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Federal Home Loan Banks

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Major Rating Factors

None

Strengths:

- Government-related entity (GRE) with critical public-policy role and integral link to the government
- One of the primary liquidity providers to U.S. mortgage and housing-market participants
- Diverse global-investor base enables ample liquidity at low funding costs across maturities
- Excellent asset quality in collateralized wholesale lending portfolio

Weaknesses:

- Private-label residential mortgage-backed securities' (RMBS) credit-related impairments remain an issue at certain FHLBs
- Weak profitability in absolute terms
- Exposure to interest rate risk on mortgage assets and credit risk in private-label RMBS portfolios
- Potential for adverse regulatory changes related to broader housing government-sponsored entity (GSE) reform

Rationale

Standard & Poor's Ratings Services' 'AAA' rating on the Federal Home Loan Banks (FHLB or FHLB System) reflects the system's status as one of three housing GSEs, its important role as a primary liquidity provider to U.S. mortgage and housing-market participants, its diverse global-investor base that enables ample liquidity at low funding costs across maturities, and its excellent aggregate asset quality in its collateralized wholesale lending portfolio.

On July 15, 2011, we placed the 'AAA' rating on the FHLB System's senior unsecured debt and the 'AAA' long-term ratings on select FHLBs on CreditWatch with negative implications. The 'A-1+' short-term ratings on those entities are not affected. The CreditWatch action follows placement of the sovereign credit rating on the U.S. on CreditWatch with negative implications (see United States of America 'AAA/A-1+' Ratings Placed on CreditWatch Negative on Rising Risk of Policy Stalemate, published July 14, 2011, on RatingsDirect on the Global Credit Portal).

The CreditWatch listing on the system's debt reflects the application of our GRE criteria, under which we equalize the rating on that debt with the sovereign rating because of the almost certain likelihood of government support. The CreditWatch listing on the FHLBs reflects the potential reduction in the implicit support that we historically have factored into the issuer credit ratings because of the important role those banks play as primary liquidity providers to U.S. mortgage and housing-market participants. Under our GRE criteria, the issuer credit rating for system banks can be one-to-three notches above the stand-alone credit profile on any of the member banks. Thus, a lower U.S. sovereign rating would directly affect the issuer credit ratings on the FHLBs.

Stand-alone credit profiles of individual FHLBs reflect their excellent loan quality and funding/liquidity benefits that accrue to them as members of the FHLB System. The individual bank rating strengths are offset by weak but adequate risk-adjusted profitability by virtue of the FHLB System's cooperative membership structure, the level of impairments and risk-taking in their respective MBS portfolios, high exposure to interest rate risk at certain FHLBs that have purchased mortgage loans from their member institutions, and potential for adverse regulatory changes related to broader housing GSE reform.

Despite continuing decline in advances, the FHLB System continues to be a reliable source of liquidity for its member institutions, supporting their participation in the U.S. housing market. The FHLB System has afforded their member institutions a readily available liquidity channel without adding unwarranted credit risk in the FHLB System's lending activities. That support was evident during the third-quarter of 2008, when advances rose to a peak of $1.01 trillion. Advances have since declined and totaled $445 billion as of March 31, 2011, because member institutions again have access to alternative sources of liquidity in the capital markets. Member institutions still have high levels of deposits and are experiencing low loan demand because of weak economic activity. We do not expect advances at the FHLBs to grow until consumer confidence returns, the housing market stabilizes, and unemployment improves. According to our economists, the economy should continue to recover at half-speed with a high unemployment rate through 2014. Housing demand is weak, and economic and political troubles overseas persist, keeping the recovery subdued.

The FHLB System has low funding costs on its debt ("consolidated obligations") because of a joint and several liability on the combined strength of the 12 independent FHLBs and the implicit government support the FHLB System receives as a GSE. Nevertheless, the FHLB System's consolidated obligations are not guaranteed by, nor are they the obligation of, the U.S. government.

The international investor base consists of many sovereign nations. However, current global economic weakness continues to bring investors to U.S.-related obligations as a safe haven for dollar-denominated and government-related assets. In addition, domestic financial institutions awash with deposits and weak loan demand have also invested excess liquidity in FHLB System consolidated obligations, keeping funding costs extremely low at the FHLBs given the demand for their securities. We expect the FHLB System's funding costs to be on par with Fannie Mae's and Freddie Mac's, with spreads slightly above U.S. Treasuries, which explicitly include the full faith and credit of the U.S. government.

The FHLB System maintains excellent asset quality through its advance-loan portfolio, which comprises 52% of combined assets. Across the FHLB System and throughout its history, no FHLB has taken a single loss related to its advance business. Member institutions must secure all advances, and FHLBs only lend as much as discounted collateral policies would warrant. We believe the FHLBs have been appropriately modifying collateral-management guidelines, which increases haircuts for additional perceived risk in collateral types or troubled originators. Furthermore, troubled originators must deliver their pledged collateral to their respective FHLBs for collateral management and security. If the Federal Deposit Insurance Corp. shuts down a member institution, it either transfers advances to an acquiring entity or, more likely, pays off the advances to release the abundant collateral and settle the closing bank's liabilities. Currently, the FHLB System lien generally supersedes even depositors in winding down a member institution.

