Federal Home Loan Bank of Chicago • 2005 Review

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The Bank's mission

The mission of the bank is to promote and support the growth and success of our members' housing, community investment, and other financial activities by:

- Serving as a reliable source of liquidity.
- Providing secured financing and asset liability management capabilities, which create value and are designed to meet our members' specific needs.
- Contributing direct support to affordable housing and community investment programs delivered through our members.

To our members:

2005 was a year of challenges and changes at your Federal Home Loan Bank. While the Bank enjoyed many successes and generated solid profits, I know that members were disappointed in two key aspects of their relationship with the Bank: the ability to redeem stock, and the trend in the dividend paid on the stock. While I communicated with you by letter about developments at the Bank several times over the course of the year, I am pleased to have this opportunity to summarize the issues we faced and our progress in addressing them. Most of all, I want to underscore my belief that these critical matters are well on the way to resolution. The entire staff of the Bank is committed to moving the Bank forward and delivering value to you, our members.

SEC registration

On February 13 of this year, we completed the process of registering the Bank's stock with the Securities and Exchange Commission, as required by our regulator, the Federal Housing Finance Board (FHFB). As a result, this is the first time that we are reporting our financial results to you in a Form 10-K, which accompanies this letter. We were pleased to be the fifth of the 12 Federal Home Loan Banks to accomplish this milestone, despite the complexity of the process and the demands of other challenges on our staff and resources.

Update on written agreement

As you know, in July 2004 we entered into a Written Agreement with the FHFB, comprising several requirements:

- Limitation on the growth of Mortgage Partnership Finance® assets on the Bank's balance sheet to no more than 10% per annum;
- Maintenance of a minimum 5.1% regulatory capital ratio;
- Review by outside consultants of the Bank's management, risk management, hedge accounting, and internal audit practices; and
- Approval by the FHFB of a new Business and Capital Management Plan.

I am pleased to report to you that most requirements of this Agreement were satisfied in 2005 and substantial progress was made on remaining issues not entirely addressed during the year:

- MPF® assets actually declined from July 2004 through year-end 2005 as consumer demand for traditional fixed-rate mortgages declined in favor of adjustable-rate and hybrid mortgage products. The Bank also faced regulatory capital constraints, limiting its ability to acquire MPF assets.This resulted in substantial declines in mortgages purchased from members despite an increase in the number of Participating Financial Institutions (PFIs) utilizing the MPF Program as a vehicle to manage their balance sheet risk.
- The Bank consistently exceeded its regulatory capital requirements — albeit at the cost of restraints on earning asset growth.

- The required consulting studies were completed, resulting in 233 Action Plans to be implemented by management. As of March 31, 2006, all but 6 of the Action Plans had been implemented.
- In February 2005, the FHFB approved the Bank's Business and Capital Management Plan for 2005-2007.

Voluntary stock redemptions

The Business and Capital Management Plan approved in 2005 focused on two key issues:

- A commitment to reduce voluntary stock by $1 billion over a three-year period, with an expectation that the Bank would convert to a new capital plan as required by the Gramm-Leach-Bliley Act in 2006 or at a time mutually agreed upon with the FHFB; and
- A goal of developing risk transfer processes for MPF loans purchased from members to facilitate the continuing evolution of the MPF Program while limiting growth of MPF assets.

Through the second quarter of 2005, the Bank was progressing well on the path laid out in this Plan. However, third quarter redemptions of voluntary stock increased beyond expectations as members sought liquidity to invest in loan growth and other investment alternatives. As a result, we found it necessary on October 18, 2005, to temporarily discontinue the redemption of voluntary stock. At that time, we entered into an Amendment to the Written Agreement with the FHFB that reduced the Bank's required regulatory capital ratio to 4.5% and also imposed a minimum dollar level of equity capital, effectively curtailing all redemptions of stock. We also agreed to revise both our Retained Earnings and Dividend Policy and business strategies and present them to the FHFB for approval.

In the days and weeks following the October announcements, my colleagues and I talked with many of you about your dissatisfaction with both the decision to discontinue stock redemptions and the reductions in the Bank's dividend rate. We pledged to you then that restoration of stock redemptions would be the highest priority of the Bank, and that we would work very hard to accomplish this task as soon as possible.

