Expense</b>						
Consolidated obligations .....	15.1	73.3	88.4	(3.0)	207.1	204.1
Deposits and other borrowings.....	<u>1.1</u>	<u>5.4</u>	<u>6.5</u>	<u>6.8</u>	<u>15.4</u>	<u>22.2</u>
Total interest expense .....	<u>16.3</u>	<u>78.7</u>	<u>94.9</u>	<u>3.8</u>	<u>222.4</u>	<u>226.3</u>
Change in net interest income .....	<u>\$ (14.2)</u>	<u>\$ 1.6</u>	<u>\$ (12.5)</u>	<u>\$ (24.3)</u>	<u>\$ (14.4)</u>	<u>\$ (38.8)</u>

\* Changes in interest income and interest expense not identifiable as either volume-related or rate-related, but rather equally attributable to both volume and rate changes, are allocated to the volume and rate categories based on the proportion of the absolute value of the volume and rate changes.

For the three and nine months ended September 30, 2005, compared to the same periods in 2004, declines in net interest income were attributable to both changes in volumes and interest rates. The declines in net interest income as a result of volume changes are consistent with our move to an advances-focused business, with higher-yield mortgage balances declining and lower-yield advances and investments increasing. The declines in net interest income as a result of interest-rate changes are primarily due to increases in short-term interest rates. We held more short-term, interest-bearing liabilities than short-term, interest-bearing assets, which primarily contributed to our interest expense increasing more than our interest income.

### Interest Income

The following table presents the components of our interest income by category of interest-earning assets and the percentage change in each category for the three and nine months ended September 30, 2005 and 2004.

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2005	2004	% Increase (Decrease)	2005	2004	% Increase (Decrease)
	(dollars in thousands)					
<b>Interest Income</b>						
Advances.....	\$ 175,152	\$ 106,592	64.3	\$ 464,825	\$ 314,151	48.0
Prepayment fees on advances.....	4	408	(99.0)	2,132	660	223.0
Subtotal.....	175,156	107,000	63.7	466,957	314,811	48.3
Investments.....	218,908	186,629	17.3	595,022	501,550	18.6
Mortgage loans held for portfolio* .	111,651	130,161	(14.2)	354,620	413,402	(14.2)
Other.....	16	9	77.8	26	9	188.9
Total interest income.....	<u>\$ 505,731</u>	<u>\$ 423,799</u>	19.3	<u>\$1,416,625</u>	<u>\$1,229,772</u>	15.2

\* Includes interest income on mortgage loans held for sale of \$12.2 million for the three and nine months ended September 30, 2005.

The increases in total interest income for the three and nine months ended September 30, 2005, compared to the same periods in 2004, are primarily due to the significant increases in the yields on our advances and the yields on our investments, partially offset by decreases in the volume of our mortgage loans held for portfolio.

*Advances.* Interest income from advances increased 63.7% and 48.3% for the three and nine months ended September 30, 2005, compared to the same periods in 2004. The increase in interest income from advances in the three months ended September 30, 2005, was primarily due to significant increases in interest rates, with increases in average advance volumes also contributing favorably to interest income. For the nine months ended September 30, 2005, the increase in interest income was due to increases in interest rates, partially offset by a decline in average advance volumes. This decline in volume was primarily the result of the maturity and nonrenewal of advances by two large members in 2004. Our average advances outstanding increased by \$1.6 billion and decreased by \$132.2 million for the three and nine months ended September 30, 2005, compared to the same periods in 2004. In addition, the average advances for the third quarter of 2005 increased by \$1.3 billion, compared to the average advances for 2004.

As part of the three-year plan, we are refocusing our business on our advances and expect to continue to increase advance volumes using differential pricing. In practice, this means that our average spread on advances relative to our cost of funds could be lower than it would be if we did not use differential pricing. We expect that the increased advance volumes from the use of differential pricing will more than compensate for any reduction in overall yield due to differential pricing.

As a result of our use of differential pricing, we expect our overall advance volumes to become even more dependent upon the borrowing decisions of a few large members. Substantial repayments of advances borrowings by our largest members could significantly decrease our amount of outstanding advances, causing our cash position to increase. However, because the spreads we earn on federal funds sold are comparable to the spreads we earn on differentially-priced advances, we would not expect repayments of advances by our largest members to negatively affect net interest income.

*Prepayment Fees on Advances.* During the three and nine months ended September 30, 2005, we received prepayment fee income of \$4,000 and \$2.1 million. Of the amount collected during the first nine months of 2005, \$1.4 million was primarily due to fees we collected from borrowers that prepaid \$268 million in advances, partially offset by termination fees charged to us due to our cancellation of interest-rate exchange agreements hedging those prepaid advances. Prepayment fee income was \$408,000 and \$660,000 during the first three and nine months of 2004. Federal regulations generally require advances with a maturity or repricing period greater than six months to carry a prepayment fee sufficient to make us financially indifferent to a borrower's decision to prepay the advances. The amount of prepayment fees depends on the prepaid advance's remaining term to maturity and interest rate.

*Investments.* Interest income from investments, which includes short-term investments (e.g., interest-bearing deposits, securities purchased under agreements to resell, and federal funds sold), and long-term investments (e.g., held-to-maturity securities and trading securities), increased by 17.3% and 18.6% in the three and nine months ended September 30, 2005, compared to the prior periods. These increases were a result of significant growth in the size of our investment portfolio, which reflects our decision in 2005 to increase net interest income from investments through a strategy of managing our business to a capital-to-assets ratio of 4.30% in order to fully use our capital and fund advances. Our interest income on investments in these periods also benefited from increases in interest rates and our decision to replace low-yield, short-term investments during 2004 with investments in higher-yield, long-term, fixed-rate callable consolidated obligations of other FHLBanks. The increases in our average yields for the investment portfolio were 21 basis points and 31 basis points for the three and nine months ended September 30, 2005.

*Mortgage Loans Held for Portfolio.* Interest income from mortgage loans held for portfolio decreased by 14.2% for the three and nine months ended September 30, 2005, compared to the same periods in 2004. The decreases were primarily due to limited purchases of mortgage loans from members during the second half of 2004 and the first half of 2005, and to our decision in early 2005 to exit the MPP. In August 2005, we sold \$1.4 billion of MPP government-insured mortgage loans to an affiliate of one of our members. The balance of our remaining mortgage loans will continue to decrease as mortgage loans are paid off.

The average balance of MPP mortgage loans during the three and nine months ended September 30, 2005, was \$8.7 billion and \$9.6 billion, compared to \$11.0 billion and \$11.2 billion in the three and nine months ended September 30, 2004.

Interest income from mortgage loans held for portfolio was also impacted by changes in interest-rate levels and estimated prepayment speeds. The average yields increased to 5.09% and 4.95% for the three and nine months ended September 30, 2005, from 4.72% and 4.91% for the applicable periods in 2004. The larger increase in yield in the three months ended September 30, 2005, compared to the same period in 2004, was primarily due to a decrease in premium amortization as a result of decreases in estimated mortgage loan prepayment speeds as long-term rates increased through the third quarter of 2005. The smaller increase in yield in the nine months ended September 30, 2005, compared to the same period in 2004, was primarily due to higher long-term market rates that existed during the first nine months of 2005. For the three months and nine months ended September 30, 2005, premium amortization on mortgage loans held for portfolio totaled \$718,000 and \$19.2 million, compared to \$13.1 million and \$28.3 million for the same periods in 2004.

## Interest Expense

The following table presents the components of our interest expense for the three and nine months ended September 30, 2005, compared to the same periods of 2004.

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2005	2004	% Increase (Decrease)	2005	2004	% Increase (Decrease)
	(dollars in thousands)					
Consolidated obligations.....	\$ 471,577	\$ 383,175	23.1	\$1,304,245	\$1,100,182	18.5
Deposits .....	7,089	3,578	98.1	16,890	8,612	96.1
Mandatorily redeemable Class B stock .....				(3)		
Other borrowings .....	<u>2,961</u>			<u>13,905</u>	<u>3</u>	4,634.0
Total interest expense.....	<u>\$ 481,627</u>	<u>\$ 386,753</u>	24.5	<u>\$1,335,037</u>	<u>\$1,108,797</u>	20.4

*Consolidated Obligations.* Interest expense on consolidated obligations increased by 23.1% and 18.5% for the three and nine months ended September 30, 2005, compared to the same periods of 2004. These increases were the result of increases in interest rates in late 2004 and the first nine months of 2005. The Seattle Bank's funding is primarily short term, with the majority of our debt either repricing or maturing within one year. Increases in the federal funds rate of 150 basis points during the first nine months of 2005 caused our interest expense to increase. This rising interest-rate environment led to the average yield on our consolidated obligations increasing by 60 basis points and 61 basis points for the three and nine months ended September 30, 2005, compared to the same periods in 2004.

We seek to manage our debt portfolio by issuing bullet and callable consolidated obligation bonds, by calling and reissuing consolidated obligation bonds to take advantage of lower interest rates, where possible, and by using a combination of callable consolidated obligation bonds and interest-rate swaps. However, due to the repayment terms on some of our consolidated obligations, which prohibit early redemptions during a lock-out period, we were not able to effectively match these repayments and redemptions to our assets during the first three and nine months of 2005. Longer-term, higher-cost consolidated obligations and the locked-out, higher-cost consolidated obligations, combined with lower interest income attributable to an advances-focused strategy, will likely result in a decrease in or continued pressure on net interest income for the next few years.

*Deposits.* Interest expense on deposits increased for the three and nine months ended September 30, 2005, due to increases in the yield paid to members of 202 basis points and 181 basis points, which were partially offset by \$217.8 million and \$308.8 million decreases in the average balances of deposits during these periods, compared to the applicable prior periods.

## Effect of Derivatives and Hedging on Net Interest Income

The following table presents the impact of derivatives and hedging on the components of our interest income and interest expense for the three and nine months ended September 30, 2005 and 2004.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
	(in thousands)			
<b>Interest Income</b>				
Advances.....	\$ (7,966)	\$ (28,910)	\$ (39,409)	\$ (90,234)
<b>Interest Expense</b>				
Consolidated obligations.....	<u>8,119</u>	<u>(29,300)</u>	<u>3,103</u>	<u>(118,155)</u>
Impact to net interest income.....	<u>\$ (16,085)</u>	<u>\$ 390</u>	<u>\$ (42,512)</u>	<u>\$ 27,921</u>

We use derivative instruments to manage our exposure to changes in interest rates and to adjust the effective maturity, repricing frequency, or option characteristics of our assets and liabilities in response to changing market conditions. Our use of interest-rate exchange agreements had a net unfavorable impact to net interest income for the three and nine months periods ended September 30, 2005, and a favorable impact to net interest income for the same periods of 2004.

We generally use interest-rate exchange agreements to hedge fixed-rate advances and consolidated obligations by effectively converting their fixed rates to short-term floating rates. Because we hold more interest-rate exchange agreements hedging consolidated obligations than hedging advances, the effective conversion to short-term floating rates on these instruments combined with increases in short-term interest rates, caused a decrease to net interest income for the three and nine months ended September 30, 2005, compared to the same periods in 2004.

### Other Income (Loss)

Other income (loss) includes member service fees, gain and loss on trading securities, gain and loss on derivatives and hedging activities, and other miscellaneous income or loss not included in net interest income. Because of the type of financial activity reported in this category, other income (loss) can be volatile from one period to another. For instance, gain and loss on derivatives and hedging activities is highly dependent on changes in interest rates and spreads between various interest-rate yield curves.

The following table presents the components of our other income (loss) for the three and nine months ended September 30, 2005 and 2004.

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2005	2004	% Increase (Decrease)	2005	2004	% Increase (Decrease)
	(in thousands)					
Service fees .....	\$ 567	\$ 559	1.4	\$ 1,617	\$ 1,717	(5.8)
Net realized gain on sale of held-to-maturity securities (HTM) .....		1,195	(100.0)		2,818	(100.0)
Net gain (loss) on trading securities .....	(13,750)	14,375	(195.7)	8,195	6,687	22.6
Net realized and unrealized gain (loss) on derivatives and hedging activities .....	17,436	(19,989)	187.2	(32,845)	(10,524)	(212.1)
Loss from early extinguishment of consolidated obligations .....				(3,041)		
Gain on sale of government-insured mortgage loans .....	7,019			7,019		
Other, net .....	(1,263)	(252)	(403.6)	(1,479)	(201)	(635.8)
Total .....	<u>\$ 10,009</u>	<u>\$ (4,112)</u>	343.4	<u>\$ (20,534)</u>	<u>\$ 497</u>	(4,231.6)

Total other income (loss) increased by \$14.1 million and decreased by \$21.0 million for the three and nine months ended September 30, 2005, compared to the same periods in 2004. In July 2005, we reclassified all of our government-insured mortgage loans from mortgage loans held for portfolio to mortgage loans held for sale on our Statement of Condition, and we began reporting the approximately \$1.9 billion of reclassified mortgage loans at the lower of cost or market value. In August 2005, we sold \$1.4 billion of these mortgage loans to an affiliate of one of our members. In September 2005, after determining the disposition of the mortgage loans had reduced our interest-rate risk profile, we reclassified the remaining approximately \$400 million of the unsold mortgage loans as held for portfolio. During the time the mortgage loans were classified as held for sale, they were measured at the lower of cost or market value. Our estimations of market value while the mortgage loans were held for sale were based on market value information available to us at the time. We realized a gain of \$7.0 million on the sale of these mortgage loans. We also incurred an unrealized loss of \$1.1 million, which was reported in other income (loss), when we reclassified the unsold mortgage loans as held for portfolio. The unrealized loss reduced the net premium associated with the government-insured mortgage loans held for portfolio.