In addition to advances, the FHLB System provides liquidity to the market by purchasing RMBS. Mortgage-backed securities (MBS) totaled $146 billion as of March 31, 2011 (approximately 17% of assets). Although they were all rated 'AAA' at purchase, most FHLBs expanded their investment portfolios selection to include nonagency RMBS, which represent approximately 11% of the combined total investment portfolio (about 4% of total assets). The mortgage and housing-market crises drove values of those bonds down significantly. Few securities have actually realized credit losses, but ongoing other-than-temporary impairment (OTTI) testing indicates the FHLBs expect some losses in the later lives of the bonds. Because of continued uncertainty in the housing markets, increased credit-related OTTI assumptions indicate higher projected losses because of increases in foreclosure and liquidation costs. Of the $236 billion in the system's investment securities at March 31, 2011, 9.8% are now below investment grade, compared with 9.2% at year-end 2010. That is significantly more than the 1.2% of investment securities rated below investment grade at year-end 2008.

The FHLBs recorded $1.1 billion in OTTI charges during 2010 and an additional $275 million of such charges during the first-quarter of 2011 related to prospective credit losses within the bonds. That is a decrease from the $2.4 billion in OTTI charges taken during 2009. The lack of liquidity that occurred in the crisis reflects the remaining noncredit-related impairment that is classified in accumulated other comprehensive income (AOCI) as unrealized losses. AOCI totals have been declining as liquidity returns to the market and shores up the market values.

However, we are concerned that at three of the FHLBs—Boston, San Francisco, and Seattle—the level of unrealized losses exceed the retained earnings of these FHLBs. This would eliminate the cushion at these FHLBs to cover any other unexpected credit loss. Although we believe that once liquidity returns to the market the level of unrealized loses would reduce. It is possible that certain losses would be credit-related losses and would hurt the FHLBs' retained earnings and capital base.

As part of a cooperative structure, the FHLB System earns relatively narrow net spreads between their assets and liabilities. Although the FHLBs' profitability measures are weak in absolute terms, they are satisfactory in our view of the low-risk nature of their core advance business. In normal economic conditions, normalized, plain-vanilla total revenue streams are adequate to cover overhead expenses and pay a dividend to member institutions. However, unstable capital markets have driven economic volatility in two areas of FHLB System's earnings: credit-related impairments on RMBS, and marks-to-market on derivative and hedging activities. FHLB System net income increased $33 million from a year earlier. That was primarily due to improvements in other noninterest charges resulting from lower net losses in the mark-to-market of certain financial instruments carried at fair value, partially offset by an increase in net OTTI losses.

Housing GSE reform is likely to affect the Federal Housing Finance Agency (FHFA) and its three housing-related GSEs: the FHLB System, Fannie Mae, and Freddie Mac. Although several bills have been introduced to Congress, we have only seen suggested reforms for certain aspects of the FHLB System in the Department of Treasury's white paper to Congress. The ultimate effect of GSE reform isn't certain, and we believe it is premature to change our view on the FHLB System or our expectation of ongoing support from the U.S. government at this time. We don't expect to see more concrete proposals until 2012 and, more likely, after the 2012 election.

Outlook

Each FHLB, except FHLB-Chicago and FHLB-Seattle, is on CreditWatch with negative implications. That reflects the July 14, 2011, ratings action of the sovereign credit rating on the U.S., which was placed on CreditWatch with negative implications. The outlook FHLB-Seattle remains negative. We expect the FHLB System as a GSE to continue to benefit from the implied support of the U.S. government for its consolidated debt obligations and continue making advances. However, if losses on its private-label MBS exceeded our expectations and affected profitability and capital on certain FHLBs, or if possible legislation or regulatory developments had an adverse affect on the FHLB System and resulted in less implicit government support, we could lower our ratings.

Critical public-policy role and link to the government

We reflect our views on the importance of a GRE's role to the government through implementation of our GRE ratings criteria. We believe the role of the FHLB System to the government is critical and define the strength of the link between it and the U.S. government as integral. It is one of the primary channels the government has established to ensure consistent liquidity to support U.S. housing and community-investment activities. The FHLB System offers a reliable source of liquidity through secured financing and MBS purchases that a private entity could not readily achieve on its own, especially without an active securitization or covered bond market.

In our rating process, we differentiate between the total FHLB System and the individual FHLB System banks. Through our criteria, we classify an individual FHLB's role, as very important and its link to the government as very strong. We assign stand-alone credit profiles for each FHLB based on our normal review process and incorporate our expectation for ongoing support that the government extends through its regulatory supervision by the FHFA. We believe a single FHLB's weakness could have a systemic impact in terms of investors' perception of th FHLB System strength or weakness in a confidence-driven environment. In part, that is why we define the link between any one FHLB and the government as very strong—because a financial distress/default of the GRE could significantly affect the government's reputation or create a perception of weakness. The likelihood of extraordinary support for a single FHLB is very high, resulting in a prescriptive rating from our criteria table one to three levels above the individual FHLB's stand-alone credit profile due to government support.

