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Federal Home Loan Bank of Topeka

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Major Rating Factors

Issuer Credit Rating
AA+/Stable/A-1+

Strengths:	Weaknesses:
• Important to the implementation of U.S. government housing policy • Important funding source for the U.S. banking system • Very strong risk-adjusted capitalization • Solid loan asset quality, and super-lien position vis-à-vis depository institutions that has historically prevented any losses on advances	• Concentrated exposure to the U.S. mortgage market • Geographically restricted to a limited region of the U.S. • Uncertainty regarding the impact of potential legislative changes • Earnings decline when advance demand is low, though profitability is not a priority of the Federal Home Loan Banks

Outlook

The stable outlook on Federal Home Loan Bank (FHLB) of Topeka indicates our expectation that the company will maintain stable operating performance, provide liquidity and manage funding needs, build retained earnings, and support the U.S. housing sector over the next 24 months. The stable outlook also reflects S&P Global Ratings' stable outlook on the U.S.

Downside scenario

If we change our rating or outlook on the U.S., we would likely reflect that change in our ratings on the FHLB System's debt and our ratings on FHLB Topeka. Although less likely, we could also lower the rating in the next two years, if, in the context of government-sponsored enterprise(GSE) reform, the role of the FHLB System in housing finance was diminished, thereby reducing its importance to the government.

Upside scenario

An upgrade would likely be contingent upon a higher rating on the U.S. government.

Rationale

S&P Global Ratings' issuer credit rating on FHLB Topeka is based on the wholesale bank's government-supported role in providing liquidity to member institutions, strong asset quality and capitalization, low funding costs, and conservative risk management. It also reflects the bank's regulated status, overseen by the Federal Housing Finance Agency (FHFA).

The rating on FHLB Topeka includes a one-notch uplift from the bank's stand-alone credit profile (SACP) of 'aa' because we expect there is a very high likelihood of the bank receiving extraordinary government support given the FHLB System's importance to the U.S. housing market and banking system.

Anchor: Adjusted for an FHLB because of regulated status, strong competitive position, and favorable funding

Our starting point--or anchor--for our ratings on U.S. finance companies that we rate under our nonbank financial institutions criteria is 'bb+'. Because of FHLB Topeka's public policy role and its regulated status, we adjust its anchor to 'bbb+', three notches above our anchor for other finance companies and equal to that of U.S. banks. This is to account for the FHFA's regulatory oversight, the favorable funding an FHLB enjoys through its close relationship with the U.S. government, its strong competitive position alongside other housing-related government-related entities (including Fannie Mae and Freddie Mac) in the U.S. housing finance market, and its statutory priority of liens in a member wind-down situation.

Business position: Stable business model and public policy role, though business is concentrated

FHLB Topeka has an established market position, recurring business volumes, and public policy role, which, in our view, offset some of the risks associated with its relative lack of business diversity.

The FHLBs are wholesale lenders that assist the financing of the U.S. housing industry. They provide secured loans, known as advances, to their members, which include commercial banks, savings and loans, credit unions, and insurance companies.

The COVID-19 pandemic illustrated the FHLB System's underlying importance to the U.S. banking sector in times of uncertainty and economic dislocation. During first-quarter 2020, advances swelled to $806.9 billion, up 26% from the prior quarter, as member companies shored up liquidity to manage the stress. This was the peak since the 2008 financial crisis. In the following quarters, actions by the Federal Reserve and the CARES Act fostered substantial liquidity in financial markets and led to an increase in low-cost deposits at member banks. Consequently, advances fell at all FHLBs throughout the remainder of 2020 and continued lower this year. Net interest income contracted with falling demand for advances, a trend we expect will continue into 2022 as elevated liquidity persists.

FHLB advances ended the first quarter of 2021 at $399.1 billion, down about 50% year over year. The decrease in advances was more distinct for commercial bank members than insurance companies. Commercial banks contracted to 39.7% of total advances from 63.3% year over year, while insurance companies (excluding captive insurance companies) grew to 30.6% from 16.2% for the same period.

FHLB Topeka is one of the smaller of the 11 FHLBs with $48.5 billion in assets, including $21.1 billion in advances as of March 31, 2021. Advance balances increased only about 5% at the onset of the COVID-19 pandemic to support members' liquidity needs, but subsequently declined approximately 32% and have remained depressed due to increased liquidity in U.S. financial markets and elevated deposit balances at member institutions. 61% of advances are to the top five borrowers as of March 31, 2021, somewhat higher than the peer average of 51%. The company's top borrower accounted for 36% and 28% of FHLB Topeka's advances outstanding as of year-end 2020 and 2019 respectively. While we view this as significantly concentrated, it is not out of line with other FHLBs. This concentration can increase the potential for asset, earnings, or even capital volatility.

The bank's mandate limits the diversity of its business. FHLB Topeka's member borrowing needs are all highly correlated to the housing market given the bank's mission to support housing finance and community development. Furthermore, it operates exclusively in Colorado, Kansas, Nebraska, and Oklahoma, so the local economic conditions significantly affect the bank's business. FHLB Topeka has some diversity across its 710 member institutions (as of year-end 2020), which consist of 556 banks, 90 credit unions, 21 savings and loan associations, 25 insurance companies, and four community development financial institutions.