The increase for the three months ended September 30, 2005, was due primarily to net realized and unrealized gains on derivatives and hedging activities and the gain on the sale of MPP government-insured mortgage loans, partially offset by a loss on trading securities. The decrease for the nine months ended September 30, 2005, was due primarily to a net realized and unrealized loss on derivatives and hedging activities, partially offset by a gain on trading securities and the gain on the sale of MPP government-insured mortgage loans.

During the first nine months of 2005, we extinguished \$100 million of consolidated obligations in the form of long-term, unswapped bullet debt with a weighted interest rate of 5.38%. This extinguishment resulted in a loss of \$3.0 million on the consolidated obligation bonds, which was partially offset by fees charged on prepaid advances and realized gains on the termination of swaption contracts. The loss on the extinguishment of consolidated obligation bonds and realized gains on the termination of swaption contracts are recorded in other income (loss), the prepayment fee on advances is recorded in interest income in the Statement of Income. We continue to review our consolidated obligations portfolio for opportunities to lower our interest expense and better match the duration of our liabilities to that of our assets.

*Net Gain (Loss) on Trading Securities and Net Realized and Unrealized Gain (Loss) on Derivatives and Hedging Activities.* Our net gain (loss) on trading securities and net realized and unrealized gain (loss) on derivatives and hedging activities generally comprise the majority of our other income (loss).

The following tables summarize the components of net gain (loss) on trading securities as well as net realized and unrealized gain (loss) on derivatives and hedging activities, for the three and nine months ended September 30, 2005 and 2004.

	<u>Trading Securities</u>	<u>Mortgage Loans/ Commitments</u>	<u>Consolidated Obligations</u>	<u>Statement of Condition</u>	<u>Intermediary Positions</u>	<u>Total</u>
<b>For the Three Months Ended September 30, 2005</b>						
Net loss on trading securities .....	\$ (13,750)	\$	\$	\$	\$	\$ (13,750)
Net realized and unrealized gain (loss) on derivatives and hedging activities .....	12,671	3,233	281	1,306	(55)	17,436
Total.....	<u>\$ (1,079)</u>	<u>\$ 3,233</u>	<u>\$ 281</u>	<u>\$ 1,306</u>	<u>\$ (55)</u>	<u>\$ (3,686)</u>
<b>For the Three Months Ended September 30, 2004</b>						
Net gain on trading securities .....	\$ 14,375	\$	\$	\$	\$	\$ 14,375
Net realized and unrealized (loss) gain on derivatives and hedging activities .....	(17,461)	214	(1,605)	(1,119)	(18)	(19,989)
Total.....	<u>\$ (3,086)</u>	<u>\$ (214)</u>	<u>\$ (1,605)</u>	<u>\$ (1,119)</u>	<u>\$ (18)</u>	<u>\$ (5,614)</u>
<b>For the Nine Months Ended September 30, 2005</b>						
Net gain on trading securities .....	\$ 8,195	\$	\$	\$	\$	\$ 8,195
Net realized and unrealized loss on derivatives and hedging activities .....	(10,526)	(13,812)	(3,752)	(4,674)	(81)	(32,845)
Total.....	<u>\$ (2,331)</u>	<u>\$ (13,812)</u>	<u>\$ (3,752)</u>	<u>\$ (4,674)</u>	<u>\$ (81)</u>	<u>\$ (24,650)</u>
<b>For the Nine Months Ended September 30, 2004</b>						
Net gain on trading securities .....	\$ 6,687	\$	\$	\$	\$	\$ 6,687
Net realized and unrealized (loss) gain on derivatives and hedging activities .....	(13,081)	953	(231)	(4,060)	(59)	(16,478)
Accounting adjustment:						
Unrealized gain from inception to March 31, 2004 .....			2,941			2,941
Reclassification of deferred interest-rate swap fees .....			3,013			3,013
Total.....	<u>\$ (6,394)</u>	<u>\$ 953</u>	<u>\$ 5,723</u>	<u>\$ (4,060)</u>	<u>\$ (59)</u>	<u>\$ (3,837)</u>

Net Gain (Loss) on Trading Securities. The following table presents the components of net unrealized gain (loss) on trading securities, compared to the net realized and unrealized gain (loss) on the interest-rate exchange agreement that economically hedges the investment held as a trading security, net of the interest expense component, for the three and nine months ended September 30, 2005 and 2004.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
	(in thousands)			
Net realized and unrealized gain (loss) on derivatives and hedging activities on interest-rate exchange agreements hedging trading securities.....	\$ 12,671	\$ (17,461)	\$ (10,526)	\$ (13,081)
Interest expense on interest-rate exchange agreements hedging trading securities .....	1,702	2,752	5,918	8,591
Net unrealized gain (loss) .....	14,373	(14,709)	(4,608)	(4,490)
Net (loss) gain from trading securities.....	(13,750)	14,375	8,195	6,687
Net difference between net gain on trading securities and net realized and unrealized loss on interest-rate exchange agreements hedging trading securities.....	\$ 623	\$ (334)	\$ 3,587	\$ 2,197

As of September 30, 2005 and 2004, our trading securities consisted of one GSE debt obligation. This trading security was economically hedged by an interest-rate exchange agreement. We recorded the changes in fair value of the trading securities and the associated interest-rate exchange agreement as "net gain (loss) on trading securities" and "net realized and unrealized gain (loss) on derivatives and hedging activities" on our Statements of Income. We report interest income earned on the trading security in "interest income" and the interest expense on the interest-rate exchange agreement in "net realized and unrealized gain (loss) on derivatives and hedging activities" on our Statement of Income.

We determine the change in fair value on the GSE debt obligation classified as a trading security using quoted market prices from securities brokers. We calculate the change in fair value on the interest-rate exchange agreement based on estimated fair values of interest-rate exchange agreements with similar terms or available market prices. Although we expect the majority of the changes in fair value of trading securities to be offset by opposite changes in fair value of the corresponding interest-rate exchange agreement, there will be differences that are reported in total other income (loss) in the Statements of Income.

In the first three and nine months of 2005, the loss on the interest-rate exchange agreement hedging the trading security contributed approximately 72.7% and 32.0% of the net \$17.4 million and \$32.8 million loss on derivatives and hedging activities, compared to 87.4% and 124.3% of the net \$20.0 million and \$10.5 million gain for the same periods in 2004. Because of the volatility of the U.S. agency obligation and agency yield-curve spreads relative to the LIBOR curve, the changes in the fair value of the trading securities have not been completely offset by the changes in the fair value of the related hedging instrument.

In December 2005, we sold the GSE debt obligation and terminated the associated interest-rate exchange agreement. The change in fair value of these financial instruments during the fourth quarter until termination of our trading activities was a gain of \$2.4 million in other income (loss).

Net Realized and Unrealized Gain (Loss) on Derivatives and Hedging Activities. For the three and nine months ended September 30, 2005, much of the change in our total net realized and unrealized gain (loss) on derivatives and hedging activities was due to changes in the fair value of mortgage delivery commitments, interest-rate futures and forwards, consolidated obligation bonds and the corresponding interest-rate exchange agreements, and swaptions. For the three and nine months ended September 30, 2004, much of the change in our total net realized and unrealized gain (loss) on derivatives and hedging activities was due to changes in the fair value of interest-rate exchange agreements that economically hedged our trading securities, and accounting adjustments related to the change in the manner of accounting we used to value and measure ineffectiveness for certain highly-effective hedging relationship transactions.

Mortgage Loans/Commitments. Commitments to purchase mortgage loans are classified as derivatives, and the changes in the fair value of the commitments are included in other income (loss). As part of the three-year plan, we are exiting the MPP, and we have ceased entering into new master commitment contracts. For the three and nine months ended September 30, 2005, the fair value on our mortgage commitments was a loss of \$9,600 and a gain of \$365,000, compared to a gain of \$214,000 and a gain of \$953,000 for the same periods in 2004.

As of September 30, 2005, we had no outstanding notional (face) amount of swaptions to economically hedge the interest rate risk allocated to our mortgage loan portfolio. For the three and nine months ended September 30, 2005, the fair value adjustment on our swaptions was a loss of \$3.7 million and \$16.0 million. We did not hold any swaptions as of the three and nine months ended September 30, 2004.

During June 2005, we restructured our hedges and funding to realign our hedge position. We reduced our reliance on swaptions for hedging against long-term decreases in interest rates, and sold mortgage-backed securities to-be-announced, or TBAs, for forward settlement to economically hedge the interest rate risk allocated to our mortgage loan portfolio. The fair value adjustment on the TBAs was a loss of \$5.6 million and \$3.5 million for the three and nine months ended September 30, 2005.

*Consolidated Obligations.* During the second quarter of 2004, we changed the manner in which we assess effectiveness for certain highly-effective consolidated obligation hedging relationships since our adoption of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, or SFAS 133, on January 1, 2001. Under our prior approach, we inappropriately assumed no ineffectiveness for these hedging transactions, since each consolidated obligation and its designated interest-rate exchange agreement had identical terms, with the exception that the interest-rate exchange agreement used in these relationships was structured with one settlement amount under the receive side of the interest-rate exchange agreement that differed from all other receive-side settlements by an amount equivalent to the concession cost associated with the consolidated obligation. During 2004, we changed our method of accounting for these relationships to begin measuring effectiveness for such transactions during each reporting period. We assessed the impact of this change on all prior annual periods since the adoption of SFAS 133 on January 1, 2001, and all prior quarterly periods for 2004 and 2003. We determined that had we applied this approach since January 1, 2001, it would not have had a material impact on the results of our operations or financial condition for any of these prior reporting periods. Changes in the value of the hedged consolidated obligations are recorded as offset to the changes in fair value to the derivatives that hedge them.

For the year ended December 31, 2004, we recorded an increase of \$2.9 million to net income before assessments, reflecting the accounting as if we had employed the new approach since the date of adoption of SFAS 133 through March 31, 2004. Of this amount, \$1.7 million related to 2003, 2002, and 2001. In addition, as part of the accounting adjustment, we reclassified \$3.0 million of deferred interest-rate swap agreement fees from interest expense to "net realized and unrealized gain (loss) on derivatives and hedging activities" in the Statements of Income. The reclassification relates to fees recognized on terminated interest-rate exchange agreements hedging consolidated obligations that had been repaid. In June 2005, we determined that the method we had used since 2004 for valuing the hedged consolidated obligations was in error. Accordingly, we reassessed the bond valuation using an appropriate method. As a result, in the second quarter of 2005, we recorded an additional loss of \$1.7 million relating to the second quarter and prior periods.

*Statement of Condition.* As of September 30, 2005, we held \$700 million notional amount of interest-rate caps that are used to economically hedge changes in the fair value of our assets and liabilities. Because the interest-rate caps do not qualify for hedge accounting treatment, the changes in the fair value of the interest-rate caps are recorded as net realized and unrealized loss on derivatives and hedging activities in the Statement of Income. The gains and losses are primarily caused by changes in the interest rates that impact the fair value of the interest-rate caps.

### **Other Expense**

Other expense includes operating expenses, Finance Board and Office of Finance assessments, and other items, which consist primarily of mortgage loan administrative fees paid to vendors related to our mortgage loans held for portfolio.

The following table presents the components of our other expense for the three and nine months ended September 30, 2005, compared to the applicable prior period.