Another reason for likely government support is that one FHLB could jeopardize the integrity of the FHLB System's consolidated obligations and the repayment of the same. The consolidated obligations are joint and several obligations of the 12 FHLBs and do not carry explicit support (i.e., guarantee) of the U.S. government. Therefore, each FHLB is responsible to the registered holders of the consolidated obligations for the payment of principal and interest on all consolidated obligations issued by the FHLBs. Per our criteria, the rating on the FHLB System's consolidated obligations is equalized to the 'AAA' sovereign rating of the U.S. government given the almost certain likelihood of extraordinary government support. The consolidated obligations continue to price at a narrow spread over U.S. treasuries (as they generally have throughout the crisis), affording the FHLBs and their member institutions low funding costs.

With consolidated obligations outstanding of $770 billion as of March 31, 2011, the FHLB System is among the largest providers of mortgage credit in the U.S. The consolidated obligations outstanding balance is down 12% from $876 billion a year earlier, reflecting lower advance demand and improved access to alternative funding sources, as well as high deposit balances for member institutions.

Profile: An Important Role In The U.S. Housing Market

In our opinion, the FHLB System serves an important role in the U.S. housing market by providing liquidity to its member institutions. The 12 individual FHLBs are located in 12 distinct regions of the U.S. The public purpose of the 12 FHLBs is to provide member institutions with advances as a supplement to deposit flows and other funding sources in meeting residential mortgage-credit needs. The FHLB System's reliability was most noteworthy during 2008, when member institution demand for liquidity was high and market confidence in asset values disappeared, resulting in FHLB System's advance balances reaching their peak of $1.01 trillion and the FHLB System's combined balance sheet swelled to $1.43 trillion. Advance balances have since subsided, but the FHLBs also provide many other services to benefit their member institutions.

We believe we can differentiate the individual FHLBs, albeit in a narrow band, because they all have the same fundamental mission, with relatively minor variations in business models propelled by managerial risk appetite and tolerance. Management teams try to differentiate themselves by emphasizing various business activities for the benefit of their respective member institutions. For example, FHLBs are all capitalize in essentially the same way to support three primary asset types: advances to members, the investment-securities portfolio, and mortgage loan purchases from members.

One revenue-diversifying and separate business activity is the purchase of whole first mortgage loans from members under the Mortgage Partnership Finance (MPF®) Program, initiated in 1997, and the Mortgage Purchase Program (MPP), which began in 2000. Under those programs, some of the FHLBs purchase and ultimately carry those mortgage loans on their balance sheets as mortgage loans held for portfolio. That affords member institutions an alternative to holding fixed-rate residential mortgage loans in their portfolios or selling them into the secondary market. The risks associated with the loans are shared; member institutions retain a portion of the related credit risk, and the FHLBs bear the interest-rate risk and a portion of the credit risk.

Combined mortgage assets totaled $59 billion as of March 31, 2011 (6.9% of assets), down from $69 billion a year earlier. We expect the trend of winding down the MPF and MPP loans to continue because certain FHLBs have discontinued their mortgage loan purchase programs.

The FHLB System's combined assets were $849 billion, and advances totaled $445 billion as of March 31, 2011. Those are down 12% and 22%, respectively, from a year earlier. FHLB System advances to member institutions have continued to decline because overall loan demand remains low, deposit balances are still high at member institutions, and other sources for liquidity are available.

Support And Ownership: A System Owned By Member Insitutions

The FHLBs are owned by their member institutions. Member institutions are primarily commercial and savings banks but have grown to include credit unions, insurance companies, and community-development financial institutions (CDFIs). Membership consisted of the following mix as of March 31, 2011: commercial banks (5,454), thrifts (1,078), credit unions (1,042), insurance companies (228), and CDFIs (5). With passage of the Gramm-Leach-Bliley Act in 1999, membership in an FHLB became voluntary.

A member institution must contribute capital to belong to an FHLB. The member institution's stock requirement is generally based on its use of FHLB products, subject to a minimum requirement based on the member institution's mortgage-related assets. In return, the member institution may borrow on a secured basis at generally attractive rates from its FHLB. In addition, member institutions may receive dividends on their shares in their FHLB, which helps to lower their all-in funding costs.

Each FHLB's member institutions elect all members of its board of directors, which comprises directors or officers of member institutions and independent directors not affiliated with member institutions. The FHFA, an independent agency of the U.S. government, closely regulates the FHLBs on expectations, requirements, and limitations of business activity. In 2010, the FHFA reconstituted the board of directors of the FHLBs' fiscal agent, the Office of Finance, with a board of directors consisting of all 12 FHLB presidents and five independent directors. The five independent directors serve as the Office of Finance's audit committee.

Strategy: Independent Management, But Similar Strategies

The FHLB System, in our view, continues to fulfill its public-policy mission to support its member institution's housing and community-development initiatives. Each of the 12 FHLBs in the FHLB System is independently managed, but all have similar strategies, with the relatively minor variations mentioned earlier. Overall, the FHLBs strive to continue to be a reliable funding source for members, to generate a sufficient level of income to pay for the required FHLB System contributions to Resolution Funding Corporation (REFCORP) and the Affordable Housing Program (AHP), as well as to continue to pay reasonable dividends to member institutions, boost retained earnings, and attract new member institutions.

