

Special Comment

Moody's Global Banking

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Rating Implications on the Federal Home Loan Banks from Other-than-Temporary Impairments

Summary

The Federal Home Loan Banks (FHLBanks) are currently facing the potential for substantial accounting impairments on their \$76.2¹ billion private label mortgage-backed securities (MBS) portfolio. Total FHLBank gross unrealized losses related to their private-label securities portfolio equaled \$13.5 billion and capital equaled \$57 billion as of September 30, 2008. If these unrealized losses are deemed "other than temporary" for accounting purposes, this would significantly impair the FHLBanks' capital levels.

Moody's current assessment of the FHLBanks' portfolios indicates that true economic losses embedded in these securities total less than \$1 billion and are manageable given the FHLBanks' capital levels. For example, all FHLBanks - without exception - can absorb Moody's expected economic losses without breaching any regulatory capital requirement. However, given current accounting standards, Moody's believes losses in excess of the ultimate economic loss may materialize through other-than-temporary impairments (OTTI) that would substantially reduce capital levels. Under a worst-case scenario, which assumes that all private label securities are categorized as OTTI, capital levels at only four of twelve FHLBanks' would remain above regulatory minimums. This could have implications from both a regulatory and markets confidence/access standpoint.

Moody's ratings of the FHLBanks are based on our expectations that these firms have a very high degree of government support. Therefore, although declines in capital and the potential regulatory and financial effects could result in reductions of the FHLBanks' Baseline Credit Assessments (BCA – the stand alone ratings), the FHLBanks' Aaa senior debt rating and Prime-1 short-term debt rating (which take into account the likelihood of government support) are likely to remain unchanged.

The FHLBank of Chicago currently has \$1.0 billion of Aa2 subordinated debt outstanding. The outlook on the subordinated debt is negative. Interest payments on the debt could be deferred for up to five years if the FHLBank of Chicago does not meet its regulatory capital requirements. Moody's remains focused on the FHLBank of Chicago's ability to manage its balance sheet to remain in compliance with its regulatory requirements should the FHLBank incur material OTTI, as well as the regulatory response to incurring material OTTI.

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¹ Based on carrying value.



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The OTTI Conundrum

Given current economic and market conditions, a key risk facing FHLBanks' creditworthiness is the potential for large losses on their combined \$76.2 billion private-label MBS securities portfolio. The FHLBanks hold these securities as long-term investments ("held-to-maturity"), and account for them on an amortized cost-basis. At September 30, 2008, based on then-current market prices, however, this portfolio was valued at \$62.7 billion, representing a \$13.5 billion unrealized loss. Although this amount is a temporary "paper loss," determining for accounting purposes whether the decline in value is "other-than-temporary" has important implications on the reported financial position of the FHLBanks.

Moody's expected loss on the FHLBanks' portfolio, if held until maturity, is low (less than \$1 billion) and very manageable given the FHLBanks' \$57.1 billion of capital at September 30, 2008. The large difference between Moody's expected economic loss and the mark-to-market loss is attributed to market illiquidity, de-leveraging and stress in the credit market in general. Individually, all twelve FHLBanks could absorb their respective losses through current capital without breaching minimum regulatory capital requirements of 4% (4.5% for the FHLBank of Chicago).

Furthermore, Moody's believes that the FHLBanks have the ability to hold the securities until maturity. The FHLBanks have maintained access to the capital markets, and the US Government has been undertaking initiatives to ensure that they maintain and improve this access. Additionally, the fact that the FHLBanks have access to the U.S. Government-Sponsored Enterprise Credit Facility (GSECF), a secured lending facility that serves as a liquidity backstop, substantially reduces the likelihood that the FHLBanks would need to sell securities to raise liquidity – an act that would crystallize otherwise unrealized losses.