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2005	2004	% Increase (Decrease)	2005	2004	% Increase (Decrease)
	(in thousands)					
Operating expenses:						
Salaries and benefits .....	\$ 5,567	\$ 5,012	11.1	\$ 20,097	\$ 17,419	15.4
Occupancy cost .....	2,476	1,145	116.2	6,531	2,980	119.2
Other operating .....	5,284	2,595	103.6	15,521	8,210	89.0
Finance Board .....	532	502	6.0	1,598	1,363	17.2
Office of Finance .....	258	232	11.2	842	854	(1.4)
Other .....	437	624	(30.0)	1,518	1,893	(19.8)
Total other expense .....	<u>\$ 14,554</u>	<u>\$ 10,110</u>	43.9	<u>\$ 46,107</u>	<u>\$ 32,719</u>	40.9

*Operating Expenses.* Operating expenses increased for the three and nine months ended September 30, 2005, compared to the same periods in 2004, primarily reflecting incremental staffing, termination-related expenses, increased occupancy costs, and an increase in professional and other contractual services costs related to implementation of the Finance Board agreement, development of the three-year plan, the requirement to register a class of our equity securities with the SEC and to comply with the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley Act, and Finance Board requirements. Other infrastructure expenses included professional services to strengthen the financial and operational systems that support our business.

As of September 30, 2005, we had 131 employees, compared to 192 as of December 31, 2004. Salaries and benefits increased by 11.1% and 15.4% in the first three and nine months ended September 30, 2005, compared to the same periods in 2004. These salary and benefit increases primarily reflected \$3.0 million in termination-related expenses and increased salaries and benefits for existing employees.

Occupancy cost primarily includes the expenses related to our leases on two offices in downtown Seattle and an emergency back-up facility outside of downtown Seattle. Occupancy cost increased by 116.2% and 119.2% for the three and nine months ended September 30, 2005, compared to the applicable prior periods. For the three and nine months ended September 30, 2005, we recorded \$1.2 million and \$2.3 million of abandonment cost on leases, reflecting our vacating leased office space to align with the reduction in staffing levels, which has been occurring during 2005. See Note 1 of the condensed notes to our unaudited financial statements for the quarter ended September 30, 2005. We expect to recognize additional abandonment costs on leases of approximately \$3 million to \$5 million during the fourth quarter of 2005.

Other operating expenses increased by 103.6% and 89.0% for the three and nine months ended September 30, 2005, compared to the same periods in 2004. The increases were due primarily to professional and other contractual services, as well as \$1.6 million of expenses related to replenishing the AHP fund as discussed under "—Assessments" below. During the first nine months of 2005, we paid consulting fees incurred in connection with the implementation of the Finance Board agreement and the three-year plan of approximately \$4.0 million. We do not expect to incur significant additional consulting fees related to the implementation of the Finance Board agreement and the three-year plan. In the first nine months of 2004, professional services included services received in connection with enhancing business processes to support the more complex risks associated with the MPP mortgage loans, employee search fees, consulting work in connection with preparation for SEC registration and compliance with the Sarbanes-Oxley Act, Finance Board requirements, and other regulatory compliance.

Finance Board and Office of Finance expenses represent costs allocated to us by the Finance Board and the Office of Finance, calculated through a formula based on our percentage of capital stock, consolidated obligations issued and consolidated obligations outstanding for the previous month for the FHLBank System as a whole.

## Assessments

Although we are exempt from all federal, state, and local taxation other than real property tax, the Financial Institutions Reform, Recovery and Enforcement Act and the GLB Act require that we, along with the other 11 FHLBanks, support the payment of part of the interest on bonds previously issued by REFCORP. The REFCORP assessment amount is determined by calculating U.S. GAAP net income before the AHP and REFCORP assessments minus the AHP assessment, then multiplying that amount by 20%. REFCORP has been designated as the calculation agent for AHP and REFCORP assessments. Each FHLBank provides its net income before AHP and REFCORP assessments to the Resolution Funding Corporation, which then performs the calculations at each quarter end. The FHLBanks must make REFCORP payments until the total amount of REFCORP assessment payments made is equivalent to a \$300 million annual (or \$75 million per quarter) annuity that has a final maturity date of April 15, 2030. The Finance Board will shorten or lengthen the period during which the FHLBanks must make these payments to REFCORP, depending on actual payments made relative to the referenced annuity. In addition, the Finance Board, with the Secretary of the Treasury, selects the appropriate discounting factors used in the payment calculations relating to the REFCORP assessments.

Annually, the FHLBanks must also set aside for the AHP the greater of \$100 million or 10% of their current year's aggregate regulatory net income. Regulatory net income for AHP assessment purposes is determined by the Finance Board, and is equal to net income reported in accordance with U.S. GAAP before mandatorily redeemable capital stock-related interest expense and AHP assessment, but after REFCORP assessment. The exclusion of mandatorily redeemable capital stock-related interest expense from our regulatory calculation is a determination of the Finance Board.

Our assessments for AHP and REFCORP for the three and nine months ended September 30, 2005 were \$5.3 million and \$4.1 million, compared to \$6.1 million and \$23.5 million for the same periods in 2004. AHP and REFCORP assessments are based on the Seattle Bank's year-to-date net income. Should we break even or incur a net loss for the year ended December 31, 2005, we would be entitled to a refund of assessments paid during the full year that were in excess of our calculated annual obligation at year end. See Notes 1 and 8 to the notes to our audited financial statements for the years ended December 31, 2004, for additional information about AHP and REFCORP.

The table below presents our AHP and REFCORP assessments for the three and nine months ended September 30, 2005, compared to the applicable prior periods.

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2005	2004	% Increase (Decrease)	2005	2004	% Increase (Decrease)
	(dollars in thousands)					
AHP .....	\$ 1,696	\$ 1,863	(9.0)	\$ 1,375	\$ 7,245	(81.0)
REFCORP .....	<u>3,572</u>	<u>4,192</u>	(14.8)	<u>2,714</u>	<u>16,302</u>	(83.4)
Total assessments .....	<u>\$ 5,268</u>	<u>\$ 6,055</u>	(13.0)	<u>\$ 4,089</u>	<u>\$ 23,547</u>	(82.6)

We have identified eight AHP projects with grant amounts totaling approximately \$1.6 million that currently do not comply with AHP grant requirements. During the quarter ended June 30, 2005, we incurred a loss of \$409,000 related to replenishing the AHP fund for two of the projects because we determined that we bore some responsibility for the noncompliance. During the quarter ended September 30, 2005, we incurred a loss of \$1.2 million related to the other six projects. We continue to evaluate our exposure to losses on outstanding AHP projects.

## Segment Results

We have historically offered products and services through two operating segments: traditional member finance and the MPP. We expect to continue to report our business using these two segments until such time as we no longer review the operating results from the MPP to make decisions about resources to be allocated to what is now considered a segment. Our exit from the MPP is part of the three-year plan.

Our traditional member finance activities include making advances, providing letters of credit, accepting deposits, and providing securities safekeeping and other services. We also include in this segment short-term investments in financial instruments that are used for managing our liquidity and long-term investments to generate income on member capital. In addition, the traditional member finance segment includes derivative instruments used as economic hedges to manage our overall interest-rate risk. Our second segment, the MPP, consists of mortgage loans we hold as a result of purchases from participating members.

Each segment includes the debt funding and derivative instruments either specifically associated with or allocated to the segment's assets, as well as other income such as service or pair-off fees. Operating expenses identified to a specific segment, such as salaries and benefits, hardware and software licensing and service fees, and other contractual services, are included in each segment. Operating expenses that are not directly associated with each segment are allocated based on its relative percentage of specifically identified operating expenses to total specifically identified operating expenses. Finally, each operating segment shares in our AHP and REFCORP assessments based on its relative percentage of income before assessments.

During the third quarter of 2004, we refined our method of allocating net interest income and other expenses between the traditional member finance and MPP segments to more accurately reflect the results associated with each operating segment. This refinement included a reallocation of short-term investments and debt to reflect the impact of mortgage loan paydowns to the MPP segment and an allocation of operating expenses not specifically identified to each segment. The applicable amounts relating to 2004 periods have been reclassified to conform to this new method of allocation. During the third quarter of 2005, we implemented a strategy of managing our business to a capital-to-assets ratio of 4.30% in order to fully use our capital and fund advances. This strategy resulted in the increase of short-term investments, which we allocate primarily to the traditional member finance segment.

### Traditional Member Finance

The following table presents the operating results of our traditional member finance segment for the three and nine months ended September 30, 2005, and each of the years ended December 31, 2004, 2003, and 2002 and total assets as of September 30, 2005, and December 31, 2004, 2003, and 2002.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
	(in thousands)			
<b>Traditional Member Finance</b>				
Interest income.....	\$ 373,775	\$ 290,451	\$ 1,020,536	\$ 812,594
Interest expense.....	373,898	256,484	983,786	725,496
Net interest income.....	(123)	33,967	36,750	87,098
Other income (loss).....	785	(4,372)	(11,259)	(1,891)
Other expense.....	(10,515)	(4,393)	(31,980)	(20,043)
Income before assessments.....	(9,853)	25,202	(6,489)	65,164
AHP .....	706	(2,057)	394	(5,320)
REFCORP.....	1,829	(4,629)	1,243	(11,969)
Total assessments.....	2,535	(6,686)	1,637	(17,288)
Net income .....	<u>\$ (7,318)</u>	<u>\$ 18,516</u>	<u>\$ (4,852)</u>	<u>\$ 47,876</u>
Total assets (as of period end).....	<u>\$42,274,197</u>		<u>\$42,274,197</u>	

	For the Years Ended December 31,		
	2004	2003	2002
	(in thousands)		
Interest income .....	\$ 1,119,028	\$ 1,112,709	\$ 1,458,101
Interest expense .....	<u>1,010,203</u>	<u>962,096</u>	<u>1,270,658</u>
Net interest income .....	108,825	150,613	187,443
Other income (loss) .....	2,723	14,882	(27,556)
Other expense .....	<u>(28,648)</u>	<u>(24,101)</u>	<u>(18,646)</u>
Income before assessments .....	82,900	141,394	141,241
AHP .....	(6,767)	(11,542)	(11,530)
REFCORP .....	<u>(15,227)</u>	<u>(25,970)</u>	<u>(25,942)</u>
Total assessments .....	<u>(21,994)</u>	<u>(37,512)</u>	<u>(37,472)</u>
Net income.....	<u>\$ 60,906</u>	<u>\$ 103,882</u>	<u>\$ 103,769</u>
Total assets (as of period end) .....	<u>\$36,151,479</u>	<u>\$39,064,788</u>	<u>\$37,527,032</u>

*Net Interest Income.* Net interest income for the traditional member finance segment decreased 100.4% and 57.8% for the three and nine months ended September 30, 2005, compared to the same periods in 2004. Net interest income has turned negative because the funding for this segment reprices much faster than the segment's advances and investments. This net interest loss is primarily caused by the negative spread related to our investments in fixed-rate consolidated obligations of other FHLBanks that are mostly funded with short-term debt, which continues to reprice at higher rates, and the high-cost, long-term borrowings that are allocated to this segment. These factors will continue to depress our net interest income in 2005 and 2006, with a diminishing effect on net interest income in later years.

*Interest Income.* Interest income increased by 28.7% and 25.6% for the three and nine months ended September 30, 2005, compared to the same periods in 2004. The increases in interest income were primarily due to higher average yields on our advances and held-to-maturity investments, as well as the increase in the size of our held-to-maturity investment portfolio. Interest income from advances increased by \$68.2 million and \$152.1 million for the three and nine months ended September 30, 2005, compared to the same periods in 2004, primarily due to higher interest rates. The average yields on advances were 3.78% and 3.51% for the three and nine months ended September 30, 2005, compared to 2.52% and 2.34% for the same periods in 2004. The average balances for advances were \$18.4 billion and \$17.8 billion for the first three and nine months ended September 30, 2005, compared to \$16.8 billion and \$17.9 billion for the same periods in 2004.

Investment interest income increased by \$32.3 million and \$93.5 million for the three and nine months ended September 30, 2005, compared to the same periods in 2004, due to increases in both investment volumes and average yields. Investment volumes grew as a result of our decision in late 2004 to replace low-yield, short-term investments with investments in high-yield, long-term, fixed-rate callable consolidated obligations of other FHLBanks, and the implementation of our 2005 strategy to fully use our capital resources by investing in short-term investments. For the three and nine months ended September 30, 2005, average balances for investments increased to \$24.7 billion and \$22.3 billion from \$22.4 billion and \$20.6 billion for the same periods in 2004.. Average yields increased to 3.52% and 3.57% for the three and nine months ended September 30, 2005, compared to average yields of 3.31% and 3.26% for the same periods in 2004. The primary reason for the changes in yields in 2005 was the increase of short-term interest rates.

