MOODY'S INVESTORS SERVICE

Credit Opinion: Federal Home Loan Banks

Global Credit Research - 05 Aug 2011

Reston, Virginia, United States

Ratings

Category	Moody's Rating
Outlook	Negative
Senior Unsecured	Aaa
Other Short Term	P-1

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Key Indicators

Federal Home Loan Banks

	[1]2011	2010	2009	2008	2007
ROAA (%)	0.17	0.31	0.16	0.09	0.25
ROAE (%)	3.29	6.38	3.95	2.17	6.01
Net Interest Margin (%)	0.49	0.56	0.46	0.40	0.42
Advances ($bil)	445.1	478.6	631.2	928.6	875.1
Investments ($bil)	328.5	330.5	284.3	305.9	297.1
Assets ($bil)	848.7	878.1	1,015.6	1,349.1	1,271.8
Equity ($bil)	44.8	43.7	42.8	51.4	53.6
Liquid Assets/ST Debt (%)	70.84	64.87	49.11	29.98	31.54

[1] As of March 31.

Opinion

SUMMARY RATING RATIONALE

The ratings of the FHLBanks reflect the combination of the following elements: 1) a baseline credit assessment (BCA) of 5, which is on a scale of 1 to 21, where 1 represents the lowest credit risk, 2) Aaa U.S. Government bond rating, 3) high dependence between the FHLBanks and the U.S. Government, and 4) high support between the two.

On August 2, 2011, as a result of confirming the U.S. government's Aaa debt rating with a negative outlook, Moody's confirmed the Aaa long-term deposit ratings of all of the FHLBanks as well as the Aaa long-term bond rating of the FHLBank System with a negative outlook. At the same time, Moody's affirmed the Prime-1 short-term deposit ratings of all of the FHLBanks and the Prime-1 short-term bond rating of the FHLBank System.

Any rating actions on the U.S. Government would likely result in all individual FHLBanks' long-term deposit ratings and the FHLBank System long-term bond rating moving in lock step with any U.S. sovereign rating action.

A BCA of 5 is the equivalent of an A1 on Moody's long-term debt rating scale. The BCAs are intended to express an opinion about the institution's intrinsic or stand-alone financial strength and specifically exclude an assessment of the probability of extraordinary support. The FHLBanks' BCA incorporates the joint and several liability of all FHLBank consolidated obligations.

The FHLBank System's BCA reflects its excellent asset quality and consistent risk-adjusted profitability, as well as the benefits associated with the joint and several liability for the FHLBanks' debt. Asset quality remains a core strength of the FHLBank System (System), having never incurred a credit loss on an advance, which represented over 52% of total assets at March 31, 2011. The FHLBank System's profitability reflects the lower risk profile of the System. The System's ROAA has been very stable with a five year standard deviation of 0.07% from year end 2006 through year-end 2010, a very low amount. The FHLBanks' 0.07% five year standard deviation of ROAA compares with a 0.52% five year standard deviation of ROAA for all US Aa-rated banks though the FHLBank System's ROAA of 0.17% at March 31, 2011 is much lower than the 1.33% ROAA of U.S. Aa-rated banks.

Credit Strengths

Credit strengths include:

Joint and several liability reduces default risk of Systemwide liabilities

Central role as liquidity provider for banks and other financial institutions

Asset quality of advance and mortgage products remains excellent

Credit Challenges

Credit challenges include:

Narrow charter and bank consolidation constrain growth and profitability

Substantial borrower concentrations at individual FHLBanks

Material private-label securities portfolio

Recent Developments

Regulatory Developments

The Federal Housing Finance Agency (FHFA), the regulator of the FHLBanks, as well as the U.S. Treasury have expressed support for several regulatory initiatives that would likely reduce the size and importance of the FHLBank System. The recommendations include: (1) limiting member banks to membership in one FHLBank; (2) limiting the level of outstanding advances to individual member banks; and (3) limiting the FHLBanks investment portfolio.

To date, specific regulatory rules have not been proposed by the FHFA. Furthermore, the FHFA has not indicated a time frame in which new regulatory rules might be proposed. Moody's does not expect these regulatory rules to be enacted in the short-term (within one year).

GSE Reform

GSE reform has not progressed very far and Moody's expects very limited progress before the end of 2013, after the next presidential election. To date, the reform is primarily focused on the roles of Fannie Mae and Freddie Mac. However, the FHLBanks are likely to be included in the reform, though the impact remains uncertain. Moody's will monitor GSE reform as it progresses, as well as its impact on the FHLBanks.

U.S. Government Developments

On August 2, 2011, Moody's confirmed the Aaa government bond rating of the United States following the raising of the statutory debt limit on August 21. The rating outlook is now negative.

