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Federal Home Loan Banks

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Federal Home Loan Banks

Major Rating Factors

None

Strengths:

- Government-related entities (GREs) with a critical public-policy role
- One of the primary liquidity providers to U.S. mortgage market participants, especially in times of stress
- Diverse global investor base that provides ample liquidity at low funding costs across maturities
- Excellent asset quality in the fully collateralized wholesale lending portfolio
- Substantial progress in lowering private-label mortgage-backed securities' (PLMBS) credit-related impairments

Weaknesses:

- Challenges to growth in advances and core mission assets
- Weaker capital than non-GREs
- Exposure to interest rate risk in mortgage and investment portfolios
- Uncertainty related to regulatory changes associated with broader housing finance reform

Rationale

Standard & Poor's Ratings Services' ratings on the senior debt of the Federal Home Loan Banks (FHLB System or System) reflect the FHLB System's status as one of three rated housing government-sponsored entities (GSEs), its important role as a liquidity provider to U.S. mortgage and housing-market participants, its diverse global investor base that provides ample liquidity at low funding costs across maturities, and the pristine aggregate asset quality of its fully collateralized wholesale lending portfolio. The rating on the FHLB System's debt reflects the application of our GRE criteria. Based on our criteria, our rating on the FHLB System's debt is the same as the U.S. sovereign rating because of the almost certain likelihood that the FHLB System would receive government support if needed, in our view.

Under our GRE criteria, the issuer credit ratings on the System Federal Home Loan Banks (or FHLBs) can be one to three notches higher than their stand-alone credit profiles because, in our view, the likelihood of the government providing extraordinary support, if needed, is high. Thus, a lower U.S. sovereign rating would, in most cases, also directly affect the issuer credit ratings on the individual FHLBs.

The FHLBs' stand-alone credit profiles reflect their excellent loan quality and the funding and liquidity benefits that they receive as members of the FHLB System. More favorable conditions in the housing markets combined with growing evidence of stabilization in home prices have lowered the risk of loss or impairments on the FHLBs' mortgage-backed securities investments. Offsetting the individual FHLBs' rating strengths are continued challenges to growth in advances and core mission assets--loans, letters of credit, and other forms of credit extension made to member institutions using mortgages and other acceptable collateral as security--for most System FHLBs. This is a result of abundant availability of cheap alternative funding (i.e., deposits) and ongoing mergers and consolidations in

the banking industry, weak but adequate risk-adjusted profitability by virtue of the FHLB System's cooperative membership structure, weaker capital than non-GRE participants, and the potential for adverse statutory and regulatory changes related to broader housing finance reform.

The FHLB System remains a reliable source of liquidity for its member institutions, supporting their participation in the U.S. housing market, particularly during times of stress. The FHLB System has afforded its member institutions readily available liquidity without adding unwarranted credit risk in the FHLB System's lending activities, based on its lending model of advances that are fully collateralized. This liquidity support was evident during the third quarter of 2008, when advances rose to a peak of $1.01 trillion. Since then, with the ebb in financial stress, advances have declined and totaled $418 billion as of March 31, 2013, as member institutions have regained access to alternative funding sources for mortgages, particularly deposits. Despite some stabilization in the housing market in recent quarters, member institutions' demand for advances remains constrained at many of the FHLBs. Notwithstanding the relative stabilization in housing market conditions, we expect growth in advances at the FHLBs overall will be limited. Although we view the improvement in household balance sheets and progressive reduction in shadow inventory as favorable developments and supportive of the housing recovery, we expect increasing interest rates and an unemployment rate that continues to hover above its historical average--at a projected 7.4% in 2013 and 6.8% in 2014--to remain drags on the recovery.

The FHLB System benefits from low funding costs on its debt (consolidated obligations) because of the implicit government support the FHLB System receives as a GRE and because consolidated obligations are a joint and several liability of the 12 independent FHLBs (meaning that they have a shared responsibility to fully repay the debt). Nevertheless, the FHLB System's consolidated obligations are neither explicitly guaranteed by, nor the obligation of, the U.S. government.