Interest income on the traditional member finance segment increased by less than 1% for the year ended December 31, 2004, compared to the same period in 2003, and decreased by 23.7% for the year ended December 31, 2003, compared to the same period in 2002. Although total interest income remained essentially unchanged in 2004 from 2003, interest income from advances declined by 18.2%, for the year ended December 31, 2004, primarily as a result of the maturity and nonrenewal of advances by two large members. In addition, the decline reflected the impact of our reduction in advance interest rates implemented in late 2002, as members took out new advances at lower interest rates, as well as our discontinuation of differential pricing. This decline was offset by increases in investment interest income of 22.0% for the year ended December 31, 2004, primarily as a result of significant increases in investment volumes. The decrease in interest income for the year ended December 31, 2003, compared to the same period in 2002, was the result of declines in both the average balances of advances and investments and

significant declines in interest rates, which impacted the yields on both advances and investments. The average balances for advances decreased to \$17.1 billion for 2004, compared to \$21.5 billion and \$21.8 billion in 2003 and 2002. The average yields on advances were 2.5%, 2.5%, and 3.0% during 2004, 2003, and 2002. Average balances for investments were \$21.4 billion, \$15.8 billion, and \$18.2 billion for 2004, 2003, and 2002, with average yields of 3.3%, 3.7%, and 4.4% during those periods.

See "– Results of Operations for the Three and Nine Months Ended September 30, 2005 and 2004 – Interest Income" for additional discussion about interest income on advances and investments.

*Interest Expense.* Interest expense for the traditional member finance segment increased by 45.8% and 35.6% for the three and nine months ended September 30, 2005, compared to the same periods in 2004. These increases were primarily the result of increases in the average balance and the interest rates of our consolidated obligation bonds related to the funding of advances and mortgage-backed securities. This segment is allocated funding that is primarily short-term, with the majority of this funding either maturing within one year or hedged with interest-rate exchange agreements that have been repriced to short-term floating rates. Interest expense for this segment is particularly sensitive to changes in short-term interest rates, such as the three-month LIBOR and the federal funds rate.

*Other Income (Loss).* Total other income (loss) was a gain of \$785,000 and a loss of \$11.3 million for the three and nine months ended September 30, 2005, compared to losses of \$4.4 million and \$1.9 million for the same periods in 2004. For the three months ended September 30, 2005, the gain was primarily due to \$14.2 million in net unrealized and realized gain on derivatives and hedging activities, offset by a \$13.8 million loss on trading securities. For the nine months ended September 30, 2005, the loss was primarily due to a combined loss of \$10.8 million in net unrealized and realized loss on derivatives and hedging activities and net gain on trading securities, and a loss of \$1.5 million due to early extinguishment of consolidated obligation bonds. Total other income for this segment decreased by \$12.2 million for the year ended December 31, 2004, compared to the same period in 2003, and increased by \$42.4 million for the year ended December 31, 2003, compared to the same period in 2002. During 2004, the decrease of \$12.2 million was due primarily to decreases in our net unrealized and realized loss on derivatives and hedging activities and net unrealized gain on trading securities. During 2003, the increase of \$42.4 million was due primarily to a \$21.4 million increase in net gains on the sale of qualifying held-to-maturity securities, and a \$16.2 million improvement in net unrealized and realized loss on derivatives and hedging activities and on trading securities. During 2002, the decrease of \$42.5 million was due primarily to a \$71.7 million increase in net realized and unrealized loss on derivatives and hedging activities partially offset by an increase of \$28.3 million in net unrealized gains on trading securities.

The majority of the net realized and unrealized gain (loss) on derivatives and hedging activities for the three and nine months ended September 30, 2005 and 2004, and the years ended December 31, 2004, 2003, and 2002, was due to changes in the fair values of interest rate exchange agreements that hedge our trading securities. The changes in fair value on the trading securities did not completely offset the changes in fair value on the hedging instruments. For the three and nine months ended September 30, 2005, other income included a loss of \$13.8 million and a gain of \$8.2 million on the trading securities, and a gain of \$12.7 million and a loss of \$10.5 million on the corresponding interest rate exchange agreements.

*Other Expense.* Other expense increased by 139.4% and 59.6% for the three and nine months ended September 30, 2005, compared to the same periods in 2004, and by 18.9% and 29.3% in 2004 and 2003, compared to the applicable prior year period. Other expense primarily consists of operating expenses, which include staffing costs, occupancy costs, professional fees, and other costs. Increases in salaries and benefits for the three and nine months ended September 30, 2005, and in 2004 and 2003, compared to the applicable prior periods, reflect salaries and benefits associated with increased staffing that occurred in 2004, professional services, and business processes, to address the increasingly complex nature of our business and regulatory environment, including SEC registration. In addition, we are in the process of implementing internal control processes and procedures over financial reporting required under Sarbanes-Oxley Act, as well as enhancing risk management and financial accounting systems, which also increased other expense.

*Total Assets.* Total assets increased \$6.1 billion as of September 30, 2005, from December 31, 2004. The increase was due to increases in investments and advances. Total assets decreased by 7.5%, to \$36.2 billion, as of December 31, 2004, compared to December 31, 2003. This decrease was primarily the result of declines in advances of \$4.8 billion, partially offset by increases in short and long-term investments of \$2.4 billion. Total assets increased 4.1% as of December 31, 2003, compared to December 31, 2002, as a result of increases in investments, which offset a slight decline in advances.

### Mortgage Purchase Program

As part of the three-year plan, we are exiting the MPP. In August 2005, we sold \$1.4 billion of government-insured mortgage loans to an affiliate of one of our members. The balance of our remaining mortgage loans will continue to decrease as mortgage loans are paid off. We expect to continue to manage the MPP as a separate segment until such time as we no longer review the operating results from the MPP to make decisions about resources to be allocated to what is now considered a segment.

The following table presents the operating results of our MPP segment for the three and nine months ended September 30, 2005, and each of the years ended December 31, 2004, 2003, and 2002 and total assets as of September 30, 2005, and December 31, 2004, 2003, and 2002.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
	(in thousands)			
<b>Mortgage Purchase Program</b>				
Interest income.....	\$ 131,956	\$ 133,348	\$ 396,089	\$ 417,178
Interest expense.....	107,729	130,269	351,251	383,301
Net interest income.....	24,227	3,079	44,838	33,877
Other income (loss).....	9,224	260	(9,275)	2,387
Other expense.....	(4,039)	(5,717)	(14,127)	(12,675)
Income before assessments.....	29,412	(2,378)	21,436	23,589
AHP.....	(2,401)	194	(1,769)	(1,926)
REFCORP.....	(5,402)	437	(3,957)	(4,332)
Total assessments.....	7,803	631	(5,726)	(6,259)
Net income.....	<u>\$ 21,609</u>	<u>\$ (1,747)</u>	<u>\$ 15,710</u>	<u>\$ 17,330</u>
Total assets (as of period end).....	<u>\$ 10,734,142</u>		<u>\$ 10,734,142</u>	
	<b>For the Years Ended December 31,</b>			
	2004	2003	2002	
	(in thousands)			
Interest income.....	\$ 553,931	\$ 470,365	\$ 216,019	
Interest expense.....	507,120	403,037	150,795	
Net interest income.....	46,811	67,328	65,224	
Other income (loss).....	787	(3,764)	883	
Other expense.....	(17,907)	(9,272)	(7,161)	
Income before assessments.....	29,691	54,292	58,946	
AHP.....	(2,424)	(4,432)	(4,812)	
REFCORP.....	(5,453)	(9,972)	(10,827)	
Total assessments.....	(7,877)	(14,404)	(15,639)	
Net income.....	<u>\$ 21,814</u>	<u>\$ 39,888</u>	<u>\$ 43,307</u>	
Total assets (as of period end).....	<u>\$ 11,934,544</u>	<u>\$ 12,099,027</u>	<u>\$ 9,157,235</u>	

*Net Interest Income.* Our net interest income for the MPP segment increased 687% and 32.4% for the three and nine months ended September 30, 2005, compared to the same periods in 2004, primarily due to the interest income earned on short-term investments allocated to this segment.

*Interest Income.* Interest income decreased by 1.0% and 5.1% for the three and nine months ended September 30, 2005, compared to the same periods in 2004, partially due to a decrease in the volume of assets. Included in the interest income amount is premium amortization of \$718,000 and \$19.2 million for the three and nine months ended September 30, 2005, compared to premium amortization of \$13.1 million and \$28.3 million for the same periods in 2004. Excluding the effect of the premium amortization for the three and nine months ended September 30, 2005 and 2004, our adjusted interest income increased by \$11.0 million for the three months and decreased by \$12.0 million for the nine months ended September 30, 2005, compared to the same periods in 2004. The decrease for the nine months was largely offset by the interest income earned on the short-term investments allocated to this segment, which was primarily earned in the third quarter. The average balances for mortgage loans held for portfolio decreased to \$8.7 billion and \$9.6 billion for the three and nine months ended September 30, 2005, from \$11.0 billion and \$11.2 billion for the same periods in 2004. The average yields on the mortgage loans held for portfolio were 5.09% and 4.95% for the three and nine months ended September 30, 2005, compared to 4.72% and 4.91% for the same periods in 2004.

Interest income for the MPP segment increased 17.8% and 117.7% for the years ended December 31, 2004 and 2003, compared to the applicable prior periods. In both years, the increase was primarily due to increases in the average balances of mortgage loans held for portfolio during the year. The increases were partially offset by significant amounts of premium amortization due to faster-than-expected prepayments and changes in prepayment speeds caused by fluctuations in interest rates. The increases were also partially offset by declines in interest rates during 2003 and 2002, which reduced the yields on mortgage loans purchased compared to the existing mortgage loans. During 2004, 2003, and 2002, the asset yields were 4.87%, 5.04%, and 5.85%.

As mortgage loans are originated, there are timing differences between the closing with a borrower until eventual sale of the mortgage loan in the secondary market. Accordingly, in a rapidly declining interest-rate environment, such as that experienced during 2003 and 2002, the interest rates on loans available for sale are higher than current market interest rates, placing a premium on these loans. We purchased most of our mortgage loans at a premium. Rapid prepayments on these loans resulted in accelerated recognition of premium amortization, which negatively impacted our yields. Net premium amortization on the mortgage loans purchased under the MPP totaled \$39.9 million, \$37.7 million, and \$12.2 million for the years ended December 31, 2004, 2003, and 2002.

See "– Results of Operations for the Three and Nine Months Ended September 30, 2005 and 2004 – Interest Income" for additional discussion about interest income on MPP loans.

*Interest Expense.* Interest expense on the consolidated obligations in the MPP segment decreased by 17.3% and 8.4% for the three and nine months ended September 30, 2005, compared to the same periods in 2004. These decreases were primarily the result of decreases in the average balance of consolidated obligations allocated to the MPP segment, primarily resulting from our exit from the MPP. Interest expense on the consolidated obligations in the MPP segment increased by 25.8% and 167.3% for the years ended December 31, 2004 and 2003, compared to the applicable prior period. These increases were primarily the result of increases in the average balance of consolidated obligations funding the MPP mortgage loans. This increase was also the result of our inability to decrease our consolidated obligations commensurately as our MPP mortgage loans were repaid, due to lock-out periods on our callable debt.

*Other Income (Loss).* Other income (loss) was a gain of \$9.2 million and a loss of \$9.3 million for the three and nine months ended September 30, 2005, compared to other income of \$260,000 and \$2.4 million for the same periods in 2004. In July 2005, we reclassified all of our government-insured mortgage loans from mortgage loans held for portfolio to mortgage loans held for sale on our Statement of Condition, and we began reporting the approximately \$1.9 billion of reclassified mortgage loans at the lower of cost or market value. In August 2005, we sold \$1.4 billion of these mortgage loans to an affiliate of one of our members. This sale resulted in a realized gain of \$7.0 million and a net realized gain, including the termination of the associated interest-rate exchange agreements, of approximately \$3.5 million, with the gain recorded in other income (loss). In September 2005, we reclassified the remaining approximately \$400 million of the unsold mortgage loans as held for portfolio due to our decision not to continue actively marketing the remaining loans. We valued the loans at the lower of cost or market on the reclassification date and recorded approximately \$1.1 million as an unrealized loss.

Other income increased 120.9% in 2004 from 2003, and decreased 526.3% in 2003 from 2002. Other income (loss) for this segment includes fair value adjustments on our mortgage-purchase commitments to participating financial institutions. In addition, for purposes of segment disclosure, we allocate swaptions and TBAs for the applicable period. For the three months ended September 30, 2005, the loss was primarily due to decreases in the fair value of swaptions of \$2.3 million, and a loss of \$5.6 million on TBAs for forward settlement to economically hedge the interest-rate risk allocated to our mortgage loan portfolio. For the nine months ended September 30, 2005, the loss included a decrease of \$10.2 million on swaptions, a loss of \$3.6 million on TBAs, and a loss on early extinguishment of consolidated obligation bonds of \$1.5 million. Effective July 1, 2003, we adopted SFAS 149, whereby commitments to purchase mortgage loans are classified as derivatives, and the changes in the fair value of the commitments are included in other income (loss). The adoption of the new accounting standard resulted in gains of \$664,000 for the year ended December 31, 2004, compared to losses of \$3.9 million for 2003.