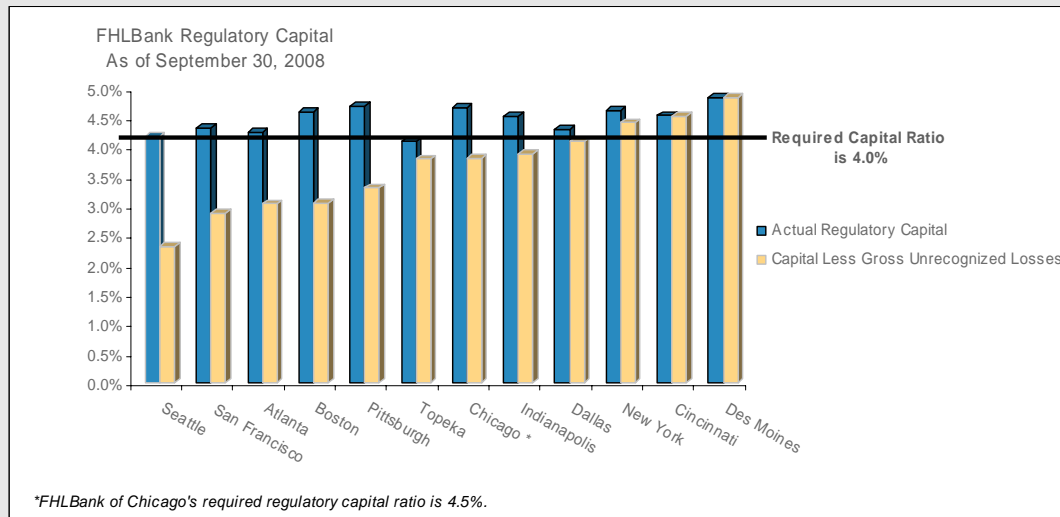
In the short term, US GAAP accounting rules may require the FHLBanks to account for securities in their portfolio as "other-than-temporarily impaired" (OTTI). This would force the FHLBanks to write down the value of these securities to current market values. Such write downs would be recorded through the income statement, potentially producing a loss that would deplete capital. This contrasts with their current cost-basis treatment where unrealized losses are not recorded in either capital or net income. Although it is highly unlikely that the FHLBanks would determine that all private-label securities are other than temporarily impaired, we have used the potential loss from all private-label MBS, as of September 30, 2008, to frame the worst case scenario.

Although the impact is not uniform among FHLBanks, for some, incurring OTTI charges could reduce capital to below regulatory minimums. For example, the FHLBank of Seattle's regulatory capital would decline to 2.31% (versus the 4% minimum) if it had to record all of its gross unrealized losses on its private-label MBS securities at September 30, 2008. At the other end of the spectrum, four FHLBanks – Cincinnati, Dallas, Des Moines and New York – have sufficient excess regulatory capital to absorb the entire gross unrealized loss on their respective portfolios at September 30, 2008 without breaching regulatory capital requirements.

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Dimensioning the OTTI Impact on Individual FHLBanks

Ongoing market volatility and the diversity in accounting (and auditing) practices make dimensioning with precision the size of potential OTTI charges difficult. However, to understand what could be the impact under a worst-case scenario, we simulated the capital position of each FHLBank after incurring the maximum OTTI charges possible (based on the difference between the FHLBanks' carrying value and the fair value of their securities as of September 30, 2008). These amounts are substantial and would result in capital levels that are below minimum regulatory requirements for all but four FHLBanks.



Moody's believes, based on its current analysis, that the ultimate loss on the private label MBS securities will be far lower. The key difference between our analysis and market pricing/unrealized losses is the exceptional liquidity premiums that are affecting market prices.

It is important to note that, if the FHLBanks were required to take the full amount of unrealized losses as OTTI, based upon this data they all would continue to maintain positive capital positions. However, they would then be subject to further market risk in the value of these securities.

To date, FHLBanks have only reported combined OTTI charges of \$209 million, (\$87 million by the FHLBank of Atlanta, \$72 million by the FHLBank of Chicago and \$50 million by the FHLBank of Seattle). If the FHLBanks are forced to recognize a substantial portion of the unrealized losses through OTTI, the impact could have important ramifications in terms of both heightened regulatory supervision due to the breach of minimum regulatory capital requirements and potentially more limited or more expensive access to capital markets.

Ramifications of OTTI Charges

The regulator of the FHLBanks, the Federal Housing Finance Agency (FHFA), is likely to focus on how closely any OTTI losses compare to its views of the ultimate economic losses embedded in the securities portfolios. Moody's believes that if the FHFA views recorded OTTI losses as being well in excess of the FHLBanks' economic losses, its actions will likely be similar to actions taken by the Federal Housing Finance Board, the FHLBanks' previous regulator, in addressing concerns regarding risk management, capital structure and governance at the FHLBank of Seattle and Chicago in 2004, respectively. Those actions focused on heightening oversight and ensuring these two FHLBanks developed business and capital plans, as well as reviewing risk management practices.