The fully collateralized nature of the lending business mitigates much of the concentration risk. Furthermore, the bank's advance volume and, therefore, revenue are typically countercyclical because members rely more on the bank in times of stress as a reliable source of funding.

Capital and earnings: Collateralized lending to financial institutions and member-capitalized co-op structure limit risk

In our assessment, FHLB Topeka's capital is very strong, based on the member-capitalized co-op structure and low-risk collateralized lending business. Also, we expect its risk-adjusted capital (RAC) ratio to remain comfortably above 15% over at least the next two years, regulatory capital measures exceed all regulatory requirements, and earnings are stable, though modest.

The FHFA requires FHLBs to keep capital in excess of 4% of assets and a leverage ratio above 5%. As of March 31, 2021, the bank had regulatory capital to assets of 5.4% and leverage of 7.7%.

Given that a significant portion of its assets are advances, which are assigned a relatively low risk weight in our methodology because all of the exposure is to financial institutions, capital on a risk-adjusted basis is stronger than the regulatory ratio. As of March 31, 2021, FHLB Topeka's RAC ratio was 18.0%. Over the next two years, we expect the bank's RAC ratio to remain relatively stable and comfortably above our 15% threshold for a very strong capital and earnings assessment considering members must scale their capital contribution to support their borrowings. Over the years, and even during the height of COVID-19, FHLB Topeka's capital ratios remained in a relatively tight band.

We expect the FHLB to remain modestly profitable and to maintain or grow retained earnings each year. Retained earnings declined in the first quarter of 2020, but for the full year, they were up relative to year-end 2019. The bank lowered its dividend from 7.5% and 2.25% at year-end 2019 for class B and class A stock, respectively, to 5.5% and 0.5% in the second quarter of 2020 and then to 5.25% and 0.25% in the third quarter, to support the growth of retained earnings.

Supporting earnings are low loan loss provisions, due to high underwriting standards, and relatively low noninterest expenses. The company derives the bulk of its revenue from interest income on investments, advances, and its mortgage loan portfolio (loans purchased from members as part of the Mortgage Partnership Finance Program).

Net income declined about 36% in 2020 compared with the prior year, primarily because of hedge losses. The decline in interest income (from advances and, to a lesser extent, investments and mortgage loans) was largely offset by the decline in interest expense on consolidated obligations. Interest income from the company's mortgage loan portfolio fell 8%, while advances declined 63%, providing some stability to interest income. Advances and mortgage loans contributed 36% and 38% of interest income in 2020, respectively, compared with 48% and 20% the year prior. FHLB Topeka's net income before affordable housing assessments improved to $48.8 million in the first quarter of 2021, versus $13.2 million in the first quarter of 2020, as a result of both higher net interest income and lower noninterest losses.

We expect subdued demand for advances, as well as low interest rates and banks retaining excess liquidity, to weigh on earnings over the next few years. However, we don't believe the absolute level of earnings is an important ratings consideration because of the bank's strong capital level and its co-op structure, the latter of which ensures that profit maximization is not a goal. Since the FHLBs return most of their profits to members in the form of dividends, and they price their advances to be competitive with the relatively low rates banks pay on deposits, the FHLBs have lower profitability than do their banking members.

Since profit maximization is not a priority and each district has somewhat unique needs, we do not anticipate any further consolidation in the system over the next 12-24 months. In 2015, FHLB Seattle merged with FHLB Des Moines, the only consolidation of in FHLB System in its 80-plus year history.

Risk position: No losses on member advances, low interest rate risk, and low risk from peripheral activities

FHLB Topeka's risk position is characterized by its very high credit quality lending portfolio, history of never having suffered a loss on a collateralized advance to a member, and low interest rate risk.

The bank follows strict underwriting standards and credit requirements from borrowers. All advances to member institutions are collateralized by loans (mainly residential mortgage loans) and securities with an estimated value significantly in excess of the advance. FHLB Topeka monitors the financial condition of its members, and manages collateral guidelines, advance rates, and security agreements to further mitigate credit risk. In addition, the FHLB has a super-lien position vis-à-vis depository members. For advances to nondepository members, the FHLB relies on stricter borrowing limits and collateral guidelines to mitigate its risk, for which it is not guaranteed priority status in liquidation.

Furthermore, a member must own FHLB's capital stock based on its total assets as a condition of membership, and is required to purchase additional activity-based capital stock as it engages in certain business activities with an FHLB. As additional security for a member's indebtedness, an FHLB has a statutory lien on that member's stock.

The bank purchases residential mortgage loan products from participating financial institutions under the Mortgage Partnership Finance (MPF) Program, a secondary mortgage market structure created and maintained by FHLB Chicago. As of March 31, 2021, the bank has the highest exposure to these mortgages of its peers--18% of total assets. These mortgages carry very limited credit risk because they are either government guaranteed or credit enhanced by the member institutions from which FHLB Topeka purchases them. Over 86% of the MPF portfolio has a FICO score greater than 700, and over 85% has a loan-to-value ratio greater than 60%.

