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Industry Report Card:

Federal Home Loan Bank System Continues To Report Satisfactory Quarterly Results While Executing Its Public-Policy Mission

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Industry Report Card:

Federal Home Loan Bank System Continues To Report Satisfactory Quarterly Results While Executing Its Public-Policy Mission

Industry Credit Outlook

The Federal Home Loan Bank System reported another satisfactory quarter while executing its public-policy mission of providing liquidity for the U.S. housing market. The FHLBs' higher net income revealed gains based on market volatility, however, as opposed to improvement in the business fundamentals. Two institutions reported net losses in second-quarter 2009 compared to six in first-quarter 2009. Demand for advances by member banks was down due to weak economic conditions that we expect to continue for the next two to three quarters. Capital continued to be satisfactory at the banks and at the system level, despite Seattle's risk-based deficiency.

Hedging gains primarily responsible for second-quarter 2009 earnings

Credit markets moved in a positive direction for the FHLBs. Combined, these institutions recorded \$979 million of net gains on derivatives and hedging activities in second-quarter 2009, compared to only \$200 million in net gains in the prior quarter. This movement was positive for their bottom lines, but these gains were based on market volatility as opposed to improvement in their fundamental businesses. In aggregate, the FHLBs more than tripled their net income to \$1.123 billion in second-quarter 2009 (after affordable housing and REFCORP assessments) from \$345 million on a linked-quarter basis. After taking \$516 million of other-than-temporary-impairment (OTTI) credit-related losses in first-quarter 2009, the FHLBs reported an additional \$437 million of OTTI credit-related losses in second-quarter 2009 that hurt operating results. Only Seattle (negative \$35 million) and Boston (negative \$5 million) recorded net losses in second-quarter 2009, compared with six FHLBs that took losses in first-quarter 2009.

Trend toward declining advances continues

Aggregate system advances declined by about 10% to \$739 billion as of June 30, 2009, from \$817 billion as of March 31, 2009, as liquidity needs in the broader financial system have ebbed. The level at the end of second-quarter 2009 is about 27% off the peak level of advances recorded as of Sept. 30, 2008. The existence of government programs that have offered FHLB members competitive sources of longer-term liquidity at favorable prices (e.g., Temporary Liquidity Guarantee Program [TLGP] debt and Term Asset-Backed Securities Loan Facility [TALF]) has eased demand for FHLB advances. Furthermore, persistent weak economic conditions and FHLB members' success in gathering deposits have kept loan demand down and, therefore, demand by members for advances has been lower. We expect advance demand to decline further in the next two to three quarters.

The FHLB System's combined regulatory capital remained adequate at June 30, 2009 (\$61.6 billion, compared to \$59.6 billion at Dec. 31, 2008). The 11 FHLB institutions operating under regulator-approved capital plans all exceeded the 4.0% total regulatory capital-to-assets ratio, with FHLB-Topeka having the smallest margin of cushion at 4.4%. These are higher levels than we had seen of late due to capital that FHLB members added last year. The advances have gradually run off, but FHLB management teams are prudently retaining the capital at least until economic conditions improve.

Only FHLB-Chicago is not operating under a Gramm-Leach-Bliley (GLB) capital plan, although one has been submitted but not yet approved for implementation. This FHLB continued to meet its higher regulatory capital requirement at June 30, 2009 (actual ratio of 5.16%, compared to the requirement in effect of 4.76%). FHLB-Chicago had been required to carry a minimum of 4.0% regulatory capital against its assets unless its nonmortgage asset ratio was greater than 11% of its total assets. The bank is operating under a cease & desist order that includes an additional minimum regulatory capital ratio of 4.5% that superseded the 4.0% regulatory requirement. However, because its average monthly nonmortgage assets were higher than 11% at June 30, 2009, it was subject to the 4.76% ratio at that date.

