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Industry Report Card:

The U.S. Federal Home Loan Bank System Shows A Profit As It Carefully Contracts Toward Its Precrisis Size

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Industry Credit Outlook

Liquidity continued to ease back into the capital markets in fourth-quarter 2009, but mortgage quality continued to fall, as the U.S. Federal Home Loan Bank (FHLB) system reported a reasonably profitable quarter at the same time its aggregate balance sheet contracted. The return to profitability, after an overall loss in the third quarter, came despite another large slug of incremental credit-related other-than-temporary-impairment (OTTI) charges on non-agency, or "private label," residential mortgage-backed securities (RMBS). Assets continued to contract toward their more normal, precrisis level, as member banks--cooperative owners of the FHLB system--responded to weak loan demand by paying back advances they had received from the system.

We expect 2010 to be a year of adequate profitability for the FHLB system banks overall. We also believe, however, that several of the FHLB system banks will likely take further charges on their private-label RMBS as the quality of underlying mortgages continues to fall.

During fourth-quarter 2009, 10 of the 12 FHLB system banks recorded a profit, compared with seven in the previous quarter. System net income improved to $552 million, on the heels of a $165 million loss in the prior quarter. Full-year 2009 net income rose 58% compared with 2008, to $1.9 billion. However, in the fourth quarter, the FHLB system banks recorded a total of $436 million in incremental credit-related OTTI on their approximately $48 billion in private-label RMBS--about 5% of their total assets. Credit-related OTTI was the primary burden to full-year profitability, with $2.4 billion in total credit-related OTTI recorded in 2009.

The FHLB system and all its individual banks continued to experience balance sheet contraction, as both their lending and funding declined in the fourth quarter. FHLB system advances to their member banks declined to a level more typical of that before the crisis, to about $631 billion from a peak of approximately $1.012 trillion at Sept. 30, 2008. The decline has occurred as member banks have taken advantage of improved availability of alternate funding sources such as deposits and senior unsecured borrowings in a more liquid market. While funding sources are improving, both the system and the member banks have seen loan demand stay lax due to nationally weak economic conditions. The FHLB system banks have appropriately tightened their lending standards to member banks whose financial profiles have weakened.

Aside from advances, the FHLB system banks' primary earning assets are their investment securities portfolios. These make up about 22% of their total assets, with only about $48 billion of these assets in private-label RMBS. Standard & Poor's expects some further credit-related OTTI in these securities in 2010, since the underlying assets are primarily poorly performing Alt-A and subprime mortgages. Conversely, however, the securities' values seem to have firmed, and unrealized losses in accumulated other comprehensive income (AOCI) may continue to decrease as liquidity comes back to the market.

The system's capital remains strong, in our view. Capital under generally accepted accounting principles (GAAP) of approximately $43 billion and regulatory capital of approximately $60 billion support about $1 trillion of assets. Aggregate capital ratios remain at more than the 4% regulatory minimum because balance sheet assets have contracted. In fact, the combined capital ratio was 5.92% at year-end 2009 and varied across the individual FHLB system banks from 4.5% to 7.6%. The individual FHLB system banks have prudently retained capital through this period of credit turmoil instead of returning it to member banks.

One of the primary differences between the FHLB system's GAAP capital and its regulatory capital is about a negative $8.2 billion of AOCI, which is excluded from regulatory capital. AOCI comes almost entirely from non-credit-related unrealized losses related to private-label RMBS. The other significant difference is $8.1 billion of mandatorily redeemable capital stock (MRCS), which qualifies as regulatory capital. Although the FHLB system banks must return the member banks' MRCS to them, they have discretion as to when they do so, which helps them manage their own financial conditions. Nearly all the system banks have stated they would slow the return of capital during this period of financial stress, even if they weren't already required to do so by their regulator, the Federal Home Finance Agency.

At year-end 2009, all the system banks were maintaining capital in excess of their regulatory minimums. However, the Seattle bank is still under a prompt corrective action with its regulator and has received a capital classification of "undercapitalized." This designation recognizes its significant OTTI and difficulty in meeting risk-based capital requirements, due to market risk in its private-label RMBS portfolio.