The internationally diverse investor base consists of many foreign central banks, fund managers, pension funds, state and local governments, and banks. We believe the share of foreign investors is lower today than before the crisis, but still significant. Notwithstanding periodic market jitters about a potential tightening of monetary policy, U.S.-dollar-denominated and government-related assets remain relatively attractive to investors, which has kept funding costs low for FHLBs. Domestic financial institutions awash with deposits and weak loan demand have also invested excess liquidity in FHLB System-consolidated obligations. We expect the FHLB System's funding costs to be at least on par with that of Fannie Mae's and Freddie Mac's unsecured debt, with spreads slightly above U.S. Treasuries, which explicitly include the full faith and credit of the U.S. government.

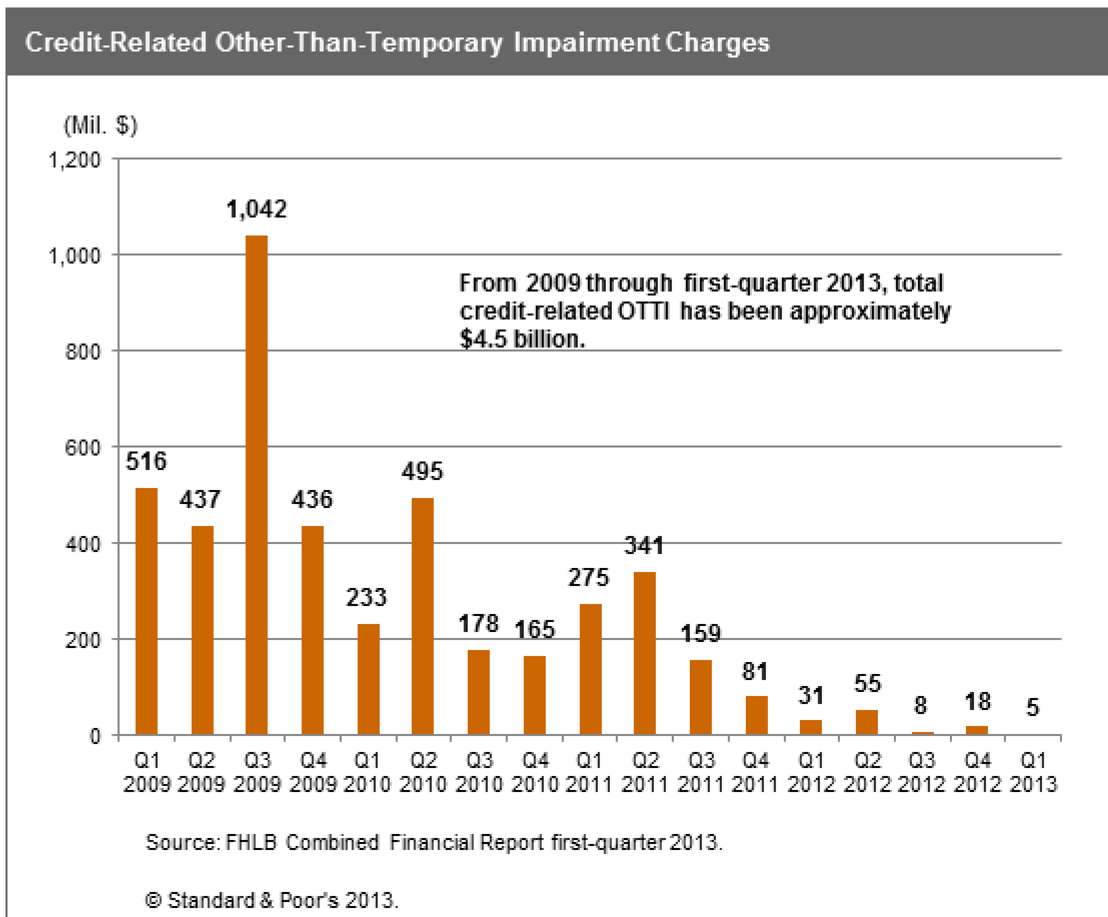
The FHLB System maintains excellent asset quality through its advance portfolio, which comprised 57% of combined assets as of March 31, 2013. Across the FHLB System and throughout its history, no FHLB has taken a single credit loss related to its advance business. Member institutions must fully secure all advances, and FHLBs only lend as much as discounted collateral policies warrant. We believe the FHLBs have been appropriately modifying collateral-management guidelines as conditions change, which typically means increased haircuts (discounts), which may result in additional collateral being demanded as risks associated with collateral types and weakening institutions rise. Troubled borrowers must begin to deliver pledged collateral to their respective FHLBs for collateral management and security if their financial positions deteriorate. If the Federal Deposit Insurance Corp. (FDIC) winds down a