Separately, since the end of first-quarter 2009, the debt capital markets have improved. The market-risk component of the FHLBs' regulatory risk-based capital requirements has declined. This is because of improved market values in the FHLBs' private-label mortgage-backed securities (MBS) portfolios that have surged back toward the minimum required level of 85% of the book value of equity after significant deterioration in first-quarter 2009. We previously explained that for every \$1 below the 85% risk-based capital ratio floor, an FHLB would have to hold an extra \$1.30 in capital. Of this, \$1 would go toward remedying the deficiency attributed to market risk, and \$0.30 would go toward increased operational risk. Therefore, although the FHLBs' private-label MBS portfolios were not specifically eroding capital, higher risk-based capital requirements converged toward actual regulatory capital levels.

At the end of second-quarter 2009, only FHLB-Seattle fell short of its risk-based capital requirement (\$2.798 billion versus the requirement of \$2.977 billion), though it improved from a \$466 million deficiency in first-quarter 2009 and was back in compliance as of July 31, 2009. (FHLB-Chicago is not subject to the risk-based capital requirement because its GLB capital plan has not been implemented.) The FHLBs' regulator subsequently declared FHLB-Seattle undercapitalized and required it to submit a capital restoration plan. Currently, FHLB-Seattle cannot redeem stock or pay dividends without regulator approval. FHLB-Seattle has the second-highest regulatory capital-to-assets ratio at 5.99%. Currently, \$2.0 billion of FHLB-Seattle's investment securities are Alt-A private-label MBS that are considered OTTI, with unrealized losses of \$1.2 billion. FHLB-Seattle has taken \$133 million in OTTI credit-related losses on these securities through the first two quarters of 2009.

With respect to FHLB member health, the FHLBs' prescribed collateral policies continued to prevent any losses on advances to troubled institutions despite numerous member failures. In all of the failures to date, no FHLB has taken any credit loss on an advance to a failed member. These advances were either assumed by another member or nonmember institution and/or repaid by the acquiring institution or the FDIC. The FHLBs' three levels of collateral management in increasing order of service level are: blanket lien against an institution's collateral; specific listing of an institution's pledged collateral; and an institution's required delivery of collateral to its FHLB.

As an FHLB perceives difficulties about its members, it intensifies scrutiny of the member and it may escalate the level of collateral monitoring. With the continuing economic difficulties and problems in commercial real estate, where smaller members are likely to have concentrations, we expect more migration of FHLB members to delivery status during the next three to four quarters. We also expect more bank failures in the same period. We do not expect any losses on FHLB advances, though, due to sound policies and practices in collateral monitoring and management.

All in all, we expect smaller members to continue originating conforming first-mortgage loans that the FHLBs will intermediate off-balance-sheet to Fannie Mae for credit guarantee. We believe we will see further credit losses in the FHLBs' private-label MBS portfolios, especially those supported by Alt-A mortgages. We also expect weak economic

conditions to limit demand for advances during the next two to three quarters until positive and sustainable GDP growth emerges. Two issues we will monitor closely are the appetite for longer-dated consolidated obligations (and the investors buying them) and regulatory reform, for which we expect alternatives to be vetted with presentation of the nation's 2010 domestic budget early next year. At that time, we expect to hear discussions about the future evolution for Fannie Mae and Freddie Mac, as well as any changes in the role of the FHLB System in support of its public-policy mission.