*Other Expense.* Other expense decreased by 29.4% for the three months and increased by 11.5% for the nine months ended September 30, 2005, compared to the same periods in 2004. The decrease for the three-month period primarily reflects the reductions in staffing levels. The increase for the nine-month period was partially due to employee termination-related expenses resulting from our decision to exit the MPP. Other expense increased 93.1% in 2004 from 2003, and 29.5% in 2003 from 2002. Other expense primarily consists of operating expenses, which include staffing costs, occupancy costs, professional fees, and other costs. We expect overall expenses for this segment to decrease as we exit the MPP.

*Total Assets.* Total assets decreased as of September 30, 2005, from December 31, 2004, due to the sale of \$1.4 billion of government-insured mortgage loans, and principal paydowns on mortgage loans held for portfolio. The decrease was substantially offset by an increase in short-term investments allocated to the MPP segment. Total MPP assets decreased 1.4% and increased 32.1% as of December 31, 2004 and 2003, compared to the applicable prior period balance. The decline in 2004 reflected the general slowdown in the overall U.S. mortgage market, the increased competition in the secondary mortgage market, and a decision on our part to limit our purchases from large participating members. The increase in 2003 was the result of large purchases of mortgage loans from our members, partially offset by high prepayment activity, which resulted in increased premium amortization and which reduced the amount of our unamortized premium on MPP on our Statements of Condition. The balance of the mortgage loan portfolio will decline in 2005 as mortgage loans are repaid and we exit the MPP. In August 2005, we sold \$1.4 billion of MPP government-insured mortgage loans to an affiliate of one of our members.

### **Ineffective Disclosure Controls and Procedures Constituted Material Weakness in Our Internal Control**

We maintain disclosure controls and procedures designed to enable us to collect, record, process, summarize, and report the financial and non-financial information required to be disclosed in our periodic reports.

As of the end of our second quarter, we carried out an evaluation, under the supervision and with the participation of senior management, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, senior management concluded that our disclosure controls and procedures were not effective, because of the material weakness in internal control over financial reporting described in the following section. We have initiated steps to remediate the material weakness, but we have concluded that as of September 30, 2005 the material weakness had not been fully remediated.

*Identification of Material Weakness in Internal Control over Financial Reporting.* Our management is responsible for establishing and maintaining adequate internal control over financial reporting at the Seattle Bank. Our internal control over financial reporting is a process designed under the supervision of our Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Seattle Bank's financial statements for external reporting purposes in accordance with U.S. GAAP. A company's internal control over financial reporting includes policies and procedures that: (1) pertain to the maintenance of records that accurately and fairly reflect, in reasonable detail, transactions and dispositions of the company's assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the company; and (3) provide

reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the company's financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. As of June 30, 2005, our management concluded that we did not maintain effective control over the completeness of communication of financial reporting information between operational departments. Specifically, we did not maintain effective controls to ensure that information regarding an investment banking contract entered into by our senior management as well as a significant information technology security deficiency was communicated to those responsible for financial reporting, so that the responsible persons could assess the impact of those issues on the financial statements. This control deficiency did not result in an adjustment or restatement of any annual or interim financial statements. However, this control deficiency, if unremediated, could result in a material misstatement to, or a material omission from, the annual or interim financial statements that would not be prevented or detected. Accordingly, our management has determined that this control deficiency constituted a material weakness. Because of this material weakness and because this material weakness had not been fully remediated as of September 30, 2005, our management has concluded that the Seattle Bank did not maintain effective internal control over disclosure controls and procedures as of June 30, 2005 and September 30, 2005.

*Remediation of Material Weakness in Internal Controls.* Our management has discussed with our audit committee the material weakness in our internal control over financial reporting as of June 30, 2005. In an effort to remediate the material weakness, we have implemented a number of changes to our disclosure controls and procedures, including the following:

- We have revised the Disclosure Practices Committee charter to, among other things, specify reporting parameters for the business unit managers to members of the Disclosure Practices Committee in order to provide better opportunity to timely evaluate and consider information relevant to public disclosures and financial reporting.
- We have created a Disclosure Assessment Team, composed of three members of the Disclosure Practices Committee, in order to quickly respond to disclosure issues. The Disclosure Assessment Team will consist of at least one member knowledgeable in financial reporting and at least one attorney. The Disclosure Assessment Team will carry out duties as assigned by the Disclosure Practices Committee, including reviewing any contracts of the type that may require disclosure entered into by the Seattle Bank up to the date of disclosure. A meeting of the Disclosure Assessment Team will be held on or near the date of filings with the SEC and other public disclosures.
- We are developing a sub-certification process whereby the Disclosure Practices Committee will review sub-certifications received from applicable employees of the Seattle Bank as part of the process for determining information to be included in public disclosures and financial reporting.

### **Summary of Critical Accounting Estimates**

Our financial statements and reported results are prepared in accordance with U.S. GAAP, which requires the use of estimates and assumptions that may affect our reported results and disclosures. Several of these accounting policies involve the use of accounting estimates that we consider to be critical as: (1) they are likely to change from period to period because they require significant management judgment and assumptions about highly complex and uncertain matters, and (2) the use of a different estimate or a change in estimate could have a material impact on our reported results of operations or financial condition. We review our estimates and assumptions

frequently. Estimates and assumptions that are significant to our results of operations and financial condition are called critical accounting estimates and are described below.

### Assets and Liabilities Reported at Fair Value

We use a variety of means to estimate the fair value of the assets, liabilities, and commitments, including derivatives, reported at fair value on our financial statements, in footnotes to the financial statements and in this management's discussion and analysis and for purposes of measuring hedge effectiveness. Where available, external pricing sources, including FT Interactive Data, a subsidiary of Interactive Data Corporation, Bloomberg L.P., and investment broker-dealers, are used to estimate the fair value of certain financial instruments. These pricing sources may provide price quotes for the financial instrument itself or for a financial instrument with similar terms or structures. The fair values of certain other instruments are based on pricing models that require the use of assumptions regarding interest rates, prepayment behavior, market volatility, and other factors. Our estimates of interest rates are based on observed LIBOR rates and interest rates on interest-rate exchange agreements. We also use an externally-sourced prepayment model that incorporates a number of market factors that is updated as these factors change. In addition, volatility estimates are provided by the Office of Finance and Bloomberg L.P. Changes in the assumptions we use can have a significant effect on the modeled valuation of these financial assets, liabilities, and commitments, thereby affecting income because these fair value changes are recorded to income in the Statements of Income.

### Derivatives and Hedging

We report all derivative financial instruments in the Statements of Condition at their fair value. We classify derivative assets and derivative liabilities according to the net fair value of derivatives with each counterparty. Subject to a master netting agreement, if the net fair value of derivatives with a counterparty is positive, the net amount is classified as an asset; if the net fair value of derivatives with a counterparty is negative, it is classified as a liability. As of September 30, 2005, and December 31, 2004, 2003, and 2002, we held derivative assets of \$8.8 million, \$24.5 million, \$45.8 million, and \$77.5 million, as well as derivative liabilities of \$229.3 million, \$274.8 million, \$306.5 million, and \$322.4 million.

The following table categorizes the estimated fair value of derivative financial instruments, excluding accrued interest, by product and type of accounting treatment as of the date indicated. Under "Fair Value," we include derivative instruments where hedge accounting is achieved. In a fair value hedge, the changes in fair value of the hedged item and the derivative offset each other, resulting in little or no impact to earnings. Under "Economic," we include hedge strategies where derivative hedge accounting is not applied and, therefore, changes in the fair value of the derivatives are recorded in current period earnings with no adjustments made to the economically hedged asset or liability. Under "Intermediary Positions," we include transactions where we act as an intermediary between our member and nonmember counterparties in order to enable our members to access the interest-rate swap market. We discontinued offering member swaps as a standard product in mid-2004, but will continue to maintain the existing products through maturity.

	As of September 30, 2005		
	Notional	Estimated Fair Value (excludes accrued interest)	Hedged Item – Cumulative Basis Adjustment
	(in thousands)		
<b>Advances</b>			
Fair value – short-cut .....	\$ 4,215,544	\$ (23,537)	\$ 23,537
Fair value – long haul .....	30,000	349	(349)
<b>Investments</b>			
Economic .....	200,000	(57,321)	63,875
<b>Consolidated Obligations</b>			
Fair value – short-cut .....	3,545,675	(47,657)	47,657
Fair value – benchmark .....	5,980,000	(116,244)	110,038
<b>Balance Sheet</b>			
Economic .....	708,500	430	
<b>Intermediary Positions</b>			

As of September 30, 2005			
	Notional	Estimated Fair Value (excludes accrued interest)	Hedged Item – Cumulative Basis Adjustment
	(in thousands)		
Member swaps .....	390,500	(7,615)	
Other .....	298,300	8,067	
<b>Other</b>			
Standalone delivery commitments .....			
<b>Total Notional and Fair Value</b>	<u>\$15,368,519</u>	\$ (243,528)	<u>\$ 244,758</u>
Accrued interest .....		23,077	
Net derivative balance .....		<u>\$ (220,451)</u>	
Net derivative assets balance .....		8,846	
Net derivative liabilities balance .....		(229,297)	
Net derivative balance .....		<u>\$ (220,451)</u>	

As of December 31,						
	2004			2003		
	Notional	Estimated Fair Value (excludes accrued interest)	Hedged Item – Cumulative Basis Adjustment	Notional	Estimated Fair Value (excludes accrued interest)	Hedged Item – Cumulative Basis Adjustment
	(in thousands)					
<b>Advances</b>						
Fair value – short-cut .....	\$ 3,686,657	\$ (141,813)	\$ 141,813	\$ 3,372,309	\$ (254,844)	\$ 254,844
Fair value – long haul .....	30,000	496	(496)			
<b>Investments</b>						
Economic .....	200,000	(52,713)	55,680*	200,000	(48,522)	44,187
<b>Mortgage Loans Held for Portfolio</b>						
Economic .....	112,000	(162)		746,000	2,061	
<b>Consolidated Obligations</b>						
Fair value – short-cut .....	2,104,195	(16,234)	16,234	10,728,495	4,038	(4,035)
Fair value – benchmark .....	6,660,000	(69,015)	64,286			
<b>Balance Sheet</b>						
Economic .....	2,150,000	1,603		700,000	6,185	
<b>Intermediary Positions</b>						
Member swaps .....	678,500	(3,907)		1,011,000	162	
Other .....	178,300	3,984		123,800	(11)	
<b>Other</b>						
Standalone delivery commitments .....	39,609	67		612,674	(2,736)	
<b>Total Notional and Fair Value</b>	<u>\$15,839,261</u>	\$ (277,694)	<u>\$ 277,517</u>	<u>\$17,494,278</u>	\$ (293,667)	<u>\$ 294,996</u>
Accrued interest .....		27,373			32,920	
Net derivative balance .....		<u>\$ (250,321)</u>			<u>\$ (260,747)</u>	
Net derivative assets balance .....		24,477			45,766	
Net derivative liabilities balance .....		(274,798)			(306,513)	
Net derivative balance .....		<u>\$ (250,321)</u>			<u>\$ (260,747)</u>	

Notional amounts are used to calculate the periodic amounts to be received and paid under interest-rate exchange agreements and generally do not represent actual amounts to be exchanged or directly reflect our exposure to credit risk. Notional amounts are not recorded as assets or liabilities in our Statements of Condition.

### Accounting Treatment for Hedging Relationships

As part of our risk management strategies, we enter into interest-rate exchange agreements that hedge our exposure to changes in interest rates. Through the use of these instruments, we may adjust the effective maturity, repricing frequency, or option characteristics to achieve our risk management objectives. We have processes in place to ensure that new hedging strategies are fully researched and analyzed prior to implementation. These activities include validation of expected accounting treatment under SFAS 133, determination of the effectiveness testing method to be used and preliminary expectations regarding effectiveness, financial instrument valuation sources, and operational procedures and controls, such that, once the hedging strategy is approved, transactions may proceed and be accurately recorded and reported in the financial statements. Once a strategy is approved, but prior to each transaction's execution:

- We formally document the hedging relationship, the strategy undertaken, and the risk management objective achieved. Documentation includes identification of the hedged item and hedging derivative instrument, the nature of the risk being hedged and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value attributable to the hedged risk will be assessed.
- We perform an assessment to confirm our expectation that the hedging relationship will be highly effective in achieving offsetting changes in the fair value attributable to the hedged risk during the hedge period.
- For written options designated as hedging recognized assets or liabilities, we ensure that the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable change in the fair value of the combined instruments as exposure to losses from an unfavorable change in their combined fair value.