member institution, it either transfers advances to an acquiring entity or, more likely, pays off the advances to release the abundant collateral pledged and settle the closing member's liabilities. Under the Federal Home Loan Bank Act, the FHLB System lien supersedes depositors in winding down a member bank. System FHLBs do not necessarily have priority in liquidation for non-FDIC institutions and have modified lending limits and parameters to reflect the added risk. Given that insurance companies are an area of growth, the FHLBs are working to achieve more certainty regarding FHLB priority access to collateral.

In addition to advances, the FHLB System provides liquidity to the mortgage industry by purchasing mortgage-related securities for its investment portfolio. The carrying value of mortgage-backed securities (MBS) totaled $137 billion as of March 31, 2013 (approximately 19% of assets). Most FHLBs had expanded their investment portfolios selection to include PLMBS prior to the housing crisis and absorbed significant losses on the values of those bonds as the market deteriorated. However, they have scaled back their portfolios through run-off and sales since. PLMBS now represent approximately 18% of the combined total MBS portfolio (about 3.4% of total assets versus more than 6% of total assets in early 2008). Total realized credit losses on these securities have been small, and we expect that losses from ongoing other-than-temporary impairments (OTTI) will likely decline over time, in line with the anticipated gradual recovery and the return of liquidity in the housing market. Of the $183.8 billion in the System's total investment securities as of March 31, 2013, 11.1% is rated speculative grade.

The FHLBs recorded just $5 million in net OTTI related to credit losses in the first quarter of 2013, down from $31 million a year ago, $275 million in first-quarter 2011 and the peak of $1.0 billion in the third quarter of 2009 (see chart 1). From 2009 through the first quarter of 2013, credit-related OTTI totaled $4.5 billion, but a significant portion of those losses occurred in 2009. The FHLB System's net OTTI losses declined to $112 million in full-year 2012 from $856 million in 2011, $1.1 billion in 2010, and $2.4 billion in 2009. Changes in the fair value of available-for-sale securities are reflected in accumulated other comprehensive income/loss (AOCI).

Chart 1



For all of the FHLBs, unrealized losses have declined substantially since their peak in 2009, in line with the stabilization in housing and improved liquidity in the mortgage markets. Moreover, corrective actions FHLBs have taken to preserve capital have resulted in a noteworthy decline in the ratio of unrealized losses to retained earnings for all FHLBs, including those that had previously been undercapitalized, such as Chicago and Seattle. We view FHLBs as much better positioned to manage the level of credit risk-related impairments in the near future because of their higher retained earnings buffers.

As part of a cooperative structure, the FHLB System earns relatively narrow net spreads between its assets and liabilities. Although the FHLBs' profitability measures are weak in absolute terms, we believe they are satisfactory in light of their low-risk core advance business. Under normal economic conditions, typical revenue streams are adequate to cover overhead expenses, build or return capital as necessary, and pay a dividend to member institutions. The FHLB System's net income declined to $580 million in the first quarter of 2013 relative to $733 million four quarters ago, but it is higher than the $358 million in the first quarter of 2011. The decline was attributable to lower net interest income (spurred by lower yields on interest-earning assets and smaller average balances in investments and mortgage loans), though it was somewhat offset by lower expenses and assessments.