Issuer Review

Table 1

Company/Issuer Credit Rating*/Comments	Analyst
<p>FHLB-Atlanta (AAA/Stable/A-1+)</p> <p>FHLB-Atlanta posted decent second-quarter results of \$192 million net income, compared with \$109 million last year. The improvement resulted mainly from the \$182 million increase in derivatives and hedging gains and \$115 million decline in trading losses. However, the company recognized \$46 million in credit-related OTTI against its private-label MBS portfolio. Net interest income declined \$137 million because interest-earning assets repriced faster than interest-bearing liabilities. Advances declined 19% from year-end 2008 due to maturing advances; prepayments as a result of member failures (no losses taken); and decreased member loan demand, which we expect to continue. Concentration of the bank's advances to its 10 largest borrowing members stands at 67%, with Bank of America (and former Countrywide Financial Corp) having the highest advances. Capital levels remained adequate with a total capital-to-assets ratio of 5.30%. We expect FHLB-Atlanta to maintain its adequate financial profile by paying a small dividend and engaging in minimal stock buybacks until the economy stabilizes.</p>	Dan Teclaw
<p>FHLB-Boston (AAA/Stable/A-1+)</p> <p>FHLB-Boston reported a weak second quarter, as it swung to a net loss of \$4.2 million from net income of \$52.5 million in the same period of 2008. The losses primarily resulted from a \$70.5 million OTTI charge in the private-label Alt-A residential MBS portfolio, as MBS valuations continued to decrease. Net interest income was steady at \$84.8 million, compared with \$84.5 million in the prior-year period, as a steeper decline in funding costs relative to asset yields led to a 10 basis point (bp) improvement in net interest spread. Advances decreased 26% to \$41 billion, reflecting increased member liquidity arising from various government support programs and higher deposit mobilization. The bank's mortgage loan portfolio decreased 7% to \$3.8 billion. The capital-to-assets ratio of 5.1% is adequate. We believe that the banks sizable exposure to the stressed private-label MBS backed by Alt-A mortgages could lead to further credit losses.</p>	Vikas Jhaveri
<p>FHLB-Chicago (AA+/Stable/A-1+)</p> <p>FHLB-Chicago posted buoyant results in the second quarter, with net income of \$103 million compared with a net loss of \$74 million in the year-ago quarter. Earnings benefited from a six-fold surge in net interest income (NII), coupled with a gain of \$122 million on derivatives and hedges. A substantial reduction in interest expense led higher NII, as the bank replaced high-cost debt with short-term, low-cost discount notes. Notably, the bank also incurred net impairment losses of \$124 million that offset the \$122 million gain mentioned above. Advances decreased 29% from December 2008 to \$27 billion, reflecting members' reduced borrowing needs. Capital metrics remain adequate.</p>	Dan Teclaw
<p>FHLB-Cincinnati (AAA/Stable/A-1+)</p> <p>FHLB-Cincinnati reported a strong second quarter, with net income increasing to \$74 million from \$65 million in the same period the previous year. This increase was largely due to a 12.7% rise in NII to \$109 million, resulting from substantial widening of average spreads on short-term and adjustable-rate assets, relative to their funding costs. We expect the lower funding costs to continue to help NII, as the company continued to prematurely refinance high-cost callable bonds at substantially lower costs. These favorable trends drove the net interest margin (NIM) up by 10 bps to 0.51%. Advances decreased 16% from year-end 2008 to \$44 billion, reflecting alternate liquidity in the form of government funding and higher deposits. Capital requirements continue to be satisfied with a regulatory capital-to-assets ratio of 4.97%. With minimal exposure to private-label MBS, we do not expect FHLB-Cincinnati to have pressure on its risk-based capital requirements like certain other FHLBs.</p>	Vikas Jhaveri
<p>FHLB-Dallas (AAA/Stable/A-1+)</p> <p>FHLB-Dallas reported modest second-quarter results, with net income of \$26 million compared with \$41 million last year. The decline primarily resulted from a \$38 million decline in NII, largely attributable to lower short-term interest rates. Other income increased \$19 million due to higher gains on derivatives and hedging activities but couldn't offset the decline in NII. Advances declined by 12% since Dec. 31, 2008, to \$53 billion, reflecting availability of funds for members from Fed and FDIC programs as well as members' lower loan demand due to weak economic conditions. Capital levels remain adequate on a risk-weighted basis with a shrinking balance sheet. We expect the company to focus on its operating performance and to maintain its strong financial profile.</p>	Dan Teclaw

FHLB-Des Moines (AAA/Stable/A-1+)

FHLB-Des Moines posted decent second-quarter results, with net income of \$76 million compared with \$48 million in the previous year's quarter. The increase was primarily driven by heightened gains on derivatives and hedging activities and trading securities, partially offset by losses on the sale of available-for-sale securities, debt extinguishment, and bonds held at fair value. NII declined 14% due to low interest rates leading to a 7 bps decline in NIM to 0.35%. Advances declined 11.3% from year-end 2008, primarily due to the availability of alternative funding options for members and prepayment of advances. The mortgage portfolio declined 24.0% from year-end 2008, primarily due to the sale of \$2.1 billion of mortgage loans to Fannie Mae through FHLB-Chicago. Mortgage loans represented 12% of total assets. Capital metrics improved, with the total capital-to-assets ratio at 4.98. We expect the bank to maintain its good financial profile and demonstrate stronger performance in the upcoming quarters.