Because of weak economic recovery and a lackluster housing–market, member institutions' demand for advances remains low. However, some FHLBs still have active mortgage loan portfolios that they aggregated from their members (MPF and MPP), but those are slowly running off at some of the FHLBs. Currently, the FHLBs of Atlanta, Chicago, Dallas, San Francisco, and Seattle are not acquiring new mortgage loans under the purchased-mortgage loan programs and have ceased to enter into new master agreements.

As of March 2011, the FHLBs of Chicago, Cincinnati, Des Moines, and Indianapolis maintained the largest percentage of the balance of mortgage loans held for portfolio, with 29%, 13%, 12%, and 11%, respectively, of the combined total. No other FHLB held 10% or more of the combined-mortgage loans. The MPF Xtra program is an alternative to the legacy MPF program. Through it, the FHLB of Chicago modified its MPF program to continue serving as an outlet for conforming mortgage loans. Loans sold to the FHLB of Chicago under the MPF Xtra program are concurrently sold to Fannie Mae and are not held on its balance sheet. Each of the FHLBs of Boston, Chicago, Des Moines, and Pittsburgh offer that product, and total volume since it was introduced in the fourth quarter of 2008 is in excess of $7.2 billion. The MPF Xtra product is useful for smaller member institutions who do not generate sufficient volume to be a direct provider of mortgage loans to Fannie Mae or Freddie Mac.

The FHLBs set aside annually a percentage of earnings for their required contribution to REFCORP and the AHP. The REFCORP obligation is expected to be satisfied during 2011, and each FHLB has agreed to, at that time, allocate at least 20% of its net income to a separate restricted retained earnings (RRE) account, enhancing each FHLB's capital position under a Joint Capital Enhancement (JCE) Agreement, executed in 2011 among the FHLBs.

Management at many of the FHLBs is focusing on attracting new member institutions, particularly insurance companies and credit unions, to broaden the revenue side of those FHLBs' income statements through increased advances. They also have focused on cost containment in recent years to preserve their business models and sustain earnings platforms. Nevertheless, expenses have broadly increased because of SEC registration and other regulatory requirements, including those related to risk management. We also expect incremental costs for the FHLBs because of the regulatory reform under way in the U.S., promulgated by the Dodd-Frank Act.

Risk Profile And Management: An Interest-Rate Risk

The FHLBs face manageable credit risk and little funding risk, given the high quality of investments they hold and the secured nature of their other financial assets. Interest-rate risk is the primary risk for the FHLBs, and they have managed it satisfactorily except in the cases of a few individual FHLBs. Each FHLB sets its own policies and procedures to evaluate, manage and control risks, but within regulatory limits that apply to the system as a whole.

Credit risk

At each of the 12 FHLbs, there is a concentration of advances to a relatively small number of member institutions, usually the largest member institutions. In most districts, the top-five borrowers hold about 50% of the advances. (The lowest top-five concentration is the FHLB of Boston with 33%; the highest is the FHLB of San Francisco with 78%.) Still, the secured nature of the FHLBs' lending and their ability to require appropriate capital when advances are made and keep it until advances are repaid substantially mitigate concentration risk.

Advances to member institutions are adequately collateralized, and as of March 31, 2011, the FHLBs had rights to collateral with an estimated value greater than the related outstanding advances. Each FHLB monitors its member institution's financial condition and manages its collateral guidelines, advance rates, and security agreements by borrower to further mitigate credit risk. Furthermore, any security interest that any depository member institution grants to an FHLB generally has priority over the claims and rights of any other party, including depositors. Repayment or assumption of advances has not yet occurred or been relied on in any insurance company failure or sale. Given those factors, no FHLB has ever taken a credit loss on any member loan, including advances to failed member institutions, and losses on advances to member institutions is unlikely to occur.

The FHLBs' securities portfolios were designed to serve as a fundamental source of balance-sheet liquidity and to support interest-rate risk-management efforts. However, in reaching for yield, some of the FHLBs increased the credit risk in their investment portfolios by adding private-label RMBS backed by Alt-A and subprime mortgages.

Another aspect of credit risk is counterparty credit related to derivatives. Each FHLB conducts its own derivatives portfolio and generally limits counterparties to high-credit-quality entities. The FHLBs closely monitor counterparty credit risk activities through credit analysis, collateral requirements, and other credit enhancements and are required to follow the requirements set forth by applicable regulation. Most FHLBs have tightened unsecured limits within counterparty agreements. Regulations are currently under consideration related to derivatives provisions of the Dodd-Frank Act that would essentially remove any unsecured exposure on derivatives and require more intensive collateral management for margin.

Market risk

In general, the FHLBs pursue matched asset-liability management. The FHLB System's access to the debt markets helps facilitate that because the FHLB System can raise money at a wide variety of maturities. The FHLB's MBS investment portfolios, however, introduce a degree of interest-rate risk because of their indeterminate maturities, as do the FHLBs' purchased mortgage loan portfolios because of prepayment uncertainties. The individual FHLBs use derivatives primarily to lower funding costs as part of their interest-rate risk management. The FHLBs are purchasing fewer mortgages and therefore reducing their need for a complex hedging book and operation. In the past, the mortgage loan portfolio dynamics at the FHLB of Chicago and the FHLB of Seattle created hedging challenges that they were ill-equipped to manage. But each has ceased acquiring new mortgage loans, and we expect hedging-related earnings volatility to decrease over time. Volatility in earnings has been muted during the past few quarters because interest rates have remained at historic lows for an extended period of time, but we expect it to resume when rates begin to increase.