Recent announcements

As you know, on April 18, 2006, we announced that the FHFB had approved our revised business strategies and Retained Earnings and Dividend Policy, and we communicated the overall plan for resuming stock redemptions. A cornerstone of this plan will be the issuance of $1 billion in subordinated debt, with a portion of the net proceeds to be used to redeem up to $795 million of voluntary stock. We expect to complete the issuance by the end of the second quarter of 2006. The entire amount of subordinated debt will be included in the calculation of the Bank's regulatory leverage limit for the first five years following the issue; beginning in year six, the amount included will be reduced annually. The Bank's regulatory leverage requirement will continue to be 4.5%. In addition, the Bank intends to redeem additional amounts of voluntary stock, subject to regulatory approval, toward the end of 2006, and again in 2007 and 2008, if necessary, to meet member requests for redemption.

Our revised Retained Earnings and Dividend Policy targets continuing increases in the Bank's retained earnings over the next few years, and sets minimum dollar amounts of annual earnings retention and maximum dividend payout levels for earnings above the minimum annual retention. As a result, we expect that the dividend rate for 2006 will be in the range of 3.0 to 3.5%. The rate for future years will depend on a number of factors, including future earnings, and the final terms of a new capital regulation recently proposed by the FHFB that would require increases in retained earnings at most of the Federal Home Loan Banks.

Business strategies: advances, MPF Program, and community investment

The Bank's business strategies are focused on two central issues:

- Delivering value to our members through competitive products and services and a reasonable return on invested capital; and
- Evolving the highly successful MPF Program to continue delivering value to members while addressing risk management and capacity issues.

As members, you joined the Federal Home Loan Bank first and foremost because we are a competitive source of liquidity and funding. We also provide unique and substantial support for your affordable housing and community investment activities. As we developed our business strategies, our management team felt it important to increase our focus on these capabilities in our Mission Statement, which we revised last year as follows:

The Mission of the Bank is to promote and support the growth and success of our members' housing, community investment and other financing activities by:

- Serving as a reliable source of liquidity.
- Providing secured financing and asset liability management capabilities which create value and are designed to meet our members' specific needs.
- Contributing direct support to affordable housing and community investment programs delivered through our members.

We recognize that our liquidity and funding services, including our affordable housing and community investment capabilities, are subject to competition. In order to expand our relationships with all of you, we have increased our efforts to serve you better than alternative sources. Our strategy is focused on several requirements for success:

- Competitive pricing
- Competitive collateral requirements
- Product development and management
- Tailored solutions to members
- Use of technology for greater efficiency and effectiveness

We continuously monitor the overall structure and pricing of our products and services. In addition to increasing the available collateral value of 1–4 family units, we have revised the pricing of most of our advance products. We have added resources to our product management function and expect to meet member needs with several new product introductions in 2006.

As noted above, purchases of mortgages through the MPF Program by the Bank, and by the eight other FHLBs that participate in the MPF Program, have declined significantly over the last 18 months from earlier levels due to trends in the mortgage market and the Bank's capital constraints. What has not changed is the attractiveness and importance of the MPF model to PFIs. Consistent with our Mission, the MPF Program is a beneficial and profitable asset liability management capability provided to FHLB members. And while total dollars of loans purchased have declined, 745 FHLB members — the highest number in the history of the program — participated in the MPF program in 2005.

The strategic challenge for the MPF Program is to deliver this capability to more members while recognizing that capacity for MPF assets on FHLB balance sheets is limited by capital and the complexities of managing mortgage interest rate risk. In fact, we anticipate that MPF holdings on the Bank's balance sheet will decline as voluntary stock is redeemed. We are working to develop off-balance sheet funding alternatives for MPF assets to enable growth while managing within overall system capacity. We have also integrated all aspects of the Bank's operations which support the MPF Program to ensure effectiveness and efficiency.

Nearly 300 of our members participated in Affordable Housing or Community Investment products and services in 2005. The Bank awarded $29 million in competitive AHP grants to create nearly 6,000 units of affordable housing; more than half of these units

accommodated very low-income residents. In addition, more than 1,600 benefited from Downpayment Plus® Program grants totaling $8 million through the AHP homeownership set-aside. The Bank's Community Investment Group provided more than $865 million in financing to support members' community lending activities, including affordable housing, community economic development, and small business lending. We look forward to expanding the reach of these important mission-based programs to more of our members in 2006 and beyond.

Building the infrastructure to serve members

Implementing these strategies requires excellence in operations, technology infrastructure, risk management, and most of all, people. All of these areas have received — and will continue to receive — substantial attention. We have recently consolidated all operations functions under new leadership at the Bank. We have sharpened our focus on technology investments, targeting critical improvements while reducing overall expenditures. We have implemented substantial changes to our overall enterprise risk management framework, made substantial progress on achieving compliance with the requirements under the Sarbanes Oxley-Act, and substantially enhanced our internal audit group under new leadership. And, we have expanded our training and development programs to increase the effectiveness of our colleagues in delivering value to our members.