Moody's placed the rating on review for possible downgrade on July 13 due to the small but rising probability of a default on the government's debt obligations because of a failure to increase the debt limit. The initial increase of the debt limit by $900 billion and the commitment to raise it by a further $1.2-1.5 trillion by yearend have virtually eliminated the risk of such a default, prompting the confirmation of the rating at Aaa.

In confirming the Aaa rating, Moody's also recognized that today's agreement is a first step toward achieving the long-term fiscal consolidation needed to maintain the US government debt metrics within Aaa parameters over the long run. The legislation calls for $917 billion in specific spending cuts over the next decade and established a congressional committee charged with making recommendations for achieving a further $1.5 trillion in deficit reduction over the same time period. In the absence of the committee reaching an agreement, automatic spending cuts of $1.2 trillion would become effective.

In assigning a negative outlook to the rating, Moody's indicated, however, that there would be a risk of downgrade if (1) there is a weakening in fiscal discipline in the coming year; (2) further fiscal consolidation measures are not adopted in 2013; (3) the economic outlook deteriorates significantly; or (4) there is an appreciable rise in the US government's funding costs over and above what is currently expected.

Rating Outlook

On August 2, 2011, as a result of confirming the U.S. government's Aaa debt rating with a negative outlook, Moody's confirmed the Aaa long-term deposit ratings of all of the FHLBanks as well as the Aaa long-term bond rating of the FHLBank System. The outlook is negative. At the same time, Moody's affirmed the Prime-1 short-term deposit ratings of all of the FHLBanks and the Prime-1 short-term bond rating of the FHLBank System.

What Could Change the Rating - Up

An upgrade of the FHLBanks' BCA could occur with more clarity on potential losses from its $35.8 billion private-label MBS portfolio, coupled with strong profitability reflected by a ROAA consistently in excess of 0.5%, a stable member profile and continued strong asset quality.

What Could Change the Rating - Down

Moody's does not expect changes to the senior debt ratings of the FHLBanks, as the FHLBanks' ratings already incorporate an expectation of a very high degree of U.S. Government support, which is a key factor in the FHLBanks' current Aaa senior debt and Prime-1 short-term debt ratings. The importance of the FHLBanks' role as a liquidity provider to U.S. banks throughout the current crisis solidifies this view.

Material declines in capital as a result of OTTI or realized losses on its securities portfolio may lead to a lower BCA.

DETAILED RATING CONSIDERATIONS

The FHLBanks' primary business is lending to member institutions in the form of advances, which are generally short-term and over-collateralized, minimizing the credit risk on these loans. The FHLBanks also purchase mortgage loans through either the Mortgage Partnership Finance® (MPF®) Program or the Mortgage Purchase Program (MPP). The FHLBanks also invest in securities, principally MBS, subject to an investment limit of three times capital without approval by the Federal Housing Finance Agency. Below are the detailed rating factors that influence the System's ratings and outlook.

Baseline Credit Assessment

Profitability

Profitability of the Federal Home Loan Bank System is modest but adequate on a risk-adjusted basis. The System's ROAA as of March 31, 2011 was 0.17%. Its ROAA for year end 2010 was 0.22%, compared to 1.33% for Aa-rated and higher U.S. domiciled banks. Similarly, the System's 0.06% standard deviation of ROAA between 2007 and 1Q11 was much lower than the 0.52% standard deviation for Aa-rated and higher U.S. banks for the period from 2006 to 2010. The lower volatility of the System's earnings is due to the superior credit quality of the FHLBanks' assets, particularly advances and the lower cost structure of the FHLBank System. On a risk-adjusted basis (ROAA % of the five-year standard deviation of ROAA), the FHLBank System's return of 2.64% for 1Q11 exceeded the 2.58% return of US Aa-rated and higher banks for 2010.

Interest Rate Risk Management

The FHLBanks conservatively manage their interest rate risk exposures through the use of debt with similar characteristics as the FHLBanks' assets, as well as derivative contracts. One of the measures the FHLBanks use to gauge their interest rate risk is the change in the duration gap between durations of assets and liabilities. The FHLBanks' interest rate risk exposures are moderate and are not uniform, reflecting different exposures, risk management strategies and asset mix. At March 31, 2011, the FHLBanks' duration gap ranged from a low of -0.7 months (FHLBank of Indianapolis) to a high of 2.0 months (FHLBank of Dallas). In addition to duration measures, FHLBanks utilize value-at-risk measurements as part of their interest rate and market risk management. Growth in MPP and MPF® conforming mortgage programs in the first half of last decade elevated interest rate risks to those FHLBanks particularly active in this line of business. However, as FHLBanks decrease their MPP and MPF® activities, the associated incremental interest rate risk should decline.