Although each FHLB's portfolio is distinct, the combined FHLB System had investments of $328 billion (39% of total system assets) as of March 31, 2011, including about $35 billion of private-label RMBS ($43 billion unpaid principal balances). During first-quarter 2011, the FHLBs recognized $127 million of combined OTTI charges related to private-label RMBS and home-equity loan investments and $148 million was reclassified from AOCI, resulting in net OTTI losses in earnings of $275 million. The securities producing most of the OTTI charges were substantially all rated 'AAA' at the time of purchase.

We expect some further increase in credit losses in the private-label RMBS, especially if residential mortgage values continue to decline and foreclosures deteriorate. However, the credit losses that we believe will be realized are not material or significant relative to the capital bases of most of the individual FHLBs, excluding the FHLBs of Boston, Seattle, and San Francisco. We expect the FHLB System's combined capitalization to remain satisfactory.

In 2009, the FHLB System developed a uniform framework for completing their OTTI analyses in accordance with Financial Accounting Standards Board guidance on the recognition and presentation of OTTI in the financial statements. That implementation provides greater consistency among the 12 FHLBs regarding OTTI analysis, including the calculation of any expected credit losses for impaired securities.

Funding and liquidity risk

The FHLB System relies heavily on capital markets for its funding, typically the issuance of consolidated obligations. The 12 FHLBs are jointly and severally responsible for the consolidated obligations, issued through the Office of Finance. The FHFA, at its discretion, may require any FHLB to make the principal or interest payments due on any other FHLB's consolidated obligations, even in the absence of a default of the primary obligor. The consolidated obligations, as GSE debt, are favorably priced, typically at small spreads to U.S. Treasury debt. That access to favorably priced funding is one of the FHLB System's major strengths. In addition, each of the FHLBs takes deposits from its member institutions, though those account for a relatively small proportion of funding.

The FHLBs maintain ample liquidity in their investment portfolios, even though the FHLBs with unrealized losses cannot readily liquidate their held-to-maturity portfolios. During first-quarter 2011, the FHLBs of Atlanta, Pittsburgh, San Francisco, and Seattle transferred all or certain private-label RMBS that had credit-related OTTI to their available-for-sale portfolios from held-to-maturity classification. This transfer increases financial flexibility and allows management the option to sell the securities, though we recognize management's intent to hold them indefinitely.

FHFA regulations stipulate minimum liquidity levels and tightly restrict eligible investments. The FHLBs' principal investments are MBS, federal funds sold, GSE securities, certificates of deposits and commercial paper. Investments rose to 39% of combined assets as of March 31, 2011, from 32% a year earlier as advances continued to decline year over year.

Profitability: Relatively Weak Year-Over-Year Improvement

Profitability at the FHLBs has improved year over year but appears weak when compared with non-GRE financial institutions. On a return-on-assets (ROA) basis, the FHLB's ROA ranged between (0.10)% - 0.28%, with an average ROA of 0.17% as of March 31, 2011. For non-GREs/commercial banks, we view 1% as a reasonable earnings benchmark in a normal economic environment. Nevertheless, we expect profitability to remain acceptable on a risk-adjusted basis given the FHLBs' low expenses, advantageous funding costs, and tax-exempt status. As cooperatives, the FHLBs strive to provide its services at a reasonable cost that does not maximize profitability.

The FHLB System's cost of funds is very favorable and reflects its GRE status and its ability to raise funds at a small spread over U.S. Treasury rates. Member institutions benefit in the form of dividends on their investment, as well as low funding costs on advances. Thus, profitability margins remain thin, even when demand for advances is strong. The aggregate net interest margin remained at 0.49% as of March 31, 2011—flat compared with last year.

Apart from their core lending activities, the FHLBs also earn a small spread on their non-MBS investment portfolios. Investing in MBS normally generates wider margins, but FHFA rules limit the amount of each FHLB's MBS investment portfolio to 300% of its capital. As of March 31, 2011, the FHLBs of Dallas, Des Moines, and Topeka had MBS holdings in excess of the current limit and are not allowed to make additional investments in MBS until their respective MBS ratio declines below 300%. They exceeded that limit when the FHFA temporarily increased the limit to 600% between 2008 and 2010.

Mortgage loans held for portfolio also contributed substantially to earnings when the associated hedging strategy was effectively implemented, but weakened earnings when this strategy was ineffectively implemented. Now that management at some of the FHLBs is de-emphasizing direct mortgage loan purchases, at least in the near term, we expect lower contributions to those FHLBs' earnings streams, particularly for the FHLB of Chicago and the FHLB of Seattle as their mortgage loans held for portfolios wind down.

Normal operating costs tend to be very low, but there has been some increase across the FHLBs because of higher technology investment for financial and regulatory reporting. Although the FHLBs benefit from their income-tax exemption, earnings are penalized by AHP- and REFCORP-related assessments. AHP supports members' affordable housing programs, and REFCORP was created in 1989 to raise approximately $30 billion to resolve thrift insolvencies. The REFCORP assessment is expected to be satisfied during 2011. In anticipation of satisfying the REFCORP obligation, all 12 FHLBs have entered into a JCE Agreement. The agreement stipulates that each FHLB will, on a quarterly basis, allocate at least 20% of its net income to a separate RRE account to build its total RRE to 1% of its total outstanding consolidated obligations. That agreement begins upon the satisfaction of the FHLB's obligation to REFCORP and will help build capital at the banks.