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If the regulator believes that the OTTI losses of any individual FHLBank will crystallize into realized losses, its actions are likely to be more severe. These could include conservatorship of the FHLBank or a forced merger of it into a healthy FHLBank. On balance, Moody's believes that the regulatory response to OTTI will be measured and will focus on capital preservation because we believe that the ultimate economic losses will be less than OTTI, possibly by a material amount.

Another risk associated with substantial OTTI losses is the potential for more limited, or more costly, access to the capital markets for the FHLBanks. Agency² debt costs relative to US Treasuries were very volatile during 2008. In addition, at times, investor demand for Agency debt with maturities extending beyond one year was virtually non-existent. Recent US Government actions aimed at increasing liquidity in the Agency market, such as the purchase of FHLBank debt by the New York Federal Reserve, have improved FHLBank debt spreads relative to US Treasuries. However, the recent increased demand for Agency debt may be transitory if investors become concerned about FHLBank capital levels.

Capital Preservation

The exposure to private-label securities and the potential associated writedowns likely mean that the FHLBanks will be preserving capital through 2009. Capital preservation is particularly important because of the FHLBanks' limited capital generation.

In order to preserve capital the FHLBanks could reduce or eliminate cash dividends. This would provide a modest capital benefit because total cash dividends equaled \$1.0 billion for the nine months ended September 30, 2008.

Another action that could be undertaken to preserve capital is the suspension of excess stock repurchases, similar to the steps taken in December 2008 by the FHLBanks of Boston and Des Moines. This action would limit member banks' ability to pull capital out of the FHLBank System. We note that substantial capital had built up in the System over the past 18 months due to increased borrowings from member banks as a result of the tightened credit markets. However, more recently, the US-government has announced several actions to increase market liquidity for banks. As a result, members of the FHLBank System may reduce borrowings from the FHLBank System in favor of US Government-supported programs. Reduced borrowings would in turn increase excess member stock. A temporary moratorium on repurchasing excess member stock would send a clear message that capital will not be leaving the FHLBank System.

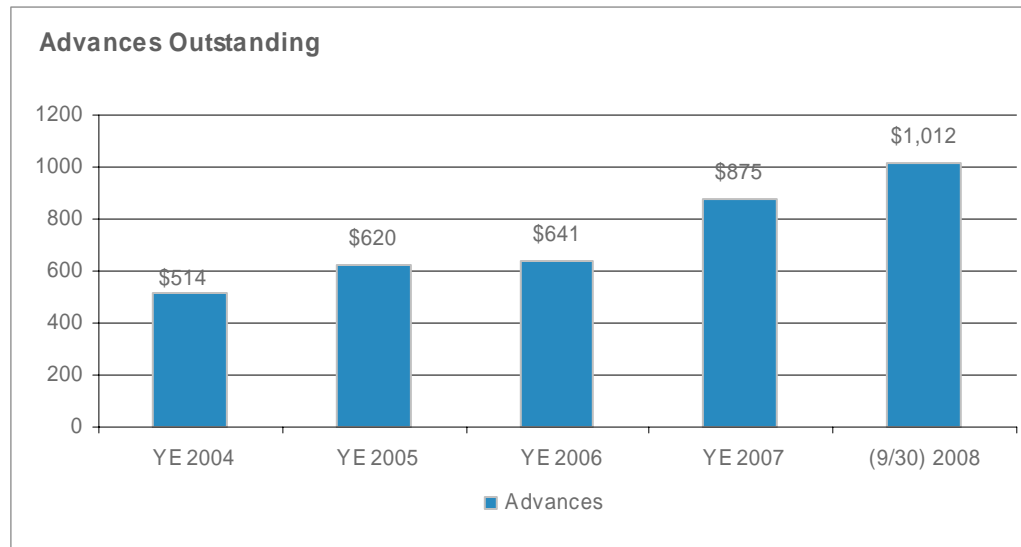
Finally, the FHLBanks could also raise the capital requirements for member banks. Member banks would then be required to purchase more capital from their FHLBank in order to remain in good standing and be able to borrow. Moody's believes that FHLBanks and regulators would be hesitant to increase capital requirements for member banks during a period of capital scarcity over an issue that does not reflect the true economics.