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FHLB-Indianapolis (AAA/Stable/A-1+)

FHLB-Indianapolis reported a moderately improved second quarter, as net income increased to \$53 million, up 11.6% from the prior year's second quarter. This increase was driven by higher NII and partially offset by a \$2 million credit loss portion of the OTTI charge on private-label MBS. NII increased by \$9 million and NIM improved by 12 bps to 0.6%, as a drop in funding costs offset the impact of lower asset yields. Advances decreased by \$5.3 billion, or 16.8% since year-end 2008. We expect this to continue, as the availability of alternative funding options and the increased deposits with member banks has reduced demand for advance funding. The mortgage portfolio declined 10.2% to \$7.9 billion since December 2008, and is expected to fall further, as many large sellers have stopped supplying mortgages. Capital remains adequate with the regulatory capital-to-assets ratio at 5.45%.

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FHLB-New York (AAA/Stable/A-1+)

FHLB-New York reported relatively strong second-quarter results, with net income of \$186 million, compared with \$74 million in the year-ago quarter and \$148 million in the previous quarter. Earnings benefited from increased NII and gains on derivatives and hedging activities, partially offset by higher credit-related OTTI charges attributable to monoline insured nonagency securities in the investment portfolio (\$5.3 million for the second quarter and \$10.6 million for the first half of the year). NIM expanded 6 bps to 0.62%, primarily due to substantially lower funding costs, as the bank issued more discount notes and short-term debt at favorable spreads. Advances fell by a modest 8% year-over-year, to \$100.5 billion, reflecting members' reduced borrowing needs, resulting from the availability of various liquidity programs initiated by the Fed. Regulatory capital levels remained adequate, with the total capital-to-assets ratio at 4.72%. The bank paid \$75 million, approximately 40% of earnings, in the form of member dividends. We expect FHLB-NY to actively seek to refinance a significant proportion of its consolidated obligations, approximately \$45 billion, which mature in less than a year.

Vandana
Sharma

FHLB-Pittsburgh (AAA/Stable/A-1+)

FHLB-Pittsburgh reported moderate second-quarter results, with net income of \$32.1 million, a decrease of 39% from the prior-year quarter, but an improvement from a loss of \$23.6 million in first-quarter 2009. Although second-quarter results were not affected by a contingency reserve relates to a derivatives counterparty, they continue to be affected by credit-related OTTI charges attributable to nonagency securities in the investment portfolio (\$39.3 million for the second quarter and \$69.8 million for the first half of the year). Despite lower advance levels and lower yields, NIM expanded 12 bps from the previous quarter to 0.39%, primarily due to lower funding costs as the bank issued more discount notes and short-term debt at favorable spreads. Average advance balances fell approximately 13% from the prior quarter, to \$47.4 billion, reflecting members' reduced borrowing needs resulting from the availability of various liquidity programs initiated by the Fed and strong deposit growth. Regulatory capital levels, as measured by capital to assets, increased to 5.8% from 5.3% in the prior quarter primarily due to the bank's decision to suspend dividends and repurchases of excess capital stock (\$1.4 billion as of the end of the second quarter) and the lower demand for advances. For the remainder of the year, we expect the bank to remain focused on its private-label MBS portfolio, which could lead to more OTTI charges.