While further credit-related OTTI is still likely to hamper earnings, we expect adequate profitability for the FHLB system banks in 2010. We recognize that they all intend to hold their private-label RMBS and, given their solid liquidity, have the wherewithal to do so. Consequently, they are unlikely, in our view, to realize market-related losses.

Separately, despite the number of bank failures to-date and our expectation for more, the FHLB system banks have still not taken any losses on advances, because they remain appropriately collateralized. Adequate earnings, with lower OTTI than in 2009 and smaller balance sheets, will also likely preserve the capital integrity of the system this year. Also, it is our view that the FHLB system's regulator would identify and remediate any single weakness promptly as it seeks to preserve investor confidence in the entire FHLB system.

Issuer Review

Table 1

Issuer/Issuer credit rating*/Comments	Analyst
Federal Home Loan Bank of Atlanta (AAA/Stable/A-1+) FHLB-Atlanta reported fair fourth-quarter results, with net income of $82.2 million, compared with a net income of $11 million in the prior quarter. It recognized credit-related other-than-temporary impairment (OTTI) losses of $53.3 million and $316.4 million related to its private-label mortgage-backed securities (MBS) investment portfolio for fourth-quarter and year-end 2009, respectively. Advances declined sequentially by another 8.9% to $114.6 billion in this quarter, as we expected, primarily as a result of lower loan demand from the members. We believe this decline may continue through first-half 2010, until the financial markets stabilize and the economy improves. Capital remained adequate, with the total regulatory capital–to–assets ratio at 6.07%, gaining from the contracting balance sheet. We expect that FHLB-Atlanta's advances will continue to decline through at least the first six months of 2010, while further OTTI losses in the private-label MBS portfolio could hurt earnings through 2010.	Dan Teclaw
Federal Home Loan Bank of Boston (AAA/Stable/A-1+) FHLB-Boston continued to report weak results; however, it swung to a net profit of $6.3 million compared with a net loss of $105 million in the linked quarter. Earnings largely reflect sequentially lower, though persistent, OTTI charges of $72 million, on private-label, Alt-A, residential mortgage-backed securities (RMBS). Net interest income (NII) improved to $88 million from $82	Vikas Jhaveri