Implications for the US Banking System

The FHLBanks were created to provide member institutions with a stable source of funding, mainly by supplying cash advances in exchange for collateral. Since the beginning of the credit crisis, the FHLBanks' role has become increasingly important, as they have been a vital source of reliable liquidity to their members and, thus, to the US banking system. During the period from June 30, 2007 (the period end prior to the credit crisis) to September 30, 2008, FHLBank advances grew 58% to over \$1.0 trillion from \$640.0 billion.

² Debt issued by Government-sponsored enterprises such as the FHLBanks, Fannie Mae and Freddie Mac.

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Moody's does not believe that the regulator would reduce the FHLBanks' lending activities even if the FHLBanks were to incur substantial OTTI charges. First, the FHLBanks are self-capitalizing, so additional lending would bring more capital into the System (i.e., member banks have to invest capital in their FHLBank to support any additional advances that they receive from their FHLBank). Second, the regulator is unlikely to force a curtailment in lending if it believes that the OTTI charges are transitory in nature. Third, and critically, the regulator would likely carefully consider the demonstrated importance of the FHLBanks to the banking system through the credit crisis.

However, alternative liquidity provided to the banks through US Government programs will likely moderate the demand for FHLBank advances in 2009. As a result, Moody's expects the growth in FHLBank advances to flatten or decline slightly.

FHLBank Ratings Implications

Moody's does not expect changes to the senior debt ratings of FHLBanks, as the FHLBanks' ratings already incorporate an expectation of a very high degree of government support, which is a key factor in their current Aaa senior debt and Prime-1 short-term debt ratings. The importance of their role as a liquidity provider to US banks throughout the current crisis solidifies this view.

The US Government has already enacted several programs to ensure the FHLBanks are able to fulfill their mission. For example, the FHLBanks were included in the GSECF to ensure that the FHLBanks had ready access to funding. In addition, the Federal Reserve has begun to purchase up to \$100 billion of direct debt obligations of Freddie Mac, Fannie Mae and the FHLBanks.

However, declines in capital as a result of OTTI may put negative pressure on the FHLBanks' BCA. BCAs are intended to express an opinion about the institutions intrinsic or stand-alone financial strength and specifically exclude an assessment of the probability of extraordinary support. Key considerations in assessing the BCAs of the FHLBanks include (1) the magnitude of OTTI charges and their effect on regulatory capital, (2) the regulatory response to the incurrence of OTTI charges, and (3) the FHLBanks' ability to continue to obtain stable, cost-effective funding.

The FHLBank of Chicago currently has \$1.0 billion of Aa2 subordinated debt outstanding. The outlook on the subordinated debt is negative. Interest payments on the debt could be deferred for up to five years if the FHLBank of Chicago does not meet its regulatory capital requirements. In addition, the FHLBank of Chicago is operating under a cease and desist order (C&D) from the FHFA. Under the terms of the C&D this Bank must maintain a minimum total capital ratio of 4.5%. As of September 30, 2008, the Bank's total capital ratio was 4.68%.

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Moody's believes the economic loss associated with the FHLBank of Chicago's private-label security portfolio is low. In fact, Moody's estimates for the FHLBank's economic losses are lower than the \$72 million of OTTI charges recorded in 2008.

However, like the FHLBank System, potential OTTI charges at the FHLBank of Chicago could be material. In assessing the likelihood of an interest deferral on the FHLBank of Chicago's subordinated debt, , Moody's is focused on several key factors: (1) The extent of the FHLBank of Chicago's financial flexibility or its ability to manage its balance sheet such that it can increase its capital ratio in a short period of time. For example, proceeds from maturing short-term assets can be used to pay down short-term debt, reducing required capital; (2) The FHFA could reduce the required regulatory capital ratio by as much as 50 basis points below the current 4.5%. There is precedent for this. In fact, the FHFA originally required the FHLBank of Chicago to maintain a total capital ratio of 5.1% as part of the June 30, 2004 Written Agreement. The FHFA and the FHLBank of Chicago amended the total capital ratio minimum as part of the C&D Order issued on October 10, 2007 and reduced the total capital ratio to the current 4.5%; (3) Lastly, Moody's notes Fannie Mae and Freddie Mac have subordinated debt with similar interest deferral features to that of the FHLBank of Chicago. Fannie Mae and Freddie Mac are not in compliance with their regulatory capital requirements but have been making interest payments on the subordinated debt as instructed by their regulator, the FHFA.

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