The combined FHLB System profitability for first-quarter 2011 increased to $358 million, from $325 million during first-quarter 2010. The increase was in part due to $130 million net gain on derivatives and hedging activities, which can be volatile, compared with last year's net losses, offset by a decrease in net-interest income. The FHLB System recorded $275 million in net OTTI charges related to private-label RMBS investments, an 18% increase from last year. The FHLB of Seattle was the only bank to have a first-quarter loss, which was primarily related to credit-related OTTI charges, as well as lower net interest income.

We expect profitability to remain pressured as both funding costs and asset yields remain low and advance demand remains muted. We expect economic expansion to be slow, so advance demand will likely continue declining into 2012.

Capital: Flexibility In Preserving Money

Capital adequacy is different for an FHLB than for other financial institutions, and it expands and contracts with members' borrowing needs. Current and former member institutions own FHLB stock, which cannot be publicly traded. We view favorably the flexibility an FHLB has in preserving its capital. An FHLB can exercise judgment to suspend or eliminate dividend payments and to repurchase excess stock from members at any time.

FHLB stock can be issued, redeemed, or repurchased only at its stated par value of $100 per share. We believe there could be significant implications for the integrity of the FHLB System if any of the FHLBs ever suffered losses that caused members of that FHLB to record impairments on their FHLB stock investments. An FHLB is not permitted to redeem shares if doing so would cause its capital to fall below minimum required regulatory levels. If a member institution exits the FHLB system, the FHLB must redeem its stock subject to any applicable redemption period, which is five years for most FHLB stock. There is some correlation between redemption requirements triggered by member institutions exiting the FHLB System—or where a member institution's lower advance activity creates excess stock—and asset levels at the FHLB.

Excess stock is capital stock a member institution holds above its initial purchase requirement. According to a 2006 FHFA rule, an FHLB is prohibited from issuing additional stock to its members if the amount of existing excess stock is more than 1% of the FHLB's total assets. The rule prevents FHLBs that exceed that threshold from paying stock dividends to members. As of March 31, 2011, the FHLBs of Atlanta, Boston, Chicago, Cincinnati, Indianapolis, Pittsburgh, San Francisco, and Seattle had excess stock outstanding greater than 1% of total assets. The FHLBs were in compliance with excess-stock rules.

Excess stock lacks some characteristics usually associated with permanent equity capital because of the redeemable nature of the common share. Nevertheless, some FHLBs have exercised discretion since mid-2008 by not paying dividends and by returning capital to members more slowly or temporarily prohibiting repurchases of excess shares. The FHLB of Boston paid dividends during the first of quarter 2011 for the first time since the fourth quarter of 2008 but still has a suspension on excess stock repurchase. The FHLB of Pittsburgh executed partial repurchases of excess capital stock in 2010 and first quarter 2011. The FHLB of San Francisco did not fully repurchase excess stock in 2010 and first-quarter 2011, but did pay dividends in 2010 and first-quarter 2011. The FHLB of Seattle is currently classified as undercapitalized and is restricted from redeeming or repurchasing capital stock or paying dividends without FHFA approval. In addition, the FHFA must approve the FHLB of Chicago's dividend declarations and capital stock repurchases according to its 2008 Consent Cease and Desist Order amendment.

We perceive a significant difference in the quality of equity between any one FHLB's paid-in capital (which may be redeemed) and its respective retained earnings. Retained earnings typically have been thin. We are concerned that at three of the FHLBs of Boston, San Francisco, and Seattle, the level of unrealized losses is approaching or may exceed the retained earnings of these FHLBs. However, all the FHLBs have been growing retained earnings to provide capital support to their mortgage loan purchase programs and investing portfolios. Through the FHLB's JCE Agreement, the banks will further build their capital base.

The Gramm-Leach-Bliley Act required each FHLB to develop an individualized capital plan to be approved by the Federal Housing Finance Board and subject each FHLB to a minimum capital-to-assets ratio of 4% (i.e., the sum of capital stock, retained earnings, and mandatorily redeemable stock divided by total assets at the end of the period). Only the FHLB of Chicago, which is the only FHLB not to have implemented its new capital plan as of March 31, 2011, has a higher capital-to-asset ratio requirement of 4.76%, at least until it implements its new capital plan. The aggregate capital-to-assets ratio was 6.65% as of March 31, 2011, compared with 6.17% a year earlier. Each FHLB adequately passed the capital-to-assets test as of March 31, 2011.