As of March 31, 2021, the investment securities portfolio totaled $12.2 billion, about a quarter of total assets. Investments included $3.2 billion in U.S. Treasuries and agency debt, and $6.8 billion of agency mortgage-backed securities at year-end 2020. FHLB Topeka has no exposure to private-label mortgage-backed securities.

The bank is exposed to interest rate risk primarily from the effect of interest rate changes on its interest-earning assets and on the funding sources that finance these assets. However, it manages the risk by issuing fixed-rate debt to fund its mortgage loan portfolio and a portion of its fixed-rate advance portfolio, and by using various derivatives.

Funding and liquidity: Stable and favorable funding supports the business model

The FHLB System's diverse and global investor base, as well as the system's ability to issue debt at a small spread to U.S. Treasury obligations, benefits FHLB Topeka's funding and liquidity. During times of stress, investors often buy FHLB debt as a safe harbor investment. Based on the availability of funding for the system during periods of uncertainty, we think access to funding is unlikely to be difficult in stress scenarios. The FHLB regularly conducts stress tests on its funding and liquidity.

In our view, FHLB Topeka and its sister banks were able to sufficiently meet their mandate of supporting the liquidity needs of their members brought on by the pandemic in early 2020, funded through the system's issuance of consolidated obligation bonds and discount notes. The bank was also able to scale back quickly once the spike in demand for funds subsided.

We consider FHLB Topeka's liquidity adequate relative to its potential cash flow requirements over the next 12-24 months. Despite market stress in the first quarter resulting from the COVID-19 pandemic, FHLB Topeka's liquidity and funding gap metrics were maintained within FHFA guidance, and we expect the bank to be able to remain in compliance with regulatory requirements over the next 12-24 months.

Comparable ratings adjustment: None

We don't include an adjustment in our rating on FHLB Topeka based on comparison with peers.

External influence: Critical to U.S. housing policy

In our opinion, there is a very high likelihood that the U.S. government would provide the bank with timely and sufficient extraordinary support in the event of financial distress. Therefore, our issuer credit rating on the bank includes one notch of uplift from our SACP.

Our view of government support in our assessment of FHLB Topeka reflects the following factors:

- Very important role providing low-cost funding to support housing and community development in the U.S., which we think are key economic and political objectives of the U.S. government; and
- Very strong link with the U.S. government, because a financially distressed or defaulted FHLB could significantly affect the government's reputation, and we believe the government has the administrative capacity and mechanisms (via the FHFA) for responding to an FHLB's financial distress in a timely manner.

Moreover, we view the government as having a track record of providing very strong and timely credit support to the FHLBs, such as their inclusion in a U.S. Treasury GSE credit facility created in September 2008.

We continue to monitor legislative proposals and judicial decisions that could affect the FHLBs, which are regulated by the FHFA. That said, we do not anticipate any meaningful reform over the next 12-24 months.

In June, the U.S. Supreme Court ruled that the president can replace the director of the FHFA at will, effectively giving the president influence over the regulatory and enforcement priorities of the agency. Following the ruling, FHFA Director Mark Calabria resigned, and President Joe Biden appointed Sandra Thompson as acting director. Separately, in May, Sen. Catherine Cortez-Masto, D-Nev, introduced the Federal Home Loan Bank Mission Implementation Act. The proposed bill, among other things, includes an increase in the annual amount set aside for Affordable Housing Program obligations to 30% of net income, from 10% currently. If passed, the FHLBs could experience earnings pressure from the increased expense related to these programs.

Ratings Score Snapshot

Issuer Credit Rating: AA+/Stable/A-1+

SACP: aa

Anchor: bb+

- Entity-Specific Anchor Adjustment: +3
- Business Position: Strong (+1)
- Capital, Leverage, and Earnings: Very Strong (+2)
- Risk Position: Very Strong (+2)
- Funding and Liquidity: Average and Adequate (0)

External Influence: +1

- Government Influence: +1
- Group Influence: 0
- Rating Above the Sovereign: 0

Additional Factors: 0

Related Criteria

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015

- Criteria | Financial Institutions | General: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014
- Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Ratings Detail (As Of August 2, 2021)*	
Federal Home Loan Bank of Topeka	
Issuer Credit Rating	AA+/Stable/A-1+
Issuer Credit Ratings History	
10-Jun-2013	AA+/Stable/A-1+
08-Aug-2011	AA+/Negative/A-1+
15-Jul-2011	AAA/Watch Neg/A-1+
Sovereign Rating	
United States	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+
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 Banks	
Senior Unsecured	AA+

Ratings Detail (As Of August 2, 2021)*(cont.)	
Senior Unsecured	AA+/A-1+
Senior Unsecured	AA+/Stable
Short-Term Debt	A-1+
Short-Term Debt	AA+/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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