During the second quarter of 2005, we adopted trade-date accounting for derivatives and hedge accounting. Under trade-date accounting, hedge accounting commences on the trade date when subsequent changes in the derivative's fair value are recorded along with the offsetting changes in fair value of the hedged item even though the hedged item has not yet settled and has not yet been recognized. On the settlement date, the adjustments attributed to the hedged item become part of its total carrying amount. Previously, we recorded the changes in fair value of both derivatives and the hedged items on their settlement dates. We have evaluated the effect of the differences between the two methods on prior periods and have determined that the effect of the differences is immaterial.

The following summarizes our accounting for our principal types of hedging relationships.

*Fair Value Hedges.* In a fair value hedge, the derivative hedges the exposure to changes in the fair value of an asset or liability that is attributable to a particular risk. We use fair value hedges to mitigate the risk of the changes in the overall fair value of hedged items. Changes in the fair value of a derivative that is effective as, and that is designated and qualifies as, a fair value hedge, along with changes in the fair value of the hedged assets or liabilities that are attributable to the hedged risk, are recorded in current period earnings. The following table details our fair value hedges by accounting designation and type of risk being hedged as of September 30, 2005.

<u>Hedging Instrument</u>	<u>Hedged Instrument</u>	<u>Accounting Designation</u>	<u>Type of Risk Being Hedged</u>	<u>Method of Assessing Hedge Effectiveness</u>	<u>Notional Amount (as of September 30, 2005)</u> (in thousands)
Interest-rate swap	Advances	Short-cut	Benchmark	Assumption of no ineffectiveness	\$ 4,215,544
Interest-rate swap	Consolidated obligation bonds	Short-cut	Benchmark	Assumption of no ineffectiveness	\$ 3,545,675
Interest-rate swap	Consolidated obligation bonds	Long haul	Benchmark	Rolling regression	\$ 5,980,000
Interest-rate cap	Capped advance	Long haul	Full fair value	Rolling regression	\$ 30,000

The following discussion describes the applicable accounting treatments for fair value hedging relationships under SFAS 133.

*Short-Cut Hedge Relationships.* A short-cut relationship implies that the hedge between the derivative and hedged item is considered to be perfectly correlated. Therefore, the changes in the fair value of the derivative and hedged item will perfectly offset, as a short-cut relationship assumes no ineffectiveness. To qualify for short-cut accounting treatment, a number of specific conditions must be met, as illustrated in the following example.

In a typical short-cut hedge, we use interest-rate swaps to hedge the changes in fair value of one or more advances or one or more consolidated obligations attributable to changes in the designated benchmark interest rate where: (1) the notional amount of the swap matches the principal amount of the asset or liability, (2) the fair value of the swap at its inception is zero, (3) the formula for computing net settlements under the interest-rate swap is the same for each net settlement, (4) the interest-bearing asset or liability is not prepayable or the interest-rate swap

contains the same prepayment criteria, (5) the expiration date of the interest-rate swap matches the maturity date of the asset or liability, (6) there is no ceiling or floor on the variable interest rate of the swap, and (7) the interval between repricing periods of the variable interest rate in the swap is no more than six months.

*Highly-Effective Hedge Relationships.* A highly-effective hedge relationship indicates that, at hedge inception and on an ongoing basis, both prospective and retrospective effectiveness results indicate that the derivative and hedged item will be highly effective in achieving offsetting changes in fair value attributable to the hedged risk. The changes in fair value for the derivative and hedged item may or may not perfectly offset, and the difference, if any, will be recognized as a net gain or loss in current period earnings in the Statements of Income. We refer to these types of hedges as fair value long haul or fair value benchmark hedges, depending upon whether we are hedging the entire fair value of the asset or liability or only the changes in fair value due to changes in the benchmark interest rate.

To determine whether a hedging relationship is highly effective, we perform effectiveness testing at the inception of the hedge and on an ongoing basis. We use a statistical method, i.e., rolling regression, to analyze the effectiveness of our long haul or benchmark fair value hedging relationships. The rolling regression method for a full fair value hedge utilizes a simple regression model in which the fair value of the hedging instrument is regressed against the fair value of the hedged item. To perform the regression, we select a statistically significant number of prices that cover the time period of the hedging relationship. Based on U.S. GAAP, if prices associated with the hedging item and prices associated with the hedged item have been, and are expected to continue to be, highly correlated, we may reasonably expect that the changes in the fair value of the hedging item will be highly-effective in offsetting the changes in the fair value of the hedged item. Based on our data, we determine if the corresponding changes in cumulative prices meet an acceptable range based on statistical measures to continue to qualify for hedge accounting.

For each of our fair value hedges, we run our effectiveness tests at inception and then at least quarterly to ensure that the hedging instrument's changes in fair value are offsetting the hedged item's changes in fair value within the parameters set forth within SFAS 133. When a hedging relationship fails the effectiveness test, we immediately discontinue hedge accounting.

In certain situations, we aggregate advances and hedge them with one or more derivative instruments. We also may aggregate certain consolidated obligations and hedge them with one or more derivative instruments. We follow the requirements set forth in SFAS 133, and these assets or liabilities that are grouped meet the homogeneity standard for fair value hedges.

*Not-Highly-Effective Hedge Relationships.* If we determine that a hedging relationship is not highly effective, we discontinue the accounting hedge relationship between the derivative and hedged item. This does not imply that there is not an economic hedge relationship between the derivative and hedged item; however, the relationship does not qualify for hedge accounting treatment under SFAS 133 and, therefore, the change in fair value of the hedged item is not recorded in current period earnings. We classify these derivatives as "freestanding" pursuant to SFAS 133. Changes in the fair value of the derivative in a freestanding hedge are recorded in current period earnings.

### **Types of Derivatives and Hedged Items**

We incur interest-rate risk on advances, mortgage loans held for portfolio, mortgage loan commitments, investments, consolidated obligations, and intermediary positions. The following discussion describes our accounting for our specific derivative instruments and hedges.

*Advances.* The optionality embedded in certain financial instruments we hold (e.g., the prepayment terms in an advance) can create interest-rate risk. When a borrower prepays an advance, we would suffer lower future income if the prepaid principal portion were invested in lower-yield assets that continued to be funded by higher cost debt. To protect against this risk, we generally charge a prepayment fee designed to make us financially indifferent to a

borrower's decision to prepay an advance. When we offer advances (other than short-term advances) that a member may prepay without a prepayment fee, we usually finance such advances with callable debt or hedge this option.

When we issue a puttable advance, we have a right to terminate the advance at our discretion. If we terminate a puttable advance, we may offer a new advance at current rates. We may hedge a puttable advance by entering into a cancelable interest-rate exchange agreement where we pay a fixed rate and receive a variable rate based on a market index, typically LIBOR. The swap counterparty can cancel the interest-rate exchange agreement on the put dates, which would normally occur in a rising rate environment, at which time we would generally terminate the advance. This type of hedge is treated as a fair value hedge under SFAS 133.

We also offer our members capped advances, or variable-rate advances with a maximum interest rate. When we issue a capped advance, we typically purchase an offsetting interest-rate cap from a broker. This type of hedge is treated as a full fair value hedge under SFAS 133.

*Mortgage Loans Held for Portfolio.* The prepayment options embedded in mortgage loans can result in extensions or contractions in the expected repayment of these assets, depending on changes in estimated prepayment speeds. In addition, to the extent that we purchased mortgage loans at premiums or discounts, net income is affected by extensions or contractions in the expected maturities of these assets. We attempt to manage the interest rate and prepayment risk associated with mortgage loans primarily through debt issuance. We use both callable and noncallable debt to attempt to achieve cash flow patterns and liability durations similar to those expected on the mortgage loans.

We may also purchase interest-rate exchange agreements to manage the prepayment risk embedded in the mortgage loans. Although these derivatives are valid economic hedges against the prepayment risk of the mortgage loans, they are not specifically linked to individual mortgage loans, and we account for these derivatives as freestanding pursuant to SFAS 133.

To enable us to lower our overall interest-rate risk profile and reduce our operating cost structure, including costs associated with managing risks related to our mortgage loans held for portfolio, we are exiting the MPP.

*Mortgage Loan Commitments.* We hedged the market value of certain commitments to purchase fixed-rate mortgage loans by selling TBAs. Mortgage loan commitments and TBAs used in our freestanding firm commitment hedges were recorded as derivative assets or liabilities at fair value in the statements of condition, with changes in fair value recognized in current period earnings. When the mortgage loans were delivered and the related commitment closed, the difference between the current market value and par value of the mortgage loans was factored into their cost basis and amortized accordingly.

*Investments.* We currently invest primarily in U.S. agency and GSE obligations, mortgage-backed securities, and the taxable portion of state or local housing finance agency securities. The interest rate and prepayment risk associated with these investment securities is managed through a combination of debt issuance and derivatives. For investment securities carried at fair value, we may also manage the risk arising from changing market prices by matching the cash outflow on the interest-rate exchange agreements with investment securities carried at fair value. These economic hedges are considered freestanding pursuant to SFAS 133.

*Consolidated Obligations.* We manage the risk arising from changing market prices of a consolidated obligation by matching the cash outflow on the consolidated obligation with the cash inflow on an interest-rate exchange agreement. In a typical transaction, the Office of Finance issues a fixed-rate consolidated obligation for the Seattle Bank, and we concurrently enter into a matching interest-rate exchange agreement in which the counterparty pays fixed cash flows, designed to mirror in timing and amount the cash outflows we pay on the consolidated obligation. Such transactions are treated as fair value hedges under SFAS 133. The net result of this transaction is that we pay a variable interest rate that closely matches the interest rates we receive on short-term or variable-rate advances. This intermediation within the financial markets permits us to raise funds at lower costs than would otherwise be available through the issuance of simple fixed or variable-rate consolidated obligations in the financial markets.

*Intermediation.* To assist our members in meeting their hedging needs, we may act as an intermediary between members and counterparties by entering into offsetting interest-rate exchange agreements. The notional amounts and settlement, interest payment, and maturity dates are identical in the offsetting interest-rate exchange agreements. Although we discontinued offering member swaps as a standard product in mid-2004, we will continue to maintain the existing transactions through maturity. The derivatives used in intermediary swaps do not qualify for hedge accounting treatment, and the fair value adjustments are recorded separately through current period earnings. The net result of the accounting for these derivatives does not significantly affect our operating results. These amounts are recorded in other income and presented as "net realized and unrealized gain (loss) on derivatives and hedging activities."

The following table summarizes the notional amounts of member intermediary swap transactions as of September 30, 2005, and December 31, 2004 and 2003, and losses on member intermediary swap transactions for the nine months ended September 30, 2005, and the years ended December 31, 2004 and 2003.

#### Member Intermediary Swap Transactions

	<u>As of September 30,</u>		<u>As of December 31</u>	
	<u>2005</u>		<u>2004</u>	<u>2003</u>
	(in thousands)			
<b>Notional amount</b>				
Member swaps* .....	\$ 160,500		\$ 560,500	\$ 950,500
Offsetting counterparty swaps* .....	<u>60,500</u>		<u>60,500</u>	<u>60,500</u>
Total notional amount .....	<u>\$ 221,000</u>		<u>\$ 621,000</u>	<u>\$ 1,011,000</u>
	<u>For the Nine Months Ended September 30,</u>		<u>For the Year Ended December 31,</u>	
	<u>2005</u>	<u>2004</u>	<u>2004</u>	<u>2003</u>
	(in thousands)			
<b>Gain (loss)</b>				
Member swaps .....	\$ 394	\$ 299	\$ 495	\$ 86
Offsetting counterparty swaps .....	<u>(433)</u>	<u>(358)</u>	<u>(572)</u>	<u>(275)</u>
Total gain (loss) .....	<u>\$ (39)</u>	<u>\$ (59)</u>	<u>\$ (77)</u>	<u>\$ (189)</u>

\* As of September 30, 2005, December 31, 2004, and December 31, 2003, the notional amounts are not equal because (i) two member swaps, each with a notional of \$50 million as of September 30, 2005, and \$250 million as of December 31, 2004, and (ii) 16 member swaps with an aggregate notional amount of \$890 million as of December 31, 2003, had offsetting terms.

We may enter into interest-rate exchange agreements to offset the economic effect of other derivatives that are no longer designated in a hedge transaction of one or more advances, investments, or consolidated obligations. In these intermediary transactions, maturity dates, call dates, and fixed interest rates match, as do the notional amounts on the de-designated portion of the interest-rate exchange agreement and the intermediary derivative.

