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Summary:
Federal Home Loan Banks

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Rationale

On Aug. 13, 2010, the Federal Home Loan Bank System reported combined net income for second-quarter 2010 of $326 million, flat with $325 million in first-quarter 2010 and down 71% from $1.123 billion in second-quarter 2009. Ten of the 12 banks reported positive net income. Only Federal Home Loan Bank (FHLB)-Pittsburgh and FHLB-Indianapolis reported net losses. These losses are primarily attributable to significant other-than-temporary impairment (OTTI) credit-related charges in their respective investment portfolios. Overall, the System's operating performance is in line with Standard & Poor's Ratings Services' expectations.

The System's total assets continued to decrease, though more slowly than in the first quarter, primarily because of lower advance balances. System earnings were flat but solid because the persistent low-rate environment and perception of the U.S. as a safe haven kept funding costs very low. OTTI continued in the System's securities portfolio as cash flow projections based on weaker assumptions (especially for prime mortgage collateral) reflected potential future credit losses. System capital remained relatively stronger than in precrisis periods, as balance sheet contraction exceeded the pace of capital return (or reduction).

We expect System contraction to be slower than in 2009, though it may continue through the next two to four quarters, depending on economic conditions and member loan demand. Total System assets decreased 3% in the second quarter to $937 billion and about 5% in the first quarter. Advances were down about 6% in second-quarter 2010 (to $540 billion) compared with more than 9% the previous quarter. This was due primarily to high deposit levels at member financial institutions, low loan demand from FHLB member banks, and continued availability of more attractively priced sources of funding and/or liquidity with lower collateral requirements. The financial condition of certain FHLBs weakened in the first six months of 2010, which tightened credit and collateral terms for advances, reducing those members' borrowing capacity.

We continue to monitor the System's investment securities portfolios, particularly private-label residential mortgage-backed securities (RMBS). In our view, private-label RMBS portfolios could experience further significant, but manageable, OTTI, especially in bonds supported by prime mortgages. This is even more likely if unemployment and general economic conditions remain weak. Private-label RMBS securities of $41.6 billion represented only about 4.5% of total System assets at June 30, 2010. The FHLBs recognized $495 million of credit-related OTTI charges on these securities during second-quarter 2010, compared with $233 million in the first quarter. Notably, FHLB-Pittsburgh accounted for $111 million of these charges (22% of the System total) in the second quarter.

We believe that mortgage-related losses will continue to grow through 2010. A faster pace of foreclosure resolutions, high inventory levels, and low sales volumes in persistently weak economic conditions likely will pressure home values further. Similar to the other portfolios of the housing government-sponsored entities (GSEs; Fannie Mae and Freddie Mac), bonds supported by prime mortgage collateral have deteriorated the most in 2010. (Alt-A performed the worst in 2009.) The 2005-2008 vintage bonds are the worst-performing RMBS and collateral by vintage.

We believe the System's capital will remain strong because management teams have discretion on how quickly to return capital through dividends. We also assume manageable future OTTI.

Combined regulatory capital decreased 1.7%, whereas total assets decreased 7.7% through the first half of the year. Total capital increased $377 million (0.9%) in first-half 2010. Excluding capital stock activity, capital improved by $1.3 billion. This was primarily from accretion of the noncredit portion of impairment losses on held-to-maturity securities, the reclassification of previous noncredit losses out of accumulated other comprehensive income into credit losses, and subsequent fair-value adjustments on available-for-sale securities as of June 30, 2010. Retained earnings increased $390 million, excluding stock dividends.

In addition to paying particular attention to the mortgage-backed securities (MBS) portfolios for the remainder of the year, we will examine how the housing GSE resolution will affect the future of the FHLB System. At an Aug. 17, 2010, conference on the future of housing finance, U.S. Treasury Secretary Timothy Geithner said the administration will unveil its plan for the GSE resolution in early 2011.

Outlook

The outlook on each FHLB except FHLB-Seattle is stable. (See Federal Home Loan Bank of Seattle, published July 2, 2010, on RatingsDirect.) We expect the FHLB System, as a GRE, to continue to benefit from the implied support of the U.S. government for its consolidated debt obligations, and to continue to make advances. However, if losses on its private-label MBS exceed our expectations and affect profitability and consequently capital on certain FHLBs, or if possible legislation or regulatory developments have an adverse affect on the System, resulting in less implicit government support, we could lower our ratings.