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December 16, 2010

Industry Report Card:

U.S. Federal Home Loan Banks Turned Good Profits On Smaller Balance Sheets In Third-Quarter 2010

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Industry Credit Outlook

The Federal Home Loan Bank System achieved another successful quarter in third-quarter 2010. All 12 regional member banks were profitable despite their continuing, though orderly, balance-sheet contraction--almost entirely because of lower loan advances. In light of the current weak economic situation and somewhat volatile investment markets, member banks remain flush with deposits as a "safe haven" and are experiencing only isolated pockets of loan demand. Until economic growth shows some strength and sustainability, Standard & Poor's Ratings Services believes the Federal Home Loan Banks (FHLBs) will linger at much smaller sizes than their highs before the 2008 financial crisis.

Cooperative ownership and statutory design enables FHLB system banks to focus on safely providing liquidity to U.S. housing-market participants. It has done this and continues to do so. Although we question the level of redundancy in the FHLB system where the individual bank business models are largely consistent, it remains a critical source of liquidity, especially for smaller member banks that lack or have limited debt-market access.

We are monitoring the FHLBs' private-label securities portfolios, which are still experiencing credit-related impairments. Currently, we believe these impairments are manageable, especially because the recorded impairments represent incremental deterioration of already-impaired securities. Almost no new securities are becoming impaired as economic weakness persists.

The Federal Home Loan Bank System reported combined net income for third-quarter 2010 of $732 million, more than double the $326 million in second-quarter 2010 and a significant improvement from a combined net loss of $165 million in third-quarter 2009. Each of the 12 FHLB system banks reported positive net income in third-quarter 2010. The improvement was generally a result of a significant reduction in other-than-temporary impairment (OTTI) losses, in contrast with last year, when five FHLB system banks reported losses due to significant OTTI charges in their respective investment portfolios. Overall, however, the System's operating performance is in line with our expectations.

As we expected, the FHLB system banks' total assets continued to decline sequentially. Assets were down 3.5% from the second quarter to $904 billion, and declined 11% from the $1.016 trillion on the books at year-end 2009. The FHLB system banks' balance sheets have contracted primarily because member banks have paid down their advances with excess deposit liquidity as loan demand has fallen and have taken advantage of the more efficient alternative funding sources that have emerged. Advances were down more than 7% in third-quarter 2010 from the second quarter. Indeed, total advances have fallen to slightly less than $500 billion--the lowest point since 2002. We believe System contraction might continue until a healthy U.S. economic expansion begins and member banks' need for advances responds to a higher demand for loans.

Even with currently low advance balances, the System remains healthy and continues to serve its primary purpose of providing liquidity to participants in the U.S. housing market. This was most evident during the low point in the most recent downturn, in October 2008, when liquidity became scarce and advances peaked at approximately $1 trillion. Now that member banks have an abundance of liquidity on their balance sheets, they have a generally lower need for advances. The FHLB System expands and contracts by design: capital builds up with growth in advances and shrinks with the decline in advances.

Our main area of concern and monitoring continues to be in the individual FHLB system banks' private-label residential mortgage-backed securities (RMBS) portfolios. FHLB system banks reported additional credit-related OTTI charges in third-quarter 2010. Private-label RMBS securities of $39.2 billion represented only about 4.3% of total system assets on Sept. 30.

The FHLBs recognized $178 million of credit-related OTTI charges on these securities in third-quarter 2010, a marked improvement from the $495 million it recognized in the second quarter. Notably, FHLB-Chicago accounted for $76 million of these OTTI charges (43% of the System total) in the third quarter. FHLB-Atlanta transferred all private-label RMBS on which it had recorded credit-related OTTI in this period to its available-for-sale (AFS) portfolio from its held-to-maturity (HTM) portfolio. FHLB-Seattle elected to transfer only certain private-label RMBS from its HTM portfolio to its AFS portfolio. FHLB-Atlanta and FHLB-Seattle did this because of a significant decline in the performance of their securities portfolios, but neither FHLB currently plans to sell these securities.

In our view, private-label RMBS portfolios could experience further significant but manageable OTTI, especially in bonds that prime mortgages support. Prime bonds saw the greatest deterioration in 2010, similar to the portfolio experience of the other government-sponsored enterprises (GSEs) supporting housing--Fannie Mae and Freddie Mac. In 2009, Alt-A loans performed the worst. Overall, the 2005-2008 bonds are the worst-performing RMBS and collateral by vintage. High unemployment continued, with the November 2010 rate rising to 9.8%, its highest level in the past seven months. We expect high home inventories and low sales volumes in a persistently weak economy to pressure home values further. These three stubborn conditions may continue to influence the performance of the mortgages underlying private-label RMBS for the next one to three years.