The following table summarizes the notional amounts of intermediary swap transactions that offset derivatives that are no longer designated in a hedge transaction as of September 30, 2005, and December 31, 2004 and 2003, and gains (losses) on intermediary swap transactions that offset derivatives that are no longer designated in a hedge transaction for the nine months ended September 30, 2005 and each of the years ended December 31, 2004 and 2003.

#### Intermediary Swap Transactions

	<u>As of September 30,</u>		<u>As of December 31</u>	
	<u>2005</u>		<u>2004</u>	<u>2003</u>
	(in thousands)			
<b>Notional amount</b>				
De-designated swaps .....	\$ 230,000		\$ 118,000	\$ 62,000
Offsetting counterparty swaps .....	<u>237,800</u>		<u>117,800</u>	<u>61,800</u>
Total notional amount .....	<u>\$ 467,800</u>		<u>\$ 235,800</u>	<u>\$ 123,800</u>

	For the Nine Months Ended September 30,		For the Years Ended March 31,	
	2005	2004	2004	2003
	(in thousands)			
<b>Gain (loss)</b>				
De-designated swaps.....	\$ (4,422)	\$ 406	\$ 1,059	\$ 715
Offsetting counterparty swaps .....	4,380	(406)	1,056	(883)
Total gain (loss) .....	<u>\$ (42)</u>	<u>\$ 0</u>	<u>\$ 3</u>	<u>\$ (168)</u>

### Amortization of Premiums and Accretion of Discounts

The amount of premium or discount on mortgage-based assets, including mortgage-backed securities, collateralized mortgage obligations, and mortgage loans purchased under the MPP, amortized or accreted into earnings during a period is dependent on our estimate of the remaining lives of these assets and actual prepayment experience. Changes in estimates of prepayment behavior create volatility in interest income because the change to a new expected yield on a pool of mortgage loans or mortgage-backed securities, given the new forecast of prepayment behavior, requires an adjustment to cumulative amortization in order for the financial statements to reflect that yield going forward. For a given change in estimated average maturity for a mortgage loan portfolio or a mortgage-backed security, the retrospective change in yield is dependent on the amount of original purchase premium or discount and the cumulative amortization or accretion at the time the estimate is changed. A change in estimated average maturity has the least effect on mortgage loans or mortgage-backed securities that have either little cumulative amortization or accretion or are nearly fully amortized or accreted. A change in estimated average maturity has its greatest effect on long-term mortgage loans and mortgage-backed securities with cumulative amortization and accretion equal to approximately half of the original purchase premium or discount.

For certain mortgage-based assets, we use a commercially available prepayment model and independent third party pricing sources, including a source that provides data on cash flows, as the basis for estimated future principal prepayments. This model uses a number of market factors, such as historical mortgage rates and housing turnover ratios, as the basis for the prepayment calculation and we are provided monthly market factor updates from the prepayment model vendor. Use of different prepayment models can result in different amounts of premium amortization and discount accretion. We review the data generated from the model against model data from the previous period as well as against commercially available prepayment rate information and the periodic changes in prepayment rates to ensure the reasonableness of the data in light of market conditions.

### Allowances for Credit Losses

We regularly evaluate our requirement for an allowance for credit losses on advances and mortgage loans purchased under the MPP. We would establish an allowance if an event were to occur that would make it probable that all principal and interest due for an advance or mortgage loan would not be collected and the resulting losses were estimable.

*Advances.* Our advances are fully collateralized by high-quality collateral and the Seattle Bank benefits from additional statutory preferences that, combined with conservative collateral practices, make the likelihood of credit losses negligible. To incur a credit loss on an advance, two credit events must occur: (1) the member or nonmember borrower would have to default, and (2) the available collateral would have to deteriorate in value prior to liquidation of that collateral. We periodically review the collateral held as security on advances and assess our borrowers' credit conditions. As of September 30, 2005, and December 31, 2004 and 2003, we had rights to collateral, either loans or securities, on a borrower-by-borrower basis, with an estimated fair value in excess of outstanding advances. We have never experienced a credit loss on our advances, and we do not anticipate any credit losses on advances in the future. Based on the foregoing, we have determined that no provision for credit losses on advances is necessary.

*Mortgage Loans.* Since the inception of the MPP, we have never experienced a credit loss nor has our supplemental insurance, or SMI, provider ever experienced a loss claim on our mortgage loan portfolio. To ensure the retention of credit risk and to cover, at a minimum, the expected losses on conventional mortgage loans

originated or acquired by a member, we require the member to fund a lender risk account, or LRA, either up front as a portion of the purchase proceeds or over time through a portion of the monthly payments. This account is established to conform to Finance Board regulations applicable to all conventional mortgage purchase programs. The Finance Board regulation stipulates that the member is responsible for all expected losses on the mortgage loans sold to us. In order to comply with this regulation, we evaluate the proposed conventional mortgage loans to be sold (either the specific portfolio or a representative sample) to determine the amount of expected losses that will occur. The SMI provider determines the minimum amount required in order to issue a policy. The member funds the LRA with the greater of the expected losses or the amount required by the SMI provider. Each master commitment contract specifies the required funding level for its associated LRA. In accordance with the applicable contract, either the purchase price for the mortgage loans purchased under a master commitment contract is discounted, or a portion of the monthly interest collected is set aside, to fund the LRA. If the member's risk account is funded through monthly payments, the member remains obligated under the master commitment contract to pay the monthly amounts that fund the LRA whether or not any of the purchased mortgage loans are in default. The LRA funds are used to offset any losses that may occur, with any excess of required balances distributed to the member in accordance with a step-down schedule that is stipulated in each master commitment contract. The LRA balances are not required after 11 years. The LRA is recorded in "other liabilities" in the Statements of Condition and totaled \$15.5 million, \$12.1 million, and \$6.6 million as of September 30, 2005, and December 31, 2004 and 2003.

In addition to the expected losses covered by the LRA, a member selling conventional mortgage loans is required to purchase SMI as a credit enhancement to cover losses over and above losses covered by the LRA. We are listed as the insured, and this coverage serves to further limit our exposure to losses. As with the funding of the LRA, a portion of the monthly interest is set aside to pay the SMI premium. The LRA and the SMI are expected to provide loss protection to support the equivalent of an investment grade rating. If the LRA and the standard SMI policy do not provide sufficient loss protection to support the equivalent of an investment grade rating, the member must purchase additional mortgage insurance coverage called SMI Plus. This policy provides additional credit enhancement coverage to achieve an equivalent of an investment grade rating. Other than the LRA, SMI, and if applicable, SMI Plus, we do not charge any other credit enhancement fees to MPP participants.

As a result of the credit enhancements described above, we and our participating members share the credit risk of the mortgage loans sold to us under the MPP. The participating member assumes a first loss obligation equivalent to a minimum of the expected losses through its LRA after the exhaustion of the borrower's equity and any primary mortgage insurance coverage, if required. If the participating member's LRA is insufficient to cover any losses, then the SMI coverage is used. Only after exhausting the SMI coverage will the Seattle Bank absorb any potential losses. Under the credit enhancement structure of the MPP, the value of the foreclosed property would have to fall below 50% of the outstanding loan amount to result in a loss to us. We regularly monitor delinquency data provided by our participating members to ensure that mortgage principal and interest are remitted timely, and perform quality control reviews on all individual mortgage loans that become 90 days delinquent. In addition, participating members are responsible for remitting principal and interest to us, even though there may be individual mortgage loans with delinquent payments to the participating member. Occasionally, we require our members to repurchase mortgage loans. These instances include failure by a member to comply with MPP requirements, breach of representations and warranties made by a member, noncompliance with final documentation, and servicing errors.

Given the level of credit enhancement available to us, we do not believe an allowance for credit losses on mortgage loans is required. We do not expect that our decision to exit from the MPP will result in increased credit risk or the need for an allowance for credit losses on mortgage loans.

### **Quantitative and Qualitative Disclosures About Market Risk**

Our business model requires us to take on market risks, such as duration risk, convexity risk, and interest-rate yield-curve risk. Duration and convexity are terms that describe exposure to parallel shifts in interest rates. Yield-curve risk refers to non-parallel shifts in short- and long-term interest rates. These measurements can be applied to individual fixed-income instruments, such as one of our mortgage-backed securities, or to an entire fixed-income portfolio such as our MPP. For example, if a portfolio has a duration of two years, this means that the portfolio's value would be expected to decline about 2% for each 1% increase in interest rates—or rise about 2% for

each 1% decrease in interest rates. Accordingly, a portfolio with a two-year duration is less risky than one that has a 10-year duration. The 10-year duration portfolio would be expected to decline in value about 10% for each 1% rise in interest rates. Convexity is another measurement of risk, measuring the rate of change of duration for a given change in interest rates. Convexity is inversely correlated to interest rates. Negative convexity implies a shortening of duration when interest rates fall and lengthening of duration in periods of rising interest rates.

In funding the MPP and our investment securities, we matched the duration of these assets with the duration of the consolidated obligations issued on our behalf in order to purchase the assets. We did not, however, effectively manage the convexity risk of these instruments. Our purchase of callable consolidated obligations of other FHLBanks funded with the issuance of consolidated obligations on our behalf contributed significantly to our convexity risk. The mismatch between the terms of the debt issued on our behalf and terms of the assets we purchased created initial increases in net interest income, but this mismatch later contributed to our financial difficulties. As of September 30, 2005, we had net unrealized market value losses of approximately \$400 million that, in accordance with U.S. GAAP, were not reported in our Statement of Condition. As of November 30, 2005, these net unrealized market value losses remained at approximately \$400 million. The amount of our net unrealized market value loss involves estimates of the market values of our assets, liabilities, and commitments.

Market risk is the risk of loss to the market value of financial instruments – and potential loss of future net interest income – that may result from changes in interest rates. Our business requires us to assume market risk, which we seek to control through our funding and investment decisions, and with interest-rate exchange agreements. Through our market-risk management, we attempt to ensure that we are profitable and to protect net interest income and market value of equity over a wide range of interest-rate environments.

Our general approach to managing market risk is to acquire and maintain a portfolio of assets and liabilities that, together with our associated interest-rate exchange agreements, limits our expected market value and income statement volatility. Our approach is consistent with Finance Board regulations regarding interest-rate exchange agreements, which enable the FHLBanks to enter into these agreements only to reduce the market-risk exposures inherent in otherwise unhedged assets and funding positions.

### **Measurement of Market Risk**

We monitor our market risk through a variety of measures. Our Board of Directors oversees policy limits for four primary risk measures – duration of equity, key-rate duration mismatch, convexity of equity, and market value of equity sensitivity. These policy measures are described below. Historically, our risk management policy included two primary measures of market risk – duration of equity and market value of equity sensitivity. Based on the decline in our market value of equity since 2002, we revised our policy limits at the direction of our Board of Directors.

In May 2005, our Board of Directors adopted our current risk management policy that added new risk management measures, convexity of equity and key-rate duration of equity mismatch, to the existing measures of duration of equity and market value of equity sensitivity. The new policy establishes limits for these measures for managing and monitoring our market risk. We monitor our market risk daily and manage market risk within the policy limits. These measures and other key terms are defined below.

- *Market Value of Equity.* Market value of equity is the present value of the expected net cash flows from all our assets, liabilities, and commitments.
- *Duration.* Duration represents the estimated change in the value of a financial instrument for a given small instantaneous parallel shift in the yield curve. Stated simply, duration is a measurement of the price sensitivity of a financial instrument to changes in interest rates. Higher duration numbers, whether positive or negative, indicate greater price-sensitivity to changes in interest rates.
- *Duration of Equity.* Duration of equity is the market value of assets multiplied by the duration of assets minus the market value of liabilities multiplied by the duration of liabilities, plus or minus the market

value of commitments multiplied by the duration of commitments, with the net result divided by the market value of equity. Duration of equity shows the sensitivity of market value of equity to instantaneous changes in interest rates. Higher duration numbers, whether positive or negative, indicate greater potential volatility of the market value of equity.

- *Market Value of Equity Sensitivity.* Market value of equity sensitivity is the change in the market value of equity, given an instantaneous parallel increase or decrease in the yield curve.
- *Convexity.* Convexity is the rate of change in duration in response to a change in interest rates. Financial instruments can have either positive or negative convexity.
- *Convexity of Equity.* Convexity of equity is the market value of assets multiplied by the convexity of assets minus the market value of liabilities multiplied by the convexity of liabilities, plus or minus the market value of commitments multiplied by the convexity of commitments, with the net result divided by the market value of equity.
- *Key-Rate Duration of Equity.* Key-rate duration of equity disaggregates duration of equity into various time segments of the yield curve to allow us to measure and manage our exposure to changes in the interest rate attributable to each time segment.
- *Key-Rate-Duration-of-Equity Mismatch.* This measurement is the difference between the highest and lowest of the key-rate-duration-of-equity time segments.

