

RESEARCH

Federal Home Loan Banks

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Primary Credit Analysts: Scott Sprinzen, New York (1) 212-438-7812;
scott_sprinzen@standardandpoors.com
 Victoria Wagner, New York (1) 212-438-7406;
victoria_wagner@standardandpoors.com
 Robert B Hoban, Jr., New York (1) 212-438-7385;
robert_hoban@standardandpoors.com

Secondary Credit Analysts: Vikas Jhaveri, New York (1) 212-438-3693;
vikas_jhaveri@standardandpoors.com
 Xavier Chavee, New York (1) 212-438-7393;
xavier_chavee@standardandpoors.com

CREDIT RATING

Not Rated

Outstanding Rating(s)

Senior unsecured <i>Local currency</i>	AAA
Short-Term debt <i>Local currency</i>	A-1+

Sovereign Rating

United States of America	AAA/Stable/A-1+
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Major Rating Factors

Strengths:

- Important role in the U.S. mortgage market
- Excellent asset quality
- Conservative risk-adjusted capitalization
- Low funding costs

Weaknesses:

- Weak profitability in absolute terms, albeit satisfactory on a risk-adjusted basis
- Exposure to interest rate risk
- Potential for adverse regulatory changes

Rationale

The 'AAA' rating on the debt of the Federal Home Loan Bank (FHLB) System reflects the System's status as a GSE and the combined financial strength of the 12 district banks (FHLBs), which issue debt (termed "consolidated obligations") on a joint and several basis through the Office of Finance, the System's fiscal agent.

The FHLB System was organized under the Federal Home Loan Bank Act of 1932.

Each of the individual FHLBs is a cooperative, the members of which consist of commercial banks, thrifts, credit unions, and insurance companies. The System has the public policy mission of supporting its members' housing and community investment activities by serving as a reliable source of liquidity through secured financing. The FHLBs also contribute direct support to affordable housing and community investment programs delivered through members. (The FHLBs are viewed as policy-based entities under Standard & Poor's Ratings Services' government support methodology. See "Rating Government-Related Entities: A Primer," published June 14, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.) The FHLBs are closely regulated by the Federal Housing Finance Board (Finance Board). The consolidated obligations are commonly viewed as "agency" obligations and priced at a narrow spread over U.S. treasuries, affording the FHLBs and their members the benefit of low funding costs.

With consolidated obligations outstanding approaching \$1 trillion, the System is among the largest providers of mortgage credit. In the highly unlikely event that the System were to experience financial distress, the federal government would have a strong incentive to provide financial support to ensure stability of the housing and capital markets. The U.S. Treasury has the authorization to purchase up to \$4 billion of consolidated obligations. Nevertheless, the 'AAA' rating on the consolidated obligations does not rely on any specific assumptions about whether such support would be forthcoming, or the form it might take. U.S. Government policy with respect to the FHLBs has varied over time. In 1989, the government effectively confiscated the accumulated retained earnings of the FHLBs to help fund the bailout of the savings and loan sector. Presently pending are regulatory changes proposed by the Finance Board that would bolster the FHLBs' retained earnings, but that could adversely affect the economics of participation in the FHLB System by member financial institutions for an extended period, since the dividends the FHLBs would be permitted to pay to their members would be lower, thereby increasing the members' all-in cost of funds.