Related Criteria And Research

- 'AAA' Ratings On Three U.S. Clearinghouses, One CSD, And Select GSEs on Watch Negative After Sovereign Action, July 15, 2011
- United States of America 'AAA/A-1+' Ratings Placed on CreditWatch Negative On Rising Risk Of Policy Stalemate, July 14, 2011
- Outlook on U.S. Financial Institutions GREs Revised To Negative Following Action on Sovereign, April 20, 2011
- Rating Government-Related Entities Methodology And Assumptions, Dec. 9, 2010

Table 1

Committee: Peer Comparison for U.S. Government-Sponsored Entities

	Atlanta	Boston	Chicago	Cincinnati	Dallas	Des Moines	Indianapolis	New York
Rating (as of March 31, 2011)	AAA/Negative/--	AAA/Negative/--	AA+/Stable/--	AAA/Negative/--	AAA/Negative/--	AAA/Negative/--	AAA/Negative/--	AAA/Negative/--
Assets (Mil. $)								
Advances	81,257	25,939	17,893	28,292	21,805	27,963	17,679	75,487
Mortgage loans, Net	1,916	3,165	16,960	7,473	195	7,220	6,469	1,271
Investments, including MBS	39,876	25,907	47,494	32,080	10,546	17,381	19,274	16,855
Other	584	584	1,664	3,481	624	277	479	3,261
Total assets	123,633	55,596	84,011	71,326	33,170	52,841	43,901	96,874
Asset Composition (% Total Assets)								
Advances	65.72	46.66	21.30	39.67	65.74	52.92	40.27	77.92
Mortgage loans	1.55	5.69	20.19	10.48	0.59	13.66	14.74	1.31
Investments, including MBS	32.25	46.60	56.53	44.98	31.79	32.89	43.90	17.40
Other	0.47	1.05	1.98	4.88	1.88	0.52	1.09	3.37
Total assets	10000.00	10000.00	10000.00	10000.00	10000.00	10000.00	10000.00	10000.00
Advance Concentrations: Top-Five Concentrations								
March 31, 2011 *	66.85	33.30	44.00	54.00	37.60	45.00	35.00	57.80
Net Income								
2011 (first quarter)	51	23	26	42	12	26	20	71
2010	278	107	366	164	105	133	111	276
2009	283	(187)	(65)	268	148	146	120	571
2008	254	(116)	(119)	236	79	127	184	259
Return On Average Assets (%)								
2011 (first quarter)	0.16	0.17	0.12	0.24	0.13	0.19	0.18	0.28
2010	0.19	0.17	0.41	0.24	0.20	0.22	0.24	0.25

Table 1

Committee: Peer Comparison for U.S. Government-Sponsored Entities (cont.)								
2009	0.16	(0.27)	(0.07)	0.32	0.21	0.21	0.23	0.45
2008	0.13	(0.14)	(0.13)	0.25	0.11	0.18	0.32	0.22
Duration Gap (In months)								
2011 (first quarter)	(0.2)	1.4	(0.1)	0.1	2.0	(0.3)	(0.7)	(0.4)
2010	(0.2)	1.1	0.0	0.1	2.0	(0.6)	(0.6)	(0.9)
2009	1.8	2.6	1.0	N/A	1.8	1.2	(1.8)	0.1
2008	5.7	(0.7)	(0.3)	(0.2)	2.3	(7.3)	(0.2)	(1.2)
Regulatory Capital Ratio (%)								
2011 (first quarter)	7.24	7.20	5.94	5.43	5.75	5.09	6.17	5.27
2010	6.74	6.83	5.90	5.43	5.19	4.94	6.00	5.30
2009	6.07	6.20	5.11	5.81	4.45	4.57	6.07	5.14
2008	4.29	4.55	4.70	4.48	4.47	4.66	4.75	4.44
PLMBS								
Residential PLMBS - AFS - Amortized Cost	3779	0	102	0	0	0	977	0
OTTI in AOCI	(319)	0	(55)	0	0	0	(188)	0
Gross Unrealized Gains	7	0	29	0	0	0	144	0
Gross Unrealized Losses	(1)	0	(1)	0	0	0	(0)	0
Est. Fair Value	3466	0	75	0	0	0	933	0
Residential PLMBS - HTM - Amortized Cost	4824	2261	2492	70	363	56	606	257
OTTI in AOCI	0	(549)	(580)	0	(57)	0	(6)	(2)
Carrying Value	4824	1711	1912	70	306	56	600	255
Gross Unrealized Gains	40	127	337	1	0	0	6	5
Gross Unrealized Losses	(152)	(87)	(2)	(0)	(17)	(4)	(10)	(1)
Est. Fair Value	4712	1752	2247	71	289	53	596	259
Fair Value PLMBS (AFS & HTM)/Amortized Cost PLMBS	95.06	77.49	89.51	101.56	79.48	93.25	96.58	100.69
Capital (Mil. $)								
Total Regulatory Capital	8,954	4,022	4,988	3,872	1,908	2,689	2,710	5,106
Required Risk-based capital	2,279	1,199	3,999	450	404	834	927	549