Impact on financial results

Unlike the typical letter to shareholders, I have reserved discussion of our financial results to this point because all of the issues and trends discussed above had an effect on our performance and dividends. Net income declined in 2005, from $365 million in 2004 ($324 million before the effects of a cumulative adjustment of prior years' net income) to $244 million, for three principal reasons: lower earning asset volume, lower overall spreads, and higher expenses. The decline in average earning asset volume of $5.2 billion was led by a $3.3 billion reduction in average MPF Loans. Average advances were also lower by $1.9 billion, due solely to prepayments by a single large member, as average advances to all other members increased. Spreads decreased as a continually flattening yield curve exerted pressure and the Bank tightened its hedging of duration. Total expenses increased from $121 million in 2004 to $132 million in 2005, although $10 million of 2005 expenses represented a non-recurring write-down of software. Net of this item, 2005 expenses were comparable to 2004. Please see the "Management's Discussion and Analysis of Financial Conditions and Results of Operations" section of the Form 10-K beginning on page 53 for detailed discussion of our 2005 results.

Commitment to building our relationships with members

As I stated at the beginning of this letter, 2005 was a year of challenges and changes. We have addressed these challenges, and will continue to do so, in pursuit of the sole objective of fulfilling our Mission to you, our members. I am extremely proud of the commitment, hard work, and sacrifice displayed by all of my colleagues during the year. Most importantly, I want to thank all of you for your participation as members and for support of your Federal Home Loan Bank.

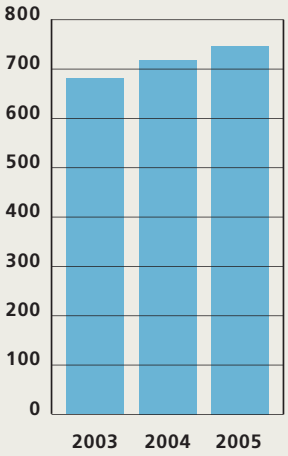
Sincerely,

J. Mikesell Thomas
President and CEO

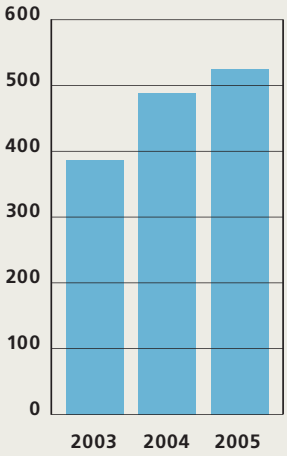
Financial highlights*

	2005	2004	2003
Total Members	881	893	884
($ in millions)			
Advances (at par)	$24,951	$23,969	$25,868
MPF® Loans (at par)	$41,800	$46,577	$47,140
Total Housing Finance Related Assets	$73,994	$76,931	$75,788
Total Assets	$85,346	$85,709	$86,942
Total Regulatory Capital	$4,506	$4,792	$4,542
Net Income	$244	$365	$437
Average Annual Dividend Rate	4.94%	6.13%	6.25%
Dividend Spread Over Average One-Year LIBOR	1.82%	4.51%	4.59%
Net Interest Income to Average Earning Assets	0.60%	0.79%	1.06%
Non-Interest Expenses to Average Assets	0.16%	0.12%	0.10%
Regulatory Capital to Total Assets	5.3%	5.6%	5.2%

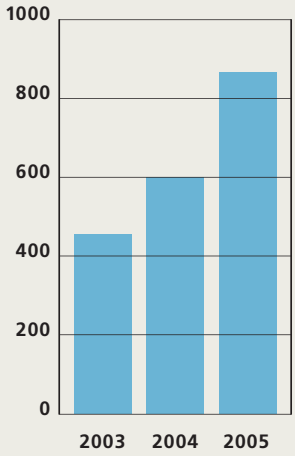
Credit customers



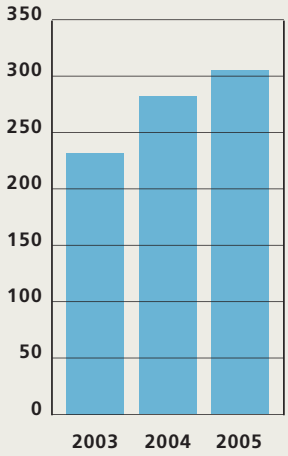
Retained earnings
dollars in millions



New Community Investment Cash Advances (CICA) and Letters of Credit
dollars in millions



MPF® Participating Financial Institutions Approved



* For complete financial results, please refer the 2005 10-K available at www.sec.gov.