Ratings on individual FHLBs reflect their very high asset quality and exceptional liquidity and funding capabilities, including the benefits that accrue from being core members of the FHLB System. The FHLBs' key function is to make advances (i.e., loans) to members. These advances are well overcollateralized, and there has not been a single loss on an advance since the inception of the FHLB System. For liquidity purposes and to earn incremental spread income, the FHLBs all hold substantial portfolios of high-quality investments. In recent years, the FHLBs have initiated programs under which they have purchased conventional or government-guaranteed (FHA/VA) fixed-rate mortgages from members. While the credit risk related to these purchased loans is largely retained by the members, the interest rate risk is borne by the FHLBs, and this has posed significant challenges in some cases, particularly since the FHLBs have lacked any ready means of monetizing these assets. While the FHLBs' profitability and capitalization measures are weak in absolute terms, they are satisfactory in view of the low-risk nature of these banks' assets and operations. Funding flexibility is superior, given the ability of the FHLBs to borrow by means of consolidated obligations. The Finance Board closely regulates the underwriting, investing, liquidity management, and capital-raising activities of the FHLBs. The solidarity within the System extends beyond the joint and several guarantees of the consolidated obligations in a default: a notable example of this is the authority of the Finance Board to require any FHLB to make the principal or interest payments due on any other FHLB's consolidated obligation, even absent a default. (This has never occurred.) The closely integrated nature of the FHLB System limits the downside risk for the FHLBs, and so explains why the individual FHLB ratings are in

a narrow band, even though the operating and financial profiles vary somewhat.

Outlook

The FHLB System, as a GSE, is expected to continue to benefit from the implied support of the U.S. government for its consolidated debt obligations. Operating performance and capitalization standards have been under some pressure, but we expect acceptable levels to be maintained at all the FHLBs. Even if proposed regulatory changes concerning retained earnings standards were implemented-which we believe would be an adverse development-the 'AAA/A-1+' rating on the consolidated obligations would not be affected. The System continues to attract new members, especially from the ranks of commercial banks, ensuring that it continues to play an important role in the U.S. home-finance market.

Profile

The FHLB System is among the largest providers of mortgage credit in the U.S. The System is made up of the 12 FHLBs, located in 12 regions of the U.S., and the Office of Finance, the system's fiscal agent for the issuance and servicing of consolidated obligations on behalf of the 12 FHLBs. The Office of Finance is located in Reston, Va., a suburb of Washington, D.C. Congress created the System in 1932. The public purpose of the 12 FHLBs is to facilitate the availability of mortgage credit by providing liquidity to their member financial institutions, providing members with advances as a supplement to deposit flows and other funding sources in meeting residential mortgage credit needs.

The Finance Board, an independent agency of the U.S. government, supervises the system. Although each FHLB is managed independently, they all operate under the regulations issued by the Finance Board. The consolidated obligations are joint and several obligations of all 12 FHLBs. Even short of a default, the Finance Board, at its discretion, may require any FHLB to make the principal or interest payments due on any other FHLB's consolidated obligation. This has never occurred. The FHLBs primarily operate as wholesale lenders, making low-risk collateralized advances to their members to fund home mortgages, multifamily and rental housing loans, and agricultural loans. Advances may be fixed or adjustable rate, and vary widely in their maturity and payment characteristics. FHLBs accept a range of collateral types, including both conforming and nonconforming mortgages, some of which cannot be readily pledged elsewhere or securitized. Because members retain ownership of the loans they pledge as collateral, these loans do not have to meet the investment criteria of the secondary mortgage market, which allows members greater underwriting flexibility. Many advance products offered by the FHLBs now incorporate rate-protection features, lessening market risk and accounting challenges for members. Still, the FHLBs compete with other funding sources, such as members' depositors and other sources of wholesale funding, including, in some cases, other FHLBs (where one or more affiliates of an FHLB's members is also a member of other FHLBs).

Apart from providing advances to members, the FHLBs purchase loans from members under the Mortgage Partnership Finance (MPF) program, initiated in 1997, and the Mortgage Purchase Program (MPP), initiated in 2001. Under these programs, the FHLBs carry mortgage loans on their balance sheets, and members are afforded an additional alternative to holding fixed-rate residential mortgage loans in their portfolio or selling them into the secondary market. The risks associated with these loans are shared with members: the originating lender-member bears the bulk of the related credit risk, while the FHLB bears the interest rate risk. Mortgage assets totaled \$105 billion at year-end 2005, down 8% from the prior year end. Mortgage assets account for approximately 11% of total assets.