million in the previous quarter, benefiting from lower funding costs. The resulting net interest margin (NIM) increased to 54 basis points (bps) from 51 bps in the prior quarter. However, for the full-year NII decreased, as interest rates remained low and advances shrunk by a considerable 34%, to $37.6 billion. Advances continued to decline throughout 2009, due to softening credit demand and strong deposit growth. We don't expect advances to trend upward until the global economy recovers, possibly triggering more member demand. Capital is adequate, with the total capital-to-assets ratio at 6.2%. We expect declining housing prices to result in further credit losses in the sizable private-label MBS portfolio.	
Federal Home Loan Bank of Chicago (AA+/Stable/A-1+) FHLB-Chicago's fourth-quarter results rebounded to a net income of $21 million after facing a huge net loss of $150 million in the prior quarter. Despite incurring $5 million in credit provisions, earnings revived because of reduced OTTI charges on its private-label mortgage-related securities. For full-year 2009, the bank incurred a net loss of $65 million. Net interest income fell 10% sequentially, even as the NIM remained steady at 0.65%. Advances continued to decline, dropping to $24.15 billion, a 36.7% decline from December 2008, reflecting member banks' reduced borrowing needs and an increase in deposits. We expect further OTTI losses to continue to hurt the bank's profitability in 2010.	Dan Teclaw
Federal Home Loan Bank of Cincinnati (AAA/Stable/A-1+) FHLB-Cincinnati reported a decent fourth quarter, with net income of $49 million, slightly down from $61 million in the linked quarter. The fall in earnings can largely be attributed to a 19% drop in net interest income to $74 million, as the spread earned continued to decrease, offsetting the positive impact of low funding costs. Consequently, the NIM fell 7 bps, to 0.38%. Advances continued to drop, and stood at $35.1 billion at Dec. 31, 2009. We expect that advance demand will remain weak until an economic recovery brings added member loan demand. Mortgage loans fell by $370 million, to $9.3 billion, as refinancing activity diminished. We expect profitability to remain stable, given the bank's minimal exposure to credit risk from its mortgage portfolio and negligible investments in private-label mortgage securities.	Vikas Jhaveri
Federal Home Loan Bank of Dallas (AAA/Stable/A-1+) FHLB-Dallas reported positive results in its fourth quarter, with net income of $39.6 million, up 124% from the prior quarter. The fourth quarter's earnings included a small, credit-related OTTI charge of $1.0 million on its non-agency residential mortgage-backed securities. For the year ended Dec. 31, 2009, the bank reported net income of $148.1 million. Advances continued to decline, falling to $47.3 billion, a 22.4% decrease from December 2008. This drop was largely attributable to reduced borrowing needs from member institutions. The bank continues to maintain adequate capital with increased retained earnings and lower accumulated other comprehensive loss from the sequential quarter, complying with regulatory capital requirements. We expect the bank will continue to focus on its operating performance and maintain its strong financial profile.	Dan Teclaw
Federal Home Loan Bank of Des Moines (AAA/Stable/A-1+) FHLB-Des Moines reported decent fourth-quarter results, with net income of $40 million compared with $35 million in the previous quarter, resulting from decreased funding costs. This was despite a marginal decline in the advances to members. NII increased 13% from the prior quarter, to $66.9 million. Consequently, the NIM improved 5 bps, to 0.39%. Advances continued to decline, though only slightly, to $35.7 billion in the quarter. The mortgage portfolio declined somewhat but still represented about 12% of total assets. The bank's private-label MBS portfolio represented only 0.3% of its total MBS portfolio of $11.3 billion. These private-label MBS investments were performing, and the bank recorded no OTTI losses. Capital metrics were down slightly quarter-over-quarter, with the total regulatory capital-to-assets ratio at 4.57%. We expect the bank to sustain its decent financial performance and to progress steadily in the upcoming quarters.	Sunsierre Newsome
Federal Home Loan Bank of Indianapolis (AAA/Stable/A-1+) FHLB-Indianapolis reported modest fourth-quarter results, with net income of $24 million, up slightly from $21.5 million in the previous quarter. Improved earnings largely reflected the bank's sequentially lower, yet persistent, credit-related OTTI charges of $15.4 million on private-label MBS. Operating expenses increased during the quarter, offsetting a portion of the improvement from lower credit-related OTTI charges. Advances continued to decline, falling about 8% quarter-over-quarter, to $22.4 billion, reflecting adequate deposit growth at member banks and reduced loan demand. The mortgage portfolio fell 2.6%, to $7.3 billion, and we expect it will fall further due to maturities and higher prepayment rates. Capital remains adequate, at a regulatory capital-to-assets ratio of 6%. We believe the bank will recognize additional impairment charges on its private-label MBS portfolio in 2010.	Sunsierre Newsome
Federal Home Loan Bank of New York (AAA/Stable/A-1+) FHLB-New York posted strong results for 2009, with net income of $570.8 million compared with $259.1 million for the prior year. However, fourth-quarter net income of $95.9 million was lower than the $140.2 million reported in the previous quarter. FHLB-New York's NII continued to find support from lower funding costs, despite a decrease in advances, which have continued to fall; these ended January 2010 at $88.4 billion after being $103.4 billion at year-end 2008. The bank continues to meet all its regulatory capital requirements and, consequently, has continued to pay a healthy dividend. The bank paid $74 million as member dividends, a level largely unchanged from the prior quarter. FHLB-New York is one of the FHLB banks with very modest exposure to non-agency securities. The majority of its credit costs relate to a handful of securities that financial guarantee provider insured.	Vandana Sharma
Federal Home Loan Bank of Pittsburgh (AAA/Stable/A-1+)	