System capital remained stronger than it had been before the financial crisis, as balance-sheet contraction exceeded the pace of capital returned to members. We expect this to continue because individual FHLB management teams have discretion as to how quickly to return capital through redeemable stock repurchases and dividends to member banks. As of Sept. 30, 2010, total regulatory capital had decreased 2.9% since year-end 2009 to $58.4 billion. At the same time, capital under generally accepted accounting principles (GAAP) increased 3.6% to $44.3 billion. The combined regulatory capital ratio was 6.47%, up from 5.92% at year-end 2009, and was 4.4% to 9.8% among FHLB system banks. GAAP capital increased on a $2.1 billion improvement in accumulated other comprehensive income. Of this, $1.9 billion is due to continuing credit market improvements in the third quarter. These improvements reduced the noncredit portion of impaired losses on securities. We believe the FHLB system banks will continue to focus on increasing its retained earnings as a loss-absorbing form of capital.

Each of the 12 FHLB system banks was in compliance with regulatory capital ratios, including FHLB-Chicago, which must keep higher minimum capital according to a 2007 cease-and-desist order issued by its regulator, the Federal Housing Finance Agency (FHFA). After third-quarter 2010, however, FHLB-Seattle entered into a consent order with the FHFA. This sets forth requirements for improving capital management, asset composition, and other operational and risk management. The FHFA continues to deem FHLB-Seattle undercapitalized.

We will also continue to follow how the housing GSE resolution will affect the future of the FHLB System. Despite speculation as to the future of the FHLBs under housing reform, we believe that the System has served and continues to serve its purpose effectively. As part of the ongoing reform, the FHFA recently proposed a rule enabling voluntary mergers of FHLBs. Although it does not specifically encourage mergers, the proposed rule offers a roadmap for how to proceed should interest exist. The 12 FHLB system banks serve a common public purpose of enhancing the availability of credit to their member institutions. The individual FHLB business models are largely consistent with one another, even though some focus more on securities portfolios and some on mortgages, while some remain plain-vanilla FHLBs offering advances and operational services to members. We believe some consolidation among FHLBs could help with capital management and efficiency, and that this would make the surviving FHLBs stronger.

Issuer Review

Table 1

Company/Issuer Credit Rating*/Comments	Analyst
Federal Home Loan Bank of Atlanta (AAA/Stable/A-1+) FHLB Atlanta posted modest third-quarter results, with net income of $74 million, compared with $75 million in the prior quarter. The bank recognized credit-related other-than-temporary impairment (OTTI) losses of $14 million (down from $72 million in the prior quarter) related to its private-label mortgage-backed securities (MBS) portfolio. Advances remained relatively stable at $99.4 billion despite reduced loan demand from the member banks. The bank's capital stock declined to $7.5 billion from $8.1 billion on Dec. 31, 2009, as it repurchased $507 million of excess activity-based capital stock. Nevertheless, capital metrics remained strong with a regulatory capital-to-assets ratio of 6.38%. Further credit-related OTTI losses may continue to burden the bank's profitability for the next few quarters.	Daniel Teclaw
Federal Home Loan Bank of Boston (AAA/Stable/A-1+) FHLB-Boston reported decent third-quarter results, as net income improved to $41.3 million from $18.7 million in the linked quarter. Earnings benefited from sequentially lower credit-related OTTI charges of $5.9 million on its private-label MBS, partially offset by a $5.7 million increase in REFCorp assessments. Net interest income (NII) remained essentially unchanged at $75.3 million and the corresponding net interest margin (NIM) was relatively flat, widening 2 basis points (bps) to 0.48%. Advances continued to recede, declining 16% from the previous quarter to $30.2 billion. This was due to subdued credit demand and strong deposit growth at member institutions. We expect advance balances to continue to decline until economic activity prompts members' demand for advances. Capital levels remain satisfactory, with the regulatory capital-to-assets ratio at 6.4%. We believe that the bank's large exposure to private-label MBS could result in further credit losses, but we expect any potential losses to be manageable.	Sunsierre Newsome
Federal Home Loan Bank of Chicago (AA+/Stable/A-1+) FHLB Chicago posted stable third-quarter results, with a net income of $117 million, compared with $116 million in the prior quarter, and a loss of $150 million in the year-ago quarter. The quarterly improvement in earnings was attributable to higher NII and a $62 million gain on derivatives and hedging activities (compared with $29 million in the linked quarter), but was constrained by $76 million of credit-related OTTI charges on the bank's private-label MBS. Credit provisions increased by $4 million to $9 million, while the NIM expanded 9 bps sequentially to 0.97%. Advances continued to decline, falling 11.4% from the prior quarter to $18.8 billion, due to member banks' repayment of advances, reduced borrowing needs, and strong deposit growth. The bank remained in compliance with all its regulatory capital requirements. We expect further credit-related OTTI losses to continue to burden the bank's profitability for the next few quarters.	Daniel Teclaw
Federal Home Loan Bank of Cincinnati (AAA/Stable/A-1+) FHLB-Cincinnati reported reasonable third-quarter results, with net income of $37 million compared to $41 million in the previous quarter. Earnings reflected lower NII and a $4 million loan-loss provision for its mortgage loans. NII fell 6% to $60 million, while NIM declined 2 bps to 0.36%, as lower asset yields--particularly from the $27.4 billion (up $5.4 billion from second quarter) investment portfolio--offset the benefit of low funding costs. Advances continued to ebb, declining 16% year to date to $29.5 billion, reflecting member banks' repayments, low loan demand, and high deposit levels. We expect demand for advances to remain low due primarily to member banks' continuing availability of more attractively priced sources of funding and/or liquidity with lower collateral requirements. Capital is adequate, with a regulatory capital-to-assets ratio of 5.88%. We expect profitability to remain stable relative to system peers, because of negligible exposure to risky private-label MBS.	Daniel Teclaw
Federal Home Loan Bank of Dallas (AAA/Stable/A-1+) FHLB-Dallas posted average third-quarter results, with net income of $27.4 million, compared with $39 million in the prior quarter. The decline in earnings primarily resulted from a $13.7 million drop in NII as advances to members decreased significantly by 34%,	Daniel Teclaw