As part of their mission, the FHLBs are required to contribute, on a consolidated basis, to service debt issued by the Resolution Funding Corp. (REFCORP), an entity established to contribute funds for support of the savings and loan deposit insurance fund. The FHLBs are also required to fund the Affordable Housing

Program (AHP). Each FHLB must pay 20% of its GAAP net earnings (after its AHP obligation, but before the assessment to REFCORP) to REFCORP to support the payment of interest on bonds issued by REFCORP. Each FHLB must also set aside for the AHP 10% of its current year's regulatory income (as defined) before charges for AHP, but after expenses for REFCORP.

The System's combined assets rose 8% to \$998 billion at Dec. 31, 2005, up from \$925 billion at year-end 2004. Advances rose 7% to \$620 billion, and represented 62% of total assets. Investments rose 18% to \$259 billion. Consolidated obligations totaled \$939 billion at June 30.

Ownership and Legal Status

The FHLBs are owned by their members. Member institutions—totaling more than 8,100—are primarily commercial banks and savings banks. Other financial institutions that are eligible to belong include credit unions and insurance companies, but few of these have chosen to become members. Mortgage banks are not eligible for membership. Federally chartered savings institutions formerly were required by law to be members of the FHLBs. With passage of the Gramm-Leach-Bliley Act in 1999, membership became voluntary.

A member must contribute capital to belong to an FHLB. The member's stock requirement is generally based on its use of FHLB products, subject to a minimum requirement based on the member's assets. In return, the member may borrow, on a secured basis, at generally attractive rates from its FHLB. In addition to borrowing rights, members generally receive dividends on their shares in their FHLB, which helps to further lower their all-in funding costs.

The members of each FHLB elect the majority of the directors on its board of directors, with the Finance Board appointing the remainder.

During the past two years, Congress has considered various bills that would establish a new regulator for the three housing-related GSEs—the FHLBs, Fannie Mae, and Freddie Mac—and to address other reform issues. Prospects for such legislation and the effect it might have on the FHLBs are highly uncertain.

Strategy

While each of the 12 FHLBs in the System is independently managed, all of the banks have been pursuing a similar strategy in recent years. Given the decline of the savings and loan industry, from which the vast majority of the FHLBs' membership had historically been derived, the banks have been seeking to increase membership from among commercial banks and other financial institutions.

Commercial banks have increased their borrowing from the FHLBs. In addition to attracting new members, the FHLBs have focused on cost containment in recent years. Nevertheless, expenses have broadly increased owing to SEC registration and other regulatory requirements, including those relating to risk management. They have also been developing more flexible advance products to serve the needs of the members. To generate a sufficient level of income to pay for the required System contributions to REFCORP and for the AHP, as well as to continue to pay attractive dividends to members, the banks have all stepped up their investing activity, especially in the area of MBS investing: each bank is allowed to hold MBS up to 300% of its equity. The banks have also diversified through the MPP and MPF programs, although with mixed results: Further expansion in this area is likely to be limited, and for some banks a retrenchment has started. The FHLBs' investment activities have also grown due to asset growth and increased liquidity needs.

Risk Management

Credit risk

Each of the FHLBs sets its own credit policies, but within strict limits that apply to the System as a whole. At each of the 12 regional banks, a large proportion of advances are made to a relatively small number of members. (For example, at the extreme, three members account for approximately 70% of FHLB-San Francisco's advances.) This credit aspect of such concentration risk is substantially mitigated by the secured nature of the lending. All advances to members are overcollateralized with predominantly high-quality mortgage collateral. In accordance with the Federal Home Loan Bank Act of 1932, any security interest granted to a FHLB by any member generally has priority over the claims and rights of any other party. (The exceptions are claims that would be entitled to priority under otherwise applicable law and where claims are secured by actual perfected security interests.) In addition, each FHLB monitors the financial condition of its members and adjusts its collateral delivery policies accordingly, extending from a blanket lien to taking delivery and perfecting a security interest in the collateral when this is deemed necessary. Given these factors, no FHLB has ever taken a credit loss on any member loan, and no losses on advances are likely.