Housing finance 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. Most of the proposals introduced in Congress so far, such as the Corker-Warner bill and Rep. Jeb Hensarling's Protecting American Taxpayers and Homeowners (PATH) Act, are at a preliminary stage and appear to largely target the future roles of Fannie Mae and Freddie Mac. Nevertheless, to the extent that new legislation erodes the special standing of the FHLB System's claims in liquidation--for example, because of a competing class of covered bonds--this could increase the FHLBs' credit risk, in our view. At this stage, we believe no reduction in support appears evident. The ultimate shape of housing finance 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. We expect public debate to continue on these proposals in the near term, and any reforms are unlikely to take effect for a number of years.

Outlook

The ratings on the FHLB System's debt and the issuer credit ratings on the FHLBs have stable outlooks. The outlook reflects the stable outlook on the U.S. rating, as well as the application of our GRE criteria. Our stable outlook on the U.S. indicates our view that the risk we will lower the rating in the near term has fallen to less than one in three. We expect the FHLB System, as a GSE, to continue to benefit from the implied U.S. government support for its consolidated debt obligations.

Critical public-policy role and link to the government

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," as defined in our GRE ratings criteria. The FHLB System 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, particularly for smaller member institutions, that a private entity could not readily achieve on its own.

In our rating process, we differentiate between the total FHLB System and the individual FHLB System Banks. Applying our criteria, we classify an individual FHLB's role as very important and its link to the government as very strong. We view the FHLBs' role and mission of being a low-cost funding source for residential mortgage lending and housing and community development as meeting a very important public policy objective. We assign stand-alone credit profiles for each FHLB and incorporate our expectation for extraordinary support into our ratings on the FHLBs. Based on our expectation that the likelihood of extraordinary support for an FHLB is very high, we incorporate one to three notches of support into the final rating. Because the 12 FHLBs have joint and several liability for the senior unsecured debt obligations that the FHLBs Office of Finance issues, we believe a single FHLB's weakness could have an impact on investors' perception of the strength or weakness of the FHLB System as a whole. That is why, in part, we define the link between each of the 12 FHLBs and the government as very strong--because financial distress or a default of a GRE could hurt the government's reputation or create a perception of weakness.

We note that FHLBs' consolidated obligations continue to price at a narrow spread over U.S. Treasuries, affording the FHLBs and their member institutions low funding costs. The FHLB System recorded $669 billion in consolidated outstanding obligations as of March 31, 2013, a 1% increase from $663 billion a year earlier but 3.3% lower than the $692 billion recorded at year-end 2012, reflecting the decline in total assets. We expect growth in consolidated

obligations to remain constrained, in line with the limited growth in advances.

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 distinct regions of the U.S. The FHLBs' public purpose is to provide member institutions with advances as a supplement to deposit flows and other funding sources to meet 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 the FHLB System's advance balances reaching their peak of $1.01 trillion and the FHLB System's combined balance sheet swelling to $1.43 trillion. Advance balances fell from their peak because members are flush with liquidity, but many FHLBs are expanding product types, targeting insurance companies for new business, and providing many other services to their member institutions.

In our view, the FHLBs all have the same fundamental mission, though their business models have minor variations according to their respective risk appetite and tolerance. Management teams try to differentiate themselves by emphasizing various business activities for the benefit of their member institutions. For example, FHLBs are all capitalized 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 distinct business activity that helps to diversify revenue is the purchase of whole first mortgage loans from members under the Mortgage Partnership Finance (MPF) Program and the Mortgage Purchase Program (MPP). Under those programs, some of the FHLBs purchase and ultimately carry those mortgage loans on their balance sheets as mortgage loans held for portfolio. This provides 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 generally 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. As of March 31, 2013, combined mortgage loans totaled $48 billion, a fraction of the peak of approximately $114 billion in 2004, and accounted for 6.5% of total assets, down from the 7.1% share a year earlier. We expect the balance of mortgage loans held on the balance sheet to continue to decline because some FHLBs have discontinued or scaled back their direct mortgage exposure programs.

The FHLB System's combined assets were $739 billion, and advances totaled $418 billion as of March 31, 2013. Those are up 0.1% and 6% respectively, from a year earlier but are down relative to the previous quarter. FHLB System advances to member institutions continue to be restrained because of overall loan demand that remains low as a result of high deposit balances at member institutions, combined with relatively weak mortgage demand.