FHLB-Pittsburgh continued to report weak results, with a fourth-quarter net loss of $5.5 million, compared with a loss of $40.4 million in the prior quarter. This loss was primarily a result of a $65.4 million OTTI credit loss charge on the bank's private-label MBS portfolio in this quarter. Despite slightly lower advances, interest income improved marginally from the prior quarter. Over the trailing 12 months, advance balances declined a substantial 33.8%, to $41.2 billion, as members continued to have limited borrowing needs. The full-year results were dominated by two major themes: OTTI of $228.5 million; and a decline in NII from advances and, to a more limited extent, investments, offset by lower funding costs. FHLB-Pittsburgh reported a relatively strong NIM of 36 bps, an increase of 7 bps from the prior year. We will continue to watch the regulatory capital classification by the Federal Housing Finance Agency (FHFA), the primarily regulator of the FHLBs. Although FHLB Pittsburgh is currently in compliance with both the capital and leverage ratio requirements (6.8% and 10.1% against requirements of 4% and 5%), we expect further volatility in the next couple of quarters, as a result of additional OTTI charges related to its private-label MBS portfolios.	Vandana Sharma
Federal Home Loan Bank of San Francisco (AAA/Stable/A-1+) FHLB-San Francisco reported net income of $515 million for 2009, up from $461 for 2008. After an operating loss in the third quarter, net income was positive, at $174 million. During the quarter, the bank reported credit-related OTTI charges of $116 million, partially offset by a net gain of $75 million associated with derivatives and hedging activities. FHLB-San Francisco's balance sheet shrank due to a 40% decline in assets, to $193 billion. Advances declined a significant 43%, to $133.6 billion. Despite being in compliance under all its regulatory capital ratios, the bank temporarily suspended dividends for the first and third quarters. This restriction was lifted in the fourth quarter, when the bank declared a modest dividend of 27 bps; it had also declared a dividend for the second quarter. Also, in 2009, the bank repurchased no excess capital stock. We don't expect significant repurchases of excess capital stock until the bank sees material stabilization in the credit costs associated with its non-agency MBS portfolio. On Dec. 31, 2009, excess capital stock totaled $6.5 billion, or 3% of total assets.	Vandana Sharma
Federal Home Loan Bank of Seattle (AA+/Stable/A-1+) FHLB-Seattle's full-year 2009 results reflected a loss of $161.6 million, compared with $199.4 million for 2008. The main driver of the operating results is the credit cost associated with the bank's private-label MBS portfolio. During 2009, FHLB-Seattle reported $311.2 million in credit-related OTTI charges associated with this portfolio. Despite lower advances--$22.3 billion compared with $36.9 billion in the prior year--FHLB-Seattle reported a modest increase in NII, primarily due to favorable funding costs. FHLB-Seattle had submitted a proposed capital restoration plan to the FHFA in August 2009. The agency didn't approve the plan, and it required the bank to submit a new plan by Oct. 31, 2009. The bank subsequently requested an extension to prepare a revised proposed capital restoration plan, and the FHFA approved an extension to Dec. 6, 2009. The bank is currently waiting for feedback from the FHFA on its most recent capital plan. We will closely monitor the actions of the regulator and the bank's capital ratios, given the potential for more uncertainty surrounding its private-label RMBS portfolio. We will also monitor demand for advances, especially from some larger members such as Bank of America.	Vandana Sharma
Federal Home Loan Bank of Topeka (AAA/Stable/A-1+) FHLB-Topeka reported modest fourth-quarter results, with a net income of $46.1 million compared with $24.5 million in the prior quarter. This is largely due to a 7% increase in NII, to $63.6 million. The increase came despite a marginal decline in advances, to $22.3 billion in the fourth quarter. The reduction in advances was primarily attributed to increasing deposits in banks after a retreat from the equity markets, various programs offered by the U.S. Federal Reserve Bank to strengthen the liquidity position of the financial markets, and sluggish loan demand. OTTI losses have been historically low, with the bank being a "hold-to-maturity" investor. Capital metrics increased slightly, bringing the capital-to-assets ratio to 4.64%, above the regulatory guidelines. We expect performance will improve in 2010 with the stabilizing economy.	Sunsierre Newsome

*Ratings are as of April 12, 2010.

Quarterly Rating Activity

There were no rating actions during the period covered by this report card.

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Table 2

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Comments and ratings reflect available public data as of April 12, 2010.

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