Securities investments made by the FHLBs are also predominantly of low asset risk, although in reaching for yield, some of the banks have increased the credit risk in their investment portfolios. The banks are active providers of funds in the interbank market, and invest in short-term corporate securities, including CP and term bonds. Investing is limited to highly rated obligations.

Each of the banks also invests in MBS, including CMOs and REMICS, which have little credit risk, but carry market risk. While this MBS investing represents incremental risk and leverages the balance sheets of the FHLBs, to date it has been well managed on the whole.

Derivatives' counterparty credit is closely monitored, and counterparties are generally limited to high credit quality entities.

Market risk

In general, the FHLBs pursue matched asset/liability management policies. Their ample access to the debt markets helps facilitate this since the System can raise funds at a wide variety of maturities. The MBS investment portfolios, however, introduce a degree of interest rate risk because of their indeterminate maturities, as do the purchased mortgage portfolios of the banks. The individual FHLBs use derivatives primarily to lower funding costs as part of their interest rate risk management.

The relatively new practice of purchasing mortgages occasions the use of derivatives to hedge the interest rate risk in the purchased 30-year fixed-rate mortgages. Some of the banks have stumbled badly in this regard, resulting in regulatory restrictions on their mortgage purchasing activities, and significant unrealized losses in their held-to-maturity securities portfolios.

Liquidity and funding

The System relies heavily on the capital markets for its funding. The Office of Finance issues consolidated obligations in a variety of maturities on behalf of the 12 FHLBs, which are jointly and severally responsible for the debt. The Finance Board, at its discretion, may require any FHLB to make the principal or interest payments due on any other FHLB's consolidated obligations, even in the absence of a default of the primary obligor. The consolidated obligations, as GSE debt, are favorably priced, typically at small spreads to Treasury debt. This access to funds, and the favorable pricing on these funds, is a major strength of the System. In addition, each of the FHLBs takes deposits from its members, although these account for a relatively small proportion of funding.

The FHLBs maintain ample liquidity in their investment portfolios, even though the banks with unrealized losses experience practical constraints on their ability to readily liquidate their "held-to-maturity" portfolios. Finance Board regulations stipulate minimum liquidity levels and tightly restrict the eligibility type of investments. The FHLBs' principal investments are MBS, overnight, and term Federal funds sold, CP, and GSE securities. Investments accounted for 26% of total assets at year-end 2005.

Accounting

All of the FHLBs were required to register a class of their equity securities with the SEC beginning in mid-2005, and thus begin making Form 10-K and 10-Q filings. As part of the registration process, the SEC and their regulators and accountants have closely scrutinized the banks' accounting practices, leading to various restatements of past financial statements. After protracted delays, all 12 of the FHLBs are now SEC registrants. Nevertheless, FHLB-Indianapolis recently announced it would not file its 2006 second-quarter 10-Q by the Aug. 14, 2006, deadline, as a result of the SEC's review of technical accounting issues related to FHLB-Indianapolis' historical hedge-effectiveness testing procedures. The SEC and FHLB-Indianapolis together are reviewing these procedures and supporting documentation under Statement of Financial Accounting Standards No. 133 (FAS 133). If the documentation ultimately proves to be unsatisfactory, FHLB-Indianapolis may have to make material restatements to past financial statements. This situation has caused the Office of Finance to further delay the preparation and disclosure of 2004-2005 consolidated financial statements for the System, and the release of restated financial statements for 2001-2003. (This report will be updated when these financial statements are available.)

Six of the FHLBs have material weaknesses in internal controls outstanding as of second-quarter 2006 primarily related to the restatement of the accounting for derivatives under FAS 133 and misclassification of certain cash-flow activities in the statement of cash flows. FHLB Des Moines cited several other material weaknesses including lack of compliance with policies and procedures over financial transactions and inadequate competence in accounting expertise. Remediation actions are underway, and the FHLBs will not be required to comply fully with Sarbanes-Oxley Section 404 internal control requirements until 2008. We will closely monitor the FHLBs' remediation progress over internal control deficiencies and Section 404 compliance.