Support And Ownership: A Cooperative Owned By Member Institutions

Member institutions own the FHLBs. Member institutions are primarily commercial and savings banks and have expanded to include credit unions, insurance companies, and community-development financial institutions (CDFIs). The membership mix as of March 31, 2013, was: commercial banks (68%), credit unions (16%), thrifts (13%), insurance

companies (3%), and CDFIs (less than 1%). With the passage of the Gramm-Leach-Bliley Act in 1999, membership in an FHLB became voluntary for federal savings associations, among other provisions.

A member institution must purchase 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. 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 total transaction funding costs (after commissions, interest, and other expenses).

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: Refocusing On Advances

The FHLB System, in our view, continues to fulfill its public-policy mission to support its member institutions' housing and community-development initiatives. Each of the 12 FHLBs in the System is independently managed but all have similar strategies, with minor variations. Overall, the FHLBs strive to remain a reliable funding source for members, to generate sufficient income to pay reasonable dividends to members, and to boost retained earnings after making the required FHLB System contributions to the Affordable Housing Program (AHP) and under the FHLBs' Joint Capital Enhancement (JCE) Agreement, the latter of which is allocated to a restricted retained earnings account at each FHLB.

To date, a tepid economic recovery combined with lackluster housing demand and ready availability of deposits among member institutions has suppressed demand for advances for the FHLB System in general, with a couple of exceptions. However, some FHLBs still have active mortgage loan portfolios that they aggregate 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 31, 2013, each of the FHLBs of Topeka, Chicago, Indianapolis, and Des Moines had more than 10% of its assets in mortgage loans held for portfolio--at 17%, 15%, 15%, and 14%, respectively. All other FHLBs were below that threshold. An alternative to the legacy MPF program is the MPF Xtra program. Through MPF Xtra, 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 subsequently sold to Fannie Mae and are not held on its balance sheet. The MPF Xtra product is useful for smaller member institutions that do not generate sufficient volume to be direct providers of mortgage loans to Fannie Mae or Freddie Mac.

The FHLBs set aside annually a percentage of earnings for their required contribution to the AHP and the JCE agreement. AHP helps members provide funding and grants to create affordable rental and home ownership

opportunities. Separately, the JCE agreement requires each FHLB to set aside 20% of its net income to a separate restricted retained earnings account at the FHLB until that account equals at least 1% of that FHLB's average balance of outstanding consolidated obligations as of the previous quarter-end. The goal of the JCE agreement is to enhance the FHLBs' capital positions.

Management at many of the FHLBs is focusing on attracting new member institutions, particularly insurance companies and, to a lesser extent, 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. Expenses dropped year over year in the first quarter of 2013 and were also lower in 2012 compared with 2011. Nevertheless, we expect some incremental cost increases for the FHLBs because of regulatory reform in the U.S., per the Dodd-Frank Act, in areas such as over-the-counter derivatives reform.