driven mainly by lower outstanding advances to the company's two largest borrowers. During the third quarter, advances outstanding to those two borrowers decreased by $13.8 billion, $12.3 billion of which was prepaid given lack of member loan demand. The company's credit-related OTTI charges on certain investments in nonagency residential MBS dropped to $379,000 from $1.1 million in the previous quarter. Capital levels remain adequate on a risk-weighted basis with a contracting balance sheet, with a total capital-to-assets ratio of 4.40%. We expect the bank to continue to focus on its operating performance and maintain its strong financial profile.

Federal Home Loan Bank of Des Moines (AAA/Stable/A-1+) FHLB-Des Moines posted good third-quarter results, with net income of $39.6 million, compared with $13.2 million in the previous quarter. The rise in earnings was primarily due to a $131 million increase in NII, partly offset by $99 million increase in other losses. NII increased mainly due to advance prepayment fee income, with one member prepaying approximately $1.1 billion of advances. The company utilized the prepayment fees to extinguish certain bonds, resulting in a rise in other losses. Total advances were relatively flat from June at $32 billion. The mortgage portfolio remained stable, representing 12.6% of total assets. The bank's private-label MBS portfolio represented only 0.2% of its total investment portfolio of $20.2 billion. This portfolio was performing and no OTTI losses were recorded. Capital metrics were adequate, with a total regulatory capital-to-assets ratio of 4.71%. We expect the bank to maintain its decent financial performance with negligible investments in private-label mortgage securities.	Daniel Teclaw
Federal Home Loan Bank of Indianapolis (AAA/Stable/A-1+) FHLB-Indianapolis reported substantially improved third-quarter results, with net income of $50.8 million, compared with a net loss of $12.9 million in the previous quarter. Earnings benefited from a 46.6% improvement in NII to $82.2 million, and significantly lower net OTTI charges of $0.6 million on private-label MBS, compared with $61.7 million in the previous quarter. Advances continued to decline, falling 15.7% year to date and 5.4% sequentially to $18.9 billion. We expect advances to continue to fall as members' excess liquidity, resulting from increased deposits, reduces demand for FHLB funding. Securities investments increased to $19.2 billion, forming 43% of total assets. Capital remains adequate, with a regulatory capital-to-assets ratio of 6.49%. We expect earnings to remain modest next quarter and for any lingering troubles in the private-label MBS portfolio to be manageable.	Sunsierre Newsome
Federal Home Loan Bank of New York (AAA/Stable/A-1+) FHLB-NY reported net income of $78.8 million, down 44% from the year-ago quarter, but an improvement from the linked quarter's $56.7 million. The bank benefitted from gains on its derivatives and hedging activities, but NII declined due to modest spread compression. The bank recorded a $3.1 million credit-related OTTI loss on its private-label MBS. Advance levels continued to recede, declining 9.2% to $85.7 billion on Sept. 30, 2010, from Dec. 31, 2009. This continues to reflect the member banks' reduced borrowing needs, an increased deposit base, and additional funding and liquidity options being available to the member banks. We think the bank remains sufficiently capitalized. It boosted its retained earnings to $701.2 million from $688.9 million at year-end 2009.	Matthew Albrecht