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FHLB-San Francisco (AAA/Stable/A-1+)

FHLB-San Francisco reported relatively strong second-quarter results, with net income of \$303 million, an increase of 36% from the prior-year quarter and 146% from the first quarter. Earnings benefited from net gains associated with the bank's derivative positions and hedges, partially offset by higher credit-related OTTI charges attributable to nonagency securities in the investment portfolio (\$88 million for the second quarter and \$176 million for the first half of the year). Despite lower advance levels and lower yields, NIM expanded 17 bps from the prior quarter to 0.77%, primarily due to lower funding costs as the bank issued more discount notes and short-term debt at lower rates. This increase in NIM was offset, in part, by increased net interest expense on derivative instruments used in economic hedges. Average advance balances fell 14% from the prior quarter to \$190.5 billion, reflecting members' reduced borrowing needs resulting from the availability of various liquidity programs initiated by the Fed and strong deposit growth. Regulatory capital levels, as measured by capital to assets, increased to 6.11% from 5.27% in the prior quarter primarily due to the bank's decision to suspend repurchases of excess capital stock (\$4.6 billion as of the end of the second quarter) and the lower demand for advances. The bank paid \$28 million, approximately 9% of earnings, in the form of member dividends. For the remainder of the year, we expect the bank to remain focused on its private-label MBS portfolio, which could lead to more OTTI charges.

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FHLB-Seattle (AA+/Stable/A-1+)

FHLB-Seattle continued to report challenging results for the second quarter, with a net loss of \$34.3 million, almost double the \$16.2 million loss in the first quarter, compared to net income of \$29.1 million for the prior-year quarter. Second-quarter results were primarily affected by credit-related OTTI charges attributable to nonagency securities in the investment portfolio (\$61.8 million for the second quarter and \$133.4 million for the first half of the year). Despite a modest decline in funding costs, NIM contracted 16 bps from the

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previous quarter to 0.33%, primarily due to lower advance levels and lower yields. Advances decreased approximately 11% from the prior quarter to \$28.3 billion, reflecting members' reduced borrowing needs resulting from the availability of various liquidity programs initiated by the Fed and strong deposit growth. Regulatory capital levels, as measured by capital to assets, increased to 5.99% from 5.24% in the prior quarter primarily due to the bank's decision to suspend dividends and repurchases or redemptions of capital stock. Despite this, the bank was determined to be undercapitalized due to a \$178.3 billion deficiency in its risk-based capital measure as of June 30, 2009, which is determined by the market values of its private-label MBS. For the remainder of the year, we expect the bank to continue to work with the Finance Agency to implement its capital plan to restore compliance against all capital requirements. The bank's challenge will be to grow retained earnings to offset further deterioration in its private-label MBS portfolio, which could lead to more OTTI charges.

FHLB-Topeka (AAA/Stable/A-1+)

FHLB-Topeka reported improved second-quarter results, with net income of \$105.2 million, compared with \$47.0 million in the same quarter last year. Earnings benefited from a \$102.4 million gain from derivatives and hedging activities, which was partially offset by a \$25.7 million loss attributable to market value changes in its trading securities. FHLB-Topeka has an \$8.4 billion held-to-maturity securities portfolio, of which \$2.2 billion is invested in private-label MBS. Net OTTI credit losses on this portfolio were \$18,000 for the second quarter and \$59,000 year-to-date in 2009. NII increased 4.3%, and NIM expanded 9 bps to 0.6% on wider spreads due to favorable short-term funding costs and increased earning assets. Advances declined 31.5% from year-end 2008 to \$24.5 billion at June 30, 2009. The decline in advances is within our expectations as members have available various funding sources initiated by the Fed and strong deposit growth. Retained earnings rose to \$306.2 million, up 95.1% from Dec. 31, 2008, and the capital-to-total assets ratio increased to 4.4%, above regulatory guidelines.

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*Ratings are as of Aug. 27, 2009.

Quarterly Rating Activity

Table 2

Recent Rating/Outlook/Credit Watch Actions*				
Company	To	From	Date	Reason
FHLB-Chicago	AA+/Stable/A-1+	AA/Stable/A-1+	July 1, 2009	The action follows the application of our recently published revised GRE methodology.
FHLB-Seattle	AA+/Stable/A-1+	AA+/Watch Neg/A-1+	July 1, 2009	The action follows the application of our recently published revised GRE methodology.
FHLB-Seattle	AA+/Watch Neg/A-1+	AA+/Stable/A-1+	June 5, 2009	The action reflects our concerns regarding FHLB Seattle's exposure to a \$5.7 billion private-label MBS portfolio.

*Actions taken since June 1, 2009.

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Table 3

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