Risk Profile And Management: A Low-Risk Strategy

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

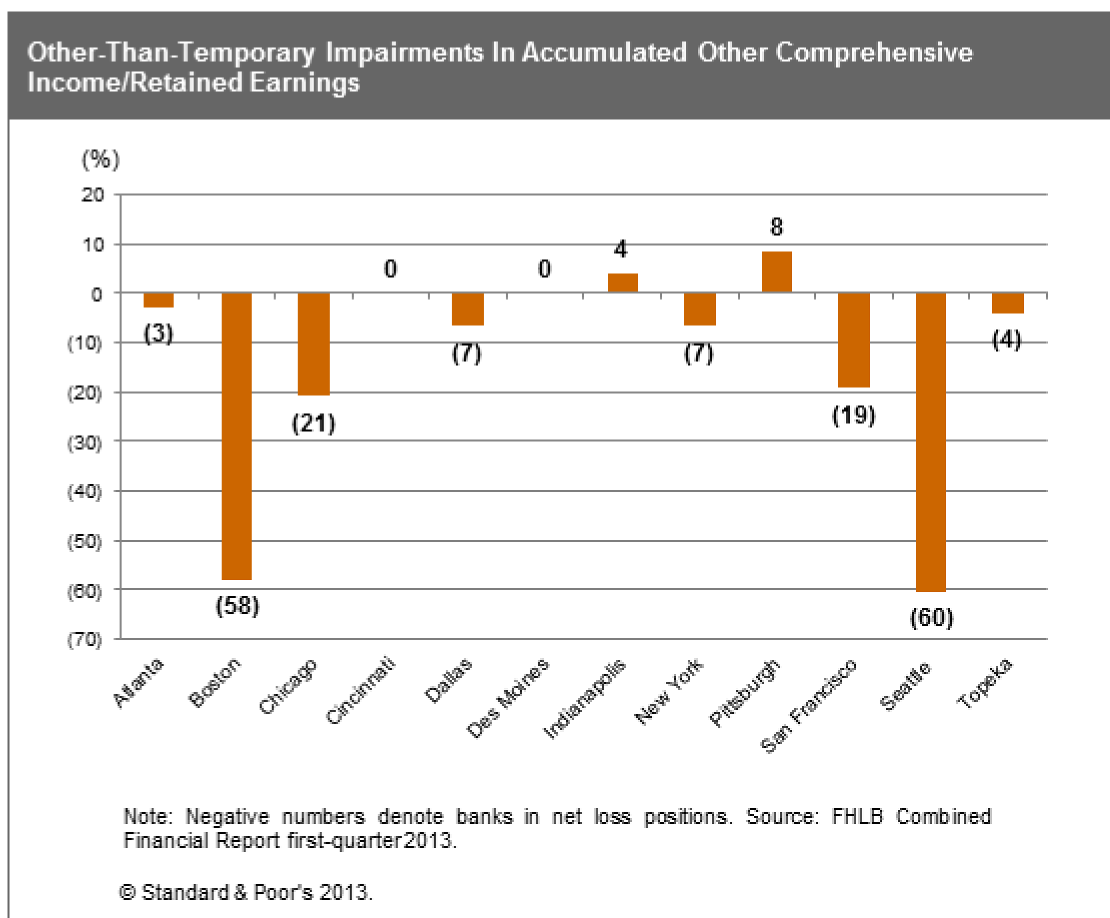
Credit risk

Most of the 12 FHLBs have a concentration of advances in a relatively small number of the largest member institutions. As of March 31, 2013, advances to the top five borrowers were 24%-80% for each of the FHLBs. Moreover, a large member borrower may borrow through separate subsidiaries from several FHLBs. 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 the FHLBs have 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 other parties, including depositors. The FHLBs rely on more strict borrowing limits and collateral guidelines to mitigate credit risk for nondepositories for which they are not guaranteed priority status in liquidation. Given those factors, no FHLB has ever taken a credit loss on any member loan since its inception, including advances to failed member institutions.

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, some of the FHLBs increased the credit risk in their investment portfolios by adding PLMBS backed by prime, Alt-A, and subprime mortgages. The FHLBs have ceased purchasing new PLMBS and have replenished a retained earnings buffer against future losses. As of March 31, 2013, all FHLBs had made visible strides toward reaching a better balance between unrealized losses and retained earnings (see chart 2).

Chart 2



Another aspect of credit risk is counterparty credit related to derivatives. Each FHLB manages 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 and engaged in fewer transactions with certain European counterparties during 2011 in response to concerns about deteriorating sovereign creditworthiness. As a result of the Dodd-Frank Act, all FHLBs are required to clear certain types of derivative transactions through a clearinghouse as of June 10, 2013. Other proposals related to derivatives provisions of the Dodd-Frank Act may alter business practices in the derivatives markets and could have an effect on the FHLBs.