Federal Home Loan Bank of Pittsburgh (AAA/Stable/A-1+) FHLB Pittsburgh reported net income of $45.1 million for third-quarter 2010, versus a net loss of $40.4 million in the prior year's quarter. Earnings improved because of significantly lower OTTI credit charges on the bank's private-label MBS portfolio, as well as gains from the sale of certain securities from its private-label MBS portfolio. The balance sheet continued to shrink, as assets fell 15.5% from year-end 2009 to $55.1 billion on Sept. 30, 2010. Advances declined 23.3% to $31.6 billion during the same period, reflecting members' reduced borrowing needs and an increased deposit base. The bank remained in compliance with all its regulatory capital requirements. The bank has announced it will buy back approximately $200 million of excess capital stock from members, but will not yet begin paying dividends. We expect the bank's private-label MBS portfolio to continue to challenge its modest profitability.	Matthew Albrecht
Federal Home Loan Bank of San Francisco (AAA/Stable/A-1+) FHLB-San Francisco posted strong third-quarter results, with net income of $137 million, substantially up from the linked quarter, and rebounding from an $85 million loss in the year-ago quarter. The improved earnings were driven by lower OTTI credit charges and net losses associated with derivatives and hedging activities. FHLB San Francisco's balance sheet continued to shrink, as its assets fell 26% from year-end 2009 to $142.7 billion on Sept. 30, 2010. Advances also declined 33% to $89.3 billion in the same period. As of Sept. 30, 2010, the bank met all its regulatory capital requirements, with the total regulatory capital ratio at a solid 9.8%. Given its surplus capital position, the bank repurchased approximately $500 million in excess capital stock. We expect the bank to refrain from any large-scale share buyback, while its private-label MBS portfolio continues to constrain its profitability.	Matthew Albrecht
Federal Home Loan Bank of Seattle (AA+/Negative/A-1+) FHLB-Seattle posted improved third-quarter results, with total net income of $9.7 million during the quarter versus a $93.8 million loss a year ago, largely due to lower charges on private-label MBS. Hedging gains of $8.1 million during the quarter also boosted net income. Advances are down $6.8 billion year to date to $15.4 billion, reflecting maturities and softer demand. The FHLB continues to classify the bank as "undercapitalized," though its capital-to-assets ratio of 5.76% was higher than the regulatory minimum. We believe the bank's regulatory capital ($2.9 billion) remains vulnerable to possible additional credit losses. The bank has agreed to a consent order, under which it must meet financial thresholds by the filing of June 30, 2011, financial statements. Assuming the bank has met those thresholds, it may begin repurchasing member stock at par at that time.	Matthew Albrecht

Federal Home Loan Bank of Topeka (AAA/Stable/A-1+) FHLB-Topeka reported decent third-quarter results, with net income of $21.6 million compared with net income of $10.1 million in the second quarter. This was primarily on account of lower derivatives and hedging losses of $52.6 million, relative to second-quarter losses of $94.2 million. Trading securities gains of $26.8 million buttressed quarterly earnings. NII declined 20% in the third quarter to $57.1 million due to lower prepayment fees on terminated advances in relation to the second quarter. Furthermore, advances declined to $20.5 billion, hurt by the still-sluggish demand for loans by member institutions. Capital was adequate, with the regulatory capital-to-assets ratio at 4.8%, above regulatory guidelines. We expect FHLB-Topeka to maintain its good financial profile, given its comprehensive and conservative governing policies and management's intention to maintain them.	Sunsierre Newsome

*Ratings are as of Dec. 12, 2010.

Quarterly Rating Activity

Table 2

Recent Rating/Outlook/CreditWatch Actions*

Issuer	To	From	Date	Reason
Federal Home Loan Bank of Seattle	AA+/Negative/A-1+	AA+/Stable/A-1+	7/2/2010	Uncertainty about FHLB Seattle's ability to maintain capital adequacy given the potential for additional deterioration in its private-label MBS portfolio.

*Actions taken since the last report card, dated April 14, 2010.

Contact Information

Table 3

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