

**Credit Opinion: Federal Home Loan Banks**

**Federal Home Loan Banks**

*Reston, Virginia, United States*

**Ratings**

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

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**Key Indicators**

**Federal Home Loan Banks**

	2007Q2	2006	2005	2004
ROAA (%)	0.24	0.26	0.26	0.23
Advances (\$bil)	640.04	640.68	619.86	581.22
Investment Securities (\$bil)	154.76	154.83	147.26	144.11
Assets (\$bil)	1,037	1,016	997	925
Equity (\$bil)	44.57	44.99	44.48	41.86
Pretax Income / Net Revenue (%)	81.02	81.67	81.25	63.81
Net Income (\$bil)	1,249	2,612	2,525	1,994
Net Interest Margin (%)	0.42	0.43	0.45	0.48

Data as of June 30, 2007

**Opinion**

**SUMMARY RATING RATIONALE**

The FHLBank System Aaa/Prime-1 long- and short-term ratings reflect the combination of the following factors: 1) a baseline credit assessment of 2 (on a scale of 1 to 6, where 1 represents the lowest credit risk), 2) Aaa local currency rating of the US Government, 3) high dependence between the FHLBank System and the US Government, and 4) high support between the two.

The FHLBank System's baseline credit assessment reflects its sound liquidity, excellent asset quality, and adequate risk-adjusted profitability. In addition, the joint and several liability for the FHLBanks' debt provides significant support to the baseline credit assessment.

**Credit Strengths**

Credit strengths include:

Joint and several liability reduces default risk of Systemwide liabilities

Central housing funding role for banks and other financial institutions, GSE status

Excellent asset quality reflects conservative underwriting standards and quality-monitoring policies

## **Credit Challenges**

Credit challenges include:

Narrow charter and bank consolidation constrain growth and profitability

Substantial borrower concentrations

## **Rating Outlook**

The stable outlook for the FHLBanks' ratings reflects Moody's expectation that the System will continue to receive strong bipartisan political support, that there will be minimal changes, if any, to its GSE status over the long term, and that the FHLBanks will retain their conservative risk temperament.

### **What Could Change the Rating - Up**

Factors that could lead to an upgrade of the System's baseline credit assessment include strong profitability reflected by a ROAA consistently in excess of 0.5%, as well as a stable member profile and continued strong asset quality.

### **What Could Change the Rating - Down**

Factors that could lead to a downgrade of the System's baseline credit assessment include highly material changes in asset/liability management or asset quality - which we do not expect - as well as adverse regulatory or statutory changes to the System's mission or GSE status. Moody's views these potential events as highly unlikely to occur for the foreseeable future.

## **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 Banks also invest in securities, principally MBS, subject to an investment limit of three times capital. 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 average ROAA from YE03 through 1H07 was 0.25% compared to a 5-year average of 2.32% (pre provision ROAA) for Aaa- and Aa-rated US domiciled banks. Over the same period, however, the System's 0.01% standard deviation of ROAA was much lower than the 0.36% standard deviation for Aaa- and Aa-rated US banks. The lower volatility of the System's returns is likely due to the superior credit quality of the FHLBanks' assets, particularly advances and the lower cost structure of the FHLBank System.

#### **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 exposure, risk management strategies and asset mix. Over the past three quarters, the FHLBanks' duration gap has ranged from a low of -0.8 months (FHLBank of Des Moines in Q207) to a high of 2.3 months (FHLBank of Cincinnati in Q207). 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 this decade elevated interest rate risks to those FHLBanks particularly active in this line of business. However, as FHLBanks decrease their MPP and MPF activities, associated incremental interest rate risk should decline.

#### **Asset Quality and Credit Risk Management**

The FHLBanks' asset quality of advances has been consistently outstanding, and we expect this to continue. To date, no credit loss has ever been incurred on advances. The FHLBanks' assets consist primarily of advances, investments and mortgage loans purchased from members. Advances represented 61.7% of assets at June 30, 2007, compared to 63% at December 31, 2006. 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 Board 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 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.

FHLBanks' investment portfolios consist primarily of MBS securities, chiefly Agency MBS or highly rated private label securities, so the loss likelihood is low, despite losses experienced by the FHLBank of New York in 2003. The FHLBanks' exposure to subprime is principally concentrated at two Banks, New York and Chicago, which have some exposure to Aaa rated subprime mortgage securities with underlying collateral primarily comprised of the less risky 2004 and 2005 vintages. Holdings of non-MBS instruments consist of high quality liquid investments such as commercial paper, federal funds, resale agreements and US Treasury securities. Agency and government debt purchased in the investment portfolios of all the of FHLBanks require the highest rating, Aaa, reflecting the System's conservative credit standards. As of June 30, 2007, almost all (99.95%) of the investments in FHLBanks' securities portfolio carried the highest two rating categories for long- and short-term ratings. Moody's believes that the FHLBanks' investment portfolio is primarily Aaa for long-term ratings.

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. At June 30, 2007, mortgage assets comprised 9.1% of System assets, versus 12.3% as of year end 2004. Moody's expects MPF and MPP assets to continue to decline largely due to renewed focus on advance business and as FHLBank member mortgage origination activities fall in concert with the weak single-family market. FHLBanks mortgage assets are more susceptible to credit loss, and in particular, carry heightened operational complexity relative to the FHLBanks' core lending business. Credit risks are being managed well however. 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

The System's liquidity is strong as a result of the substantial benefits derived from its GSE status and its internally-generated liquidity resources. Internal sources include the FHLBanks' short-term investments, as well as their entire investment portfolios, comprised primarily of Agency and highly-rated private label MBS securities. Short-term investments (i.e., cash, interest bearing deposits, federal funds sold and repurchase agreements) represented 33% of short-term debt (i.e., deposits, discount notes and consolidated obligations maturing within one year) at June 30, 2007. In addition, the FHLBanks' held in aggregate \$155 billion in their investment securities portfolios (37% of short-term debt) at June 30, 2007.

The FHLBanks' unusually broad and deep global market access is another significant support. The FHLBanks, as well as other GSEs, have a historical role as liquidity providers during times of stress in the mortgage market. The FHLBanks are mandated by regulation to maintain a minimum of five days of liquidity without access to the capital markets (a tiny amount), though individual Banks have the discretion to maintain longer periods of liquidity without access to the capital markets and generally do so. For example, several FHLBanks, such as Boston, San Francisco, Atlanta and Des Moines maintain policies to voluntarily maintain liquidity in excess of 90 days. Moody's believes that the remaining FHLBanks maintain liquidity well in excess of five days, though those FHLBanks do not publically disclose their policies.

#### Other

In August 2007, the FHLBanks of Dallas and Chicago announced that the two Banks have engaged in preliminary merger discussions. In Moody's view, the ratings implications of a merger are likely to be neutral. A merger of these two FHLBanks would likely result in a modest amount of cost savings, as well as an increase in the asset base over which to spread the FHLBanks' fixed costs. These two Banks have complementary member bases in that the members are about the same size and number.

A significant underpinning of the Baseline Credit Assessment is the joint and several nature of the 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 Banks 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.

#### Support and Dependence

High dependence and support levels for the FHLBank System reflects the importance of the System to its member institutions and their ability to support housing finance and community development.

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