### **Market-Risk Management**

Our market-risk measures reflect the sensitivity of our business to changes in interest rates, primarily because of mismatches in the maturities and embedded options associated with our mortgage-based assets and the consolidated obligation bonds we use to fund these assets. The prepayment options embedded in mortgage-based instruments may be exercised at any time, while the call options embedded in our callable debt are exercisable on a set date or series of dates following a lock-out period. These differences in the structure and characteristics of the mortgage prepayment options embedded in our mortgage-based assets and the debt call options in the consolidated obligations sold on our behalf cause the market values of our mortgage-based assets and callable debt to respond differently to changes in interest rates and the shape of the yield curve. For example, a significant drop in interest rates will likely trigger immediate prepayment of our mortgage-based assets, while the debt issued to fund the purchase of those assets may or may not be callable depending on the remaining length of the lock-out periods, the exercise prices of the call options, and whether the options are exercisable continuously, periodically, or on a specific date.

We evaluate our market-risk measures on an ongoing basis, under a variety of parallel and non-parallel shock scenarios. As of September 30, 2005, our market-risk measures were within our policy limits.

### **Instruments That Address Market Risk**

We use interest-rate exchange agreements, such as interest-rate swaps, interest-rate caps and floors, forward purchase and sale agreements, and swaptions, to manage our exposure to changes in interest rates. This enables us to adjust the effective maturity, repricing frequency, or option characteristics of our assets and liabilities in response to changing market conditions.

To manage interest-rate risk, we create a relationship that designates a derivative financial instrument (e.g., an interest-rate exchange agreement) as a hedge of an interest-rate exposure on an asset or liability. The accounting treatment for these hedges depends on the characteristics of the derivative instrument and hedged item and their correlation to one another and is specified in SFAS 133 and its amendments.

Some of the specific types of instruments we use to manage our interest-rate risk are described in the table below.

<b>Hedge Instrument</b>	<b>Hedged Item</b>	<b>Purpose of Hedge Transaction</b>
Pay fixed, receive LIBOR swap; we own option to cancel swap if applicable	Putable or callable advance; fixed-rate advance with option to cancel advance prior to maturity date	To provide customized advance products to our customers at minimal risk to us
Purchased interest-rate cap	Capped advance	To provide customized advance products to our customers at minimal risk to us
Pay fixed, receive LIBOR swap	Fixed-rate advance	To provide customized advance products to our customers at minimal risk to us
Pay LIBOR, receive fixed swap; pay LIBOR, receive fixed swap in which counterparty owns option to cancel swap	Bullet fixed-rate debt; callable fixed-rate debt in which we own option to call debt prior to stated maturity date	To achieve low cost funds with minimal risk to us
Short sale of agency mortgage-based securities	MPP loans	To hedge market value of MPP loans until long-term debt can be issued
Payer or receiver swaptions	Mortgage-based assets, including MPP mortgage loans and mortgage-backed securities	To hedge our prepayment risk on our mortgage-based assets and manage our duration of equity

The total notional amount of interest-rate exchange agreements outstanding was \$15.4 billion as of September 30, 2005, compared to \$15.8 billion as of December 31, 2004, \$17.5 billion as of December 31, 2003, and \$18.7 billion as of December 31, 2002. The notional amount of interest-exchange agreements declined between December 31, 2004 and December 31, 2003, due to reductions in fair value hedges of consolidated obligations and declined between December 31, 2003 and 2002, due to changes in the accounting for hedges of mortgage loan commitments.

The notional amount of these agreements serves as a factor in determining periodic interest payments or cash flows received and paid, and does not represent actual amounts exchanged or our exposure to credit or market risk. Therefore, the notional amount is significantly greater than the potential market or credit loss that could result from such transactions. Notional values are not meaningful measures of the risks associated with interest-rate exchange agreements or other derivatives, which can only be meaningfully measured on a market-value basis, taking into consideration the cost of replacing interest-rate exchange agreements with similar agreements from a highly rated counterparty.

### **Credit-Risk Management**

Credit risk is the risk of loss due to default. We face credit risk on advances, certain investments, mortgage loans, interest-rate exchange agreements, and counterparty exposures.

*Advances.* We have never experienced a credit loss on advances. We protect against credit risk on advances by requiring collateral on all advances we fund. We can also call for additional or substitute collateral during the life of an advance to protect our security interest. The FHLBank Act limits eligible collateral to certain investment securities, residential mortgage loans, deposits with the Seattle Bank, and other real estate-related assets. The GLB Act and other federal regulations allow the FHLBanks to expand eligible collateral for many of their members. Members that qualify as community financial institutions, defined in the GLB Act as FDIC-insured depository institutions with average assets for the past three calendar years totaling no more than \$548 million, may pledge small-business, small-farm, and small-agribusiness loans as collateral for advances. Advances to community financial institutions secured with expanded collateral represented \$120.2 million of the \$17.7 billion of advances outstanding as of September 30, 2005, \$328.2 million of the \$14.9 billion of advances outstanding as of December 31, 2004, \$210.3 million of the \$19.7 billion of advances outstanding as of December 31, 2003, and \$117.2 million of the \$20.0 billion of advances outstanding as of December 31, 2002. We believe that we have the

policies and procedures in place to effectively manage this credit risk. Accordingly, we have not provided any allowance for losses on advances, including those referenced above.

*Investments.* We are subject to credit risk on some investments. We limit our unsecured credit exposure to any counterparty, other than the U.S. government or its agencies or GSEs, based on the credit quality and capital level of the counterparty and the capital level of the Seattle Bank. As of September 30, 2005 and December 31, 2004, our unsecured credit exposure was \$16.4 billion and \$9.9 billion, primarily consisting of \$6.5 billion and \$8.0 billion of other FHLBank consolidated obligations and \$8.0 billion and \$1.7 billion of federal funds sold. As of December 31, 2003, our unsecured credit exposure to counterparties other than the U.S. government or its agencies or instrumentalities was \$6.9 billion. This primarily included \$2.5 billion of federal funds sold and \$3.5 billion of other FHLBank consolidated obligations. As of December 31, 2002, our unsecured credit exposure was \$4.8 billion, consisting primarily of \$3.6 billion of federal funds sold and \$715 million in interest-bearing deposits in banks. Pursuant to the Finance Board agreement, we may not purchase additional investments in the consolidated obligations of other FHLBanks without Finance Board approval.

*Mortgage Loans Held for Portfolio.* The Seattle Bank has never experienced a credit loss nor has our SMI provider experienced a loss claim on an MPP mortgage loan. Under the MPP, we have purchased mortgage loans from members, and the participating members continue to bear a portion of the credit risk on the outstanding loans. Our total par value of mortgage loans outstanding through the MPP was \$7.6 billion, \$10.4 billion, \$11.1 billion, and \$8.9 billion, as of September 30, 2005, and December 31, 2004, 2003, and 2002, which comprised \$417.3 million, \$2.3 billion, \$2.5 billion, and \$2.4 billion in government-insured mortgage loans and \$7.1 billion, \$8.1 billion, \$8.6 billion, and \$6.5 billion in conventional mortgage loans. The conventional mortgage loans are credit-enhanced by our participating members to a level equivalent to at least an investment-grade rating through the lender risk account and supplemental mortgage insurance. As part of the three-year plan, we are exiting from the MPP. However, we do not expect that this decision will impact the credit risk of the mortgage loans held for portfolio. We conduct a loss reserve analysis on a quarterly basis and have determined that no loan loss allowance is necessary, and believe that we have the policies and procedures in place to appropriately manage this credit risk.

*Derivative Credit-Risk Exposure and Counterparty Ratings.* The Seattle Bank is subject to credit risk because of the potential nonperformance by a counterparty to an agreement. The degree of counterparty risk on interest-rate exchange agreements and other derivatives depends on our selection of counterparties and the extent to which we use netting procedures and other credit enhancements to mitigate the risk. We manage counterparty credit risk through credit analysis, collateral management, and other credit enhancements. We require agreements to be in place for all counterparties. These agreements must include provisions for netting exposures across all transactions with that counterparty. The agreements also require the counterparties to collateralize exposures with the thresholds for priority collateral tied to the credit risk of the counterparty. For example, a counterparty must deliver collateral to the Seattle Bank if the total market value of our exposure to that counterparty rises above a specific threshold. As a result of these risk mitigation initiatives, we do not currently anticipate any credit losses on our interest-rate exchange agreements.

Our credit risk equals the estimated cost of replacing favorable interest-rate swaps, forward agreements, and purchased caps and floors, if the counterparty defaults, net of the value of related collateral. Our maximum credit risk, taking into consideration master netting agreements but before considering collateral, was approximately \$6.9 million, \$21.8 million, \$45.2 million, and \$77.2 million as of September 30, 2005, and December 31, 2004, 2003, and 2002. In determining maximum credit risk, we consider accrued interest receivable and payable, and the legal right to offset assets and liabilities by counterparty. Our net exposure after considering collateral was approximately \$6.9 million, \$16.3 million, \$25.1 million, and \$44.7 million as of September 30, 2005, and December 31, 2004, 2003, and 2002. Our counterparty credit exposure, by credit rating, was as follows.

	As of September 30, 2005			
	Notional Amount	Total Net Exposure at Fair Value	Collateral Held	Net Exposure After Collateral
	(in thousands)			
AA+ .....	\$ 694,130	\$	\$	\$

AA .....	1,699,757			
AA-.....	8,509,657			
A+.....	3,952,475	6,650		6,650
A.....	352,000			
Member institutions (1).....	160,500	226		226
Total.....	<u>\$15,368,519</u>	<u>\$ 6,876</u>	<u>\$</u>	<u>\$ 6,876</u>

As of December 31, 2004				
	Notional Amount	Total Net Exposure at Fair Value	Collateral Held	Net Exposure After Collateral
(in thousands)				
AAA.....	\$ 149,350	\$	\$	\$
AA .....	1,504,843			
AA-.....	8,646,559			
A+.....	4,031,400	20,080	5,552	14,528
A.....	795,000	1,079		1,079
Not rated .....	151,609			
Member institutions (1).....	560,500	658		658
Total.....	<u>\$15,839,261</u>	<u>\$ 21,817</u>	<u>\$ 5,552</u>	<u>\$ 16,265</u>

As of December 31, 2003				
	Notional Amount	Total Net Exposure at Fair Value	Collateral Held	Net Exposure After Collateral
(in thousands)				
AAA.....	\$ 149,350	\$	\$	\$
AA .....	2,600,871			
AA-.....	6,234,983	448		448
A+.....	5,691,900	38,639	20,100	18,539
A.....	685,000	4,718		4,718
Not rated .....	569,000			
Member institutions (1).....	950,500	1,390		1,390
Total.....	<u>\$16,881,604</u>	<u>\$ 45,195</u>	<u>\$ 20,100</u>	<u>\$ 25,095</u>

As of December 31, 2002				
	Notional Amount	Total Net Exposure at Fair Value	Collateral Held	Net Exposure After Collateral
(in thousands)				
AAA.....	\$ 147,550	\$	\$	\$
AA+.....	235,000			
AA .....	956,050			
AA-.....	3,258,799	733		733
A+.....	10,104,427	64,197	29,703	34,494
A.....	2,165,400	13,278	2,822	10,456
Member institutions (1).....	1,850,500	(968)		(968)
Total.....	<u>\$18,717,726</u>	<u>\$ 77,240</u>	<u>\$ 32,525</u>	<u>\$ 44,715</u>

(1) Collateral held with respect to interest-rate exchange agreements with member institutions represents either collateral physically held by or on behalf of the Seattle Bank or collateral assigned to the Seattle Bank, as evidenced by a written security agreement, and held by the member institution for the benefit of the Seattle Bank. This notional amount excludes stand-alone delivery commitments.

We have never experienced a loss on a derivative transaction due to default by a counterparty. We believe that the credit risk on our interest-rate exchange agreements is low because we contract with counterparties that are of very high credit quality. As of September 30, 2005, 17 counterparties represented the total notional amount of our outstanding interest-rate exchange agreements excluding agreements in which we served as intermediaries. As of September 30, 2005, approximately 70.9% of the total notional amount of our outstanding interest-rate exchange agreements were with ten counterparties rated AA- or higher. Excluding interest-rate exchange agreements in which we are an intermediary for members and which are fully collateralized, almost 100% as of September 30, 2005 and

December 31, 2004, approximately 96% as of December 31, 2003, and approximately 100% as of December 31, 2002, of the notional amount of our outstanding interest-rate exchange agreements were with counterparties with credit ratings of "A" or equivalent from an NRSRO, such as Standard & Poor's or Moody's.