Table 1

Committee: Peer Comparison for U.S. Government-Sponsored Entities (cont.)								
Excess over risk-based capital	6,675	2,823	989	3,421	1,504	1,855	1,783	4,558
Excess Stock	3,100	2,029	1,464	1,263	211	52	1,200	-
MRCS	531	107	531	331	18	7	658	59
OTTI - Credit								
2011 YTD	(52)	(31)	(20)	-	(1)	-	(18)	(0)
2010	(143)	(85)	(163)	-	(3)	-	(70)	(8)
2009	(316)	(444)	(437)	-	(4)	-	(60)	(21)
2008	(186)	(382)	(292)	-	-	-	-	-
Total Impairment								
2011 YTD	(25)	(7)	-	N/A	-	-	(3)	0
2010	(200)	(49)	(42)	-	(17)	-	(24)	(5)
2009	(1,306)	(1,329)	(1,404)	-	(80)	-	(413)	(141)
2008	(186)	(382)	(292)	-	-	-	-	-
Credit OTTI / Total Impairment								
2011 YTD	208.00	450.63	N/A	N/A	N/A	N/A	618.47	N/A
2010	71.50	173.09	388.10	N/A	14.85	N/A	292.12	164.73
2009	24.20	33.41	31.13	N/A	5.03	N/A	14.53	14.89
2008	100.00	99.93	100.00	N/A	N/A	N/A	N/A	N/A
Retained Earnings								
2011 YTD	1,160	270	1,125	445	462	565	437	716.65
2010	1,124	249	1,099	438	452	556	428	712
2009	873	142	708	412	356	484	349	689
2008	435	(20)	540	326	216	382	283	383
OTTI In AOCI								
2011 YTD	(319)	(550)	(606)	(0)	(57)	-	(50.3)	(89)
2010	(396)	(622)	(664)	-	(63)	-	(75.9)	(93)
2009	(739)	(929)	(978)	(0)	(67)	-	(324)	(111)
2008	-	-	-	-	-	-	-	-
OTTI In AOCI / Retained Earn (%)								
2011 YTD	27.50	203.95	53.87	0.00	12.40	0.00	11.51	12.46
2010	35.23	249.42	60.42	0.00	13.99	0.00	17.74	13.05
2009	84.67	654.23	138.14	0.10	18.69	0.00	92.84	16.11
2008	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Miscellaneous								
Members in 2011	N/A	457	761	739	913	1211	407	335
Members in 2010	1,110	459	775	735	918	1,219	410	336
Members in 2009	1,195	462	792	735	923	1,226	417	331
Members in 2008	1,238	461	816	728	923	1,245	424	311

Table 1

Committee: Peer Comparison for U.S. Government-Sponsored Entities (cont.)								
Member failures in 2011	10	N/A	5	0	0	1	N/A	1
Member failures in 2010	57	N/A	16	1	4	5	0	5
Member failures in 2009	44	N/A	19	2	5	10	5	1
Member failures in 2008	7	N/A	0	0	3	0	0	0
Actual Leverage Capital Ratio vs. a minimum req of 5%***	10.90	10.90	N/A	8.10	8.60	7.60	9.30	7.90

Information is as of March, 2011 unless otherwise indicated. *Capital includes mandatorily redeemable capital stock, excludes AOCI. **As of quarter end March 31, 2011. Atlanta is for top-10 exposures. Indianapolis is for top-three exposures. Cincinnati is for top-four. *** Excludes the FHLBank of Chicago, which had not implemented a new capital plan as of March 31, 2011, but was in compliance with all its minimum regulatory capital requirements.

Ratings Detail (As Of July 19, 2011)*	
Federal Home Loan Banks	
Senior Unsecured (5437 Issues)	AAA/Watch Neg
Senior Unsecured (1 Issue)	AAA/A-1+
Short-Term Debt (1 Issue)	A-1+
Sovereign Rating	
United States of America (Unsolicited Ratings)	AAA/Watch Neg/A-1+
Related Entities	
Federal Home Loan Bank of Atlanta	
Issuer Credit Rating	AAA/Watch Neg/A-1+
LOC Evaluation (0 Issues)	AAA/A-1+
Federal Home Loan Bank of Boston	
Issuer Credit Rating	AAA/Watch Neg/A-1+
LOC Evaluation (0 Issues)	AAA/A-1+
Federal Home Loan Bank of Chicago	
Issuer Credit Rating	AA+/Stable/A-1+
Subordinated (1 Issue)	AA-
LOC Evaluation (0 Issues)	AA/A-1+
Federal Home Loan Bank of Cincinnati	
Issuer Credit Rating	AAA/Watch Neg/A-1+
Federal Home Loan Bank of Dallas	
Issuer Credit Rating	AAA/Watch Neg/A-1+
Federal Home Loan Bank of Des Moines	
Issuer Credit Rating	AAA/Watch Neg/A-1+
Federal Home Loan Bank of Indianapolis	
Issuer Credit Rating	AAA/Watch Neg/A-1+
LOC Evaluation (0 Issues)	AAA/A-1+
Federal Home Loan Bank of New York	
Issuer Credit Rating	AAA/Watch Neg/A-1+
LOC Evaluation (0 Issues)	AAA/A-1+

Ratings Detail (As Of July 19, 2011)***(cont.)**	
Federal Home Loan Bank of Pittsburgh	
Issuer Credit Rating	AAA/Watch Neg/A-1+
Federal Home Loan Bank of San Francisco	
Issuer Credit Rating	AAA/Watch Neg/A-1+
LOC Evaluation (0 Issues)	AAA/A-1+
Federal Home Loan Bank of Seattle	
Issuer Credit Rating	AA+/Negative/A-1+
LOC Evaluation (0 Issues)	AA+/A-1+
Federal Home Loan Bank of Topeka	
Issuer Credit Rating	AAA/Watch Neg/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.