Market risk

In general, the FHLBs pursue matched asset-liability management. The FHLB System's access to the debt markets helps facilitate this because the FHLB System can raise money at a wide range of maturities and with a wide variety of features. The FHLBs' MBS and mortgage investment portfolios introduce a degree of interest rate risk because of their indeterminate maturities as a result of varying prepayment rates. The individual FHLBs may also use derivatives to manage their interest rate risks within appropriate limits. Although each FHLB's portfolio is distinct, the combined FHLB System had investments of $259 billion (35% of total FHLB System assets) as of March 31, 2013, including

about $25 billion of PLMBS (approximately $26 billion at amortized cost). During first-quarter 2013, the FHLBs recognized $5 million of total credit-related OTTI charges related to private-label RMBS.

Because we expect continued rehabilitation in the housing markets, credit losses in the private-label RMBS portfolio may continue to decline. As a result, the credit losses that could be realized are not significant relative to the FHLBs' capital bases. 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 that the Office of Finance issues. 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. This access to favorably priced funding is one of the FHLB System's major strengths benefiting its members. FHFA regulations stipulate minimum liquidity levels and tightly restrict eligible investments. Generally, each FHLB maintains liquidity to meet the credit and liquidity needs of its members, as well as current and future financial commitments. They also maintain liquidity to redeem or repurchase excess capital stock. The FHLB System has retained access to public debt markets to meet liquidity needs even in times of stress, but it also relies on highly liquid investment portfolios. The FHFA requires each FHLB to maintain contingent liquidity to cover five days without accessing public debt markets, among other standards. The FHLBs' principal investments are GSE and private-label MBS securities, federal funds sold, interest-bearing deposits, reverse repurchase agreements, and municipal and Treasury securities. Investments were 35% of combined assets as of March 31, 2013, down from 38% a year earlier.

Profitability: Appropriate For Its Mission

The FHLBs' profitability declined 21% year over year, attributable to lower net interest income (spurred by lower yields on interest-earning assets and smaller average balances in investments and mortgage loans), though it was somewhat offset by lower expenses and assessments. Their return on average assets (ROA) varied between 0.18% and 0.56%, with an overall System ROA of 0.30% in the first quarter of 2013. That compares with a 1.12% ROA for all FDIC institutions in the same period. 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 their services at reasonable costs (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 because FHLBs seek to pass their funding advantage onto their members.

The aggregate net interest margin was 0.46% for the FHLB System in the first quarter of 2013--down from 0.55% in the same period last year. Lower yields on interest-bearing assets and reduced balances of investments as well as mortgage loans largely account for this decline.

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 regulatory capital, a limit every FHLB (except Chicago and Indianapolis) was in compliance with as of March 31, 2013. The Chicago and Indianapolis banks are not required to sell any previously purchased MBS, though they are precluded from purchasing additional MBS investments until their MBS ratios decline below 300%.

Mortgage loans held for portfolio also contributed substantially to earnings at certain FHLBs if the associated hedging strategy was effectively implemented. However, when interest rates declined and refinancing prepayments greatly exceeded historical levels, this strategy became ineffective and weakened some FHLBs' earnings during the last crisis. Because of managements' de-emphasis on direct mortgage loan purchases in recent years, we expect smaller 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 we expect some increase across the FHLBs because of greater technology investment for financial and regulatory reporting. Although the FHLBs benefit from their income-tax exemption, AHP assessments reduce earnings.

The combined FHLB System's profitability for first-quarter 2013 decreased to $580 million from $733 million during first-quarter 2012, largely because of lower net interest income, offset somewhat by lower expenses and assessments. In the first quarter, net interest income post-provisions was down 17% over the prior year as a result of the shrinking earning asset base and a lower margin. Noninterest income improved 12% as a result of lower credit-related impairments and lower losses on trading securities. Noninterest expenses also declined slightly, helping results.

Although we expect the housing recovery to gather steam, it won't be at full-throttle. As a result, we expect profitability to remain muted as funding costs and asset yields remain low and advance demand remains constrained. We expect economic expansion to be gradual and tepid in contrast with prior recovery cycles.

Capital: Flexible And Adequate

Capital adequacy is different for FHLBs 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 System FHLBs have in preserving their capital. An FHLB can exercise judgment, within FHFA guidelines, 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. If any of the FHLBs ever suffered losses that caused members of that FHLB to record impairments on their FHLB stock investments, we believe that could have significant implications for the integrity of the FHLB System. 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 a member institution's lower advance activity creating excess stock--and asset levels at the FHLB.