Audit Committee Report, March 27, 2006

The Audit Committee of the Federal Home Loan Bank of Chicago (the "Bank") is comprised of four outside directors. In accordance with its written charter adopted by the Board of Directors, the Audit Committee assists the Board in fulfilling its responsibility for oversight of the Federal Home Loan Bank of Chicago's accounting, reporting and financial practices, including the integrity of its financial statements.

The Audit Committee had eight meetings during 2005 and during six of these meetings the Audit Committee met separately with the internal and independent auditors.

Management has the responsibility for the preparation and integrity of the Bank's financial statements, accounting and financial reporting principles and internal controls and procedures designed to assure compliance with accounting standards and applicable laws and regulations. The Bank's independent auditor, PricewaterhouseCoopers LLP, is responsible for performing an independent audit of the financial statements and expressing an opinion on the conformity of those financial statements with generally accepted accounting principles. The Internal Audit Department is responsible for preparing an annual audit plan and conducting internal audits under the direction and control of the General Auditor, who is accountable to the Audit Committee. The Audit Committee oversees and monitors these processes on behalf of the Board of Directors.

The Audit Committee has reviewed and discussed the 2005 audited financial statements with management and the independent auditors. The Audit Committee has reviewed and discussed with the independent auditor all communications required by generally accepted auditing standards, including those described in Statement on Auditing Standards No. 61, as amended, *"Communication with Audit Committees,"* and SAS No. 90, *"Audit Committee Communications,"* and, with and without management present, discussed and reviewed the results of the independent auditors' audit of the financial statements. The Audit Committee has also received the written disclosures and the letter from the independent auditor required by the Independence Standards Board Standard No.1, *Independence Discussions with Audit Committees,* and has discussed the auditor's independence with the independent auditor.

Based on the review and discussions referred to above, the Audit Committee recommended to the Board of Directors that the Bank's audited financial statements be included in the Bank's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, for filing with the Securities and Exchange Commission.

Audit Committee Members
David Kuhl, *Chairman*
James McKenna, *Vice Chair*
Terry Grosenheider
Thomas Herlache

Board of Directors

James K. Caldwell, Chairman
President and
Chief Executive Officer
The First Citizens State Bank of Whitewater

P. David Kuhl, Vice Chairman
Chairman and
Chief Executive Officer
Busey Bank Urbana

Thomas M. Goldstein
Senior Executive Vice President
LaSalle Bank Corporation

Terry W. Grosenheider
Private Banking Relationship Manager
U.S. Bank, N.A.

Thomas L. Herlache
President, CEO,
and Chairman of the Board
Baylake Bank

Alex J. LaBelle
Smothers Realty Group

Roger L. Lehmann
President, CEO, and Chairman
The Harvard State Bank

Gerald J. Levy
Chairman
Guaranty Bank

Kathleen E. Marinangel
CEO, President, and Chairman of the Board
McHenry Savings Bank

Richard K. McCord
President and
Chief Executive Officer
Illinois National Bank

James F. McKenna
President and CEO
North Shore Bank

Management Committee

J. Mikesell Thomas
President and
Chief Executive Officer

Mark P. Bagnoli
Executive Vice President
Chief Risk Officer

Gnanesh Coomaraswamy
Executive Vice President
Financial Markets

Eldridge Edgecombe
Senior Vice President
Community Investment Officer

Matthew R. Feldman
Executive Vice President
Operations

Peter E. Gutzmer
Executive Vice President
General Counsel and Corporate Secretary

Charles A. Huston
Executive Vice President
Member Relationship Management

Roger D. Lundstrom
Executive Vice President
Financial Information

Michael E. McFerrin
Executive Vice President
Financial Markets

Senior Vice Presidents

Patricia S. Brannon
Senior Vice President
Short Term Markets

Michael A. Ericson
Senior Vice President
Accounting Policy and SEC Reporting

Agnes M. Hardison
Senior Vice President
Chief Credit Officer

Thomas H. Harper
Senior Vice President
General Auditor

David J. Matthews
Senior Vice President
Information Systems

William D. Miller
Senior Vice President
Treasurer

Mark E. Raaberg
Senior Vice President
Market Risk Analysis

Eric S. Schambow
Senior Vice President
MPF® Program Provider

Thomas D. Sheehan
Senior Vice President
Member Relationship Management

Dennis M. Toolan
Senior Vice President
Accounting and Financial Analysis

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