Asset Quality and Credit Risk Management

The asset quality of FHLBank advances has been consistently outstanding, and we expect this to continue. To date, no credit loss has ever been incurred on an advance. The FHLBanks' assets consist primarily of advances, investments and mortgage loans purchased from their members. Advances represented approximately 52% of assets at March 31, 2011. The FHLBanks' collateral requirements on advances, and their preferred creditor status, support credit quality in the event a member defaults on its advances. Each FHLBank has sole credit approval power and establishes its own underwriting standards and eligible collateral within Federal Housing Finance Agency guidelines. Eligible collateral includes current first-lien residential mortgages (overwhelmingly single-family) or securities backed by such mortgages, Federal Agency securities, FHLBank deposits and other real estate-related assets approved by the relevant FHLBank's board of directors. Moody's expects the FHLBanks' advance lending activities to increase as many Banks are renewing their focus on this core business line while continuing to shift away from growth strategies that centered on their mortgage purchase programs.

The FHLBanks' investment portfolios consist primarily of MBS securities, chiefly Agency MBS or private-label MBS. Moody's expected loss on the FHLBank System's private-label MBS is manageable as they have already taken approximately $3.7 billion of cumulative credit-related OTTI charges from 2009 through March 31, 2011. Holdings of non-MBS instruments consist of high-quality liquid investments such as commercial paper, federal funds, resale agreements, U.S. Government guaranteed debt and U.S. Treasury securities. Agency and government guaranteed debt purchased in the investment portfolios of the FHLBanks require the highest rating, Aaa, reflecting the System's conservative credit standards. Potential losses on each of the respective FHLBanks' private-label security portfolio represent the most significant credit risk to the FHLBanks, in Moody's view.

The FHLBanks' conforming mortgage loan programs, MPF® and MPP, provide members with an alternative to Fannie Mae and Freddie Mac execution. MPF® and MPP programs grew rapidly since their inception in 1999 through 2004. However, the mortgage asset balance has been declining as several FHLBanks discontinued participation in the programs. At March 31, 2011, mortgage assets comprised 6.9% of System assets, versus 12.4% as of year-end 2004. The FHLBanks' mortgage assets are more susceptible to credit loss and in particular, carry heightened operational complexity relative to the FHLBanks' core lending business. Credit risk performance of MPF® and MPP programs has been very good to date exceeding that of similar programs of Fannie Mae and Freddie Mac. This excellent track record reflects the high quality of mortgage assets purchased into the FHLBanks' MPF® and MPP programs.

Liquidity and Funding

FHLBank funding spreads has tightened considerably since the second half of 2009 resulting in margin expansion as its liabilities re-priced quicker than its assets in a declining rate environment. The FHLBanks' GSE status has provided it with consistent and stable access to the debt market. The FHLBanks internal sources of liquidity are modest. As of March 31, 2011, the FHLBanks had approximately $432.3 billion in short-term debt outstanding, which includes discount notes and bonds maturing within a one year period. In total, short-term debt comprised about 57% of total debt - a very high figure. Liquid assets were approximately 70.8% of short-term debt as of March 31, 2011. Liquid assets include cash, cash equivalents, interest-bearing deposits, federal funds, repurchase agreements, as well as a portfolio of trading, available-for-sale, and held to maturity investment securities less private label mortgage backed securities. These assets are of high quality, with the investment securities portfolio comprised of U.S. Treasury and Agency securities, state and local housing agency obligations and MBS.

The Federal Housing Finance Agency, the regulator of the FHLBanks, requires each FHLBank to maintain sufficient liquidity, through short-term investments, in an amount at least equal to an FHLBank's anticipated cash outflows under two different scenarios. One scenario assumes that an FHLBank cannot access the capital markets for a period of between 10 to 20 days, with initial guidance set at fifteen days and members do not renew any maturing, prepaid and called advances. The second scenario assumes that an FHLBank cannot access the capital markets for a period of between three to seven days, with initial guidance set at five days during which members will automatically renew maturing and called advances for all members except very large, highly rated members. In addition, many FHLBanks maintain a policy of maintaining 90 days of liquidity without access to the capital markets. In Moody's view the new liquidity requirement, as well as the FHLBanks' internal policies are modestly positive.

Other

A significant underpinning of the BCA is the joint and several nature of the FHLBanks' consolidated obligations. The financial strength of individual FHLBanks is very sound, and the joint and several liability contributes to the overall strength of the FHLBank System by narrowing the ratings differences among the individual FHLBanks that could exist were ratings to exclude the joint and several feature. As a result, the ratings of the weakest FHLBanks are increased, and the ratings of the strongest are lowered.