Excess stock is capital stock a member institution holds in excess of its requirement. According to an FHFA rule, an FHLB is prohibited from creating member excess capital stock by paying stock dividends or issuing new excess capital stock to its members if the amount of existing excess stock is more than 1% of the FHLB's total assets. As of March 31, 2013, the FHLBs of Boston, Cincinnati, Indianapolis, San Francisco, and Seattle had excess capital stock outstanding greater than 1% of total assets.

Excess stock lacks some characteristics usually associated with permanent equity capital because the common shares are redeemable. 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 completed a partial stock repurchase in March 2013, but continues its moratorium on repurchases other than in limited cases involving member-related insolvency. The FHLB of Pittsburgh conducted some repurchases in February and April 2013 after assessing capital adequacy. The FHLB of Chicago announced a plan to repurchase excess capital stock in May 2013, after setting explicit retained earnings targets. The FHLB of San Francisco repurchased excess stock in the first quarter of 2013, and the bank plans to continue repurchasing excess stock. The FHLB of Seattle remains under a consent order arrangement with the FHFA and is still unable to pay dividends. However, the FHFA has allowed FHLB Seattle to repurchase $25 million of excess capital stock per quarter, but only if the bank's financial condition (measured by market value of equity to par value of common stock ratio) does not deteriorate and upon receipt of a no-objection consent from the FHFA. The FHFA also allowed the FHLB of Seattle to pay a dividend in the third quarter of 2013 of up to 10% of its net income; future dividend payments are subject to FHFA approval.

Retained earnings typically have been relatively thin but adequate. All the FHLBs have been increasing retained earnings to provide capital support to their mortgage loan purchase programs and investing portfolios. As of March 31, 2013, the FHLB System recorded $10.9 billion in retained earnings, 19% higher than a year ago. We believe retained earnings provide a more stable and permanent form of loss-absorbing capital than paid-in capital, which can fluctuate with member activity levels. In our view, the FHLBs of Boston and Seattle now have unrealized losses that are more manageable relative to their retained earnings. Through the FHLBs' JCE Agreement, each of the FHLBs will further build its capital base by allocating at least 20% of its net income to a separate restricted retained earnings account until reaching an amount equal to at least 1% of its average balance of outstanding consolidated obligations for the previous quarter for which it is the primary obligor.

The Gramm-Leach-Bliley Act required each FHLB to develop an individualized capital plan to be approved by the former Federal Housing Finance Board and subject each FHLB to a minimum regulatory capital-to-assets ratio of 4%. (The ratio is defined as the sum of capital stock, retained earnings, and mandatorily redeemable capital stock divided by total assets at the end of the period. Regulatory capital also includes any permitted general allowance for losses and

any other amount from sources available to absorb losses that the FHFA has determined by regulation to be appropriate to include.) The FHLBs were in compliance with regulatory capital minimums as of March 31, 2013, and the aggregate regulatory capital-to-assets ratio for the FHLB System was 6.71% at that time, compared with 7.02% a year earlier.

Related Criteria And Research

Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Ratings Detail (As Of August 5, 2013)	
Federal Home Loan Banks	
Senior Unsecured	AA+
Senior Unsecured	AA+/A-1+
Senior Unsecured	AA+/Stable
Short-Term Debt	A-1+
Sovereign Rating	
United States of America (Unsolicited Ratings)	AA+/Stable/A-1+
Related Entities	
Federal Home Loan Bank of Atlanta	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Boston	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Chicago	
Issuer Credit Rating	AA+/Stable/A-1+
Subordinated	AA-
Federal Home Loan Bank of Cincinnati	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Dallas	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Des Moines	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Indianapolis	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of New York	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Pittsburgh	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of San Francisco	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Seattle	
Issuer Credit Rating	AA/Stable/A-1+
Federal Home Loan Bank of Topeka	
Issuer Credit Rating	AA+/Stable/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

Ratings Detail (As Of August 5, 2013) (cont.)

across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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