As part of the SEC registration process, all 12 banks decided to implement FASB 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity" (FAS 150), retroactive to Jan. 1, 2004. Under FAS 150, an FHLB must reclassify mandatorily redeemable stock to the liability section of the balance sheet, and any dividends paid or accrued are recorded as interest expense in the consolidated statement of income. Application of FAS 150 has an effect on the unique capital structure of the FHLBs' member shares. When a member bank exercises a written stock redemption right, gives notice of its intent to withdraw from membership, or attains nonmember status by merger or acquisition, charter termination, or involuntary termination from membership, the capital is reclassified to liabilities at its fair value. Nevertheless, the Finance Board has determined that regulatory capital should include the portion of stock that has been reclassified to liabilities.

Based on collateral held as security for advances, and the fact that there has never been a credit loss on an advance, the FHLBs have not established loan-loss allowances for advances.

The adoption of FAS 155 and FAS 156 has the potential of affecting the financial condition and operations of the FHLBs. Specifically, FAS 155 amends current derivative and securitization accounting standards that include permitting fair value remeasurement of hybrid financial instruments that contain an embedded derivative that under current standards may require bifurcation. FHLBs hold hybrid instruments such as convertible advances and putable debt in their portfolios. Several FHLBs such as FHLB New York and Seattle are currently evaluating the implications of adopting in 2007, which could result in more income statement volatility and variability in the comparability of peer financial reports due to the fair value measurement optionality. FAS 156 requires servicing assets to be measured initially at fair value and provides an optional fair value accounting treatment. The FHLBs do not anticipate FAS 156 having a material impact when adopted in January 2007.

Profitability

The FHLBs' profitability measures are weak compared to those of most banks. As cooperatives, the FHLBs are not focused exclusively on profitability and earnings growth, which is also a reflection of their public mission to provide another source of mortgage funding to the U.S. housing market. Apart from their direct return on investment in the form of dividends, members benefit from low funding costs on advances. While the System's cost of funds is very favorable, reflecting its GSE status and hence its ability to raise funds at a small spread on Treasury rates, this benefit is substantially passed through to members in the pricing on advances. Also, while each FHLB sets its own pricing on advances, in general all have been restricted in their ability to price by their members'—especially larger members'—ability to fund themselves elsewhere. Even when the demand for advances is strong, the banks have not necessarily been able to raise pricing materially, and so profitability is likely to remain thin. Normal operating costs tend to be very low, reflecting the wholesale nature of operations and the emphasis placed on cost control in recent years throughout the System. The FHLBs also benefit from their exemption from income taxes. On the other hand, earnings are penalized by AHP- and REFCORP-related assessments.

The FHLBs also make a small spread on their non-MBS investment portfolios. Investing in MBS normally generates wider margins, but the amount of this investing is limited by a Finance Board rule to 300% of equity at each FHLB since it involves increased interest rate risk. The practice of purchasing mortgages on the balance sheet has been a substantial contributor to earnings where it has been successfully executed. Nevertheless, this new business line necessitates the use of derivatives to hedge the interest rate risk in the purchased 30-year fixed-rate mortgages. Some of the FHLBs have stumbled badly in this regard, resulting in regulatory restrictions on their mortgage purchasing activities.

Because a relatively large portion of the FHLBs' income is derived from the investment of capital in a leveraged asset portfolio, the interest rate environment largely drives profitability. With rates rising since the second half of 2004, so has profitability. Combined net income increased 25% in 2005 compared to 2004—to \$2.4 billion, compared to \$1.88 billion—due to higher interest income on advances and investments. Combined net income broadly increased during the first half of 2006 compared to the year-earlier period, and prospects are favorable for some further earnings improvement over the near term. Nevertheless, profitability measures remain below historical levels, as general competitive pressures and market forces have retarded spread on the advance book. Nevertheless, the FHLBs' very low expenses, advantageous funding costs, and tax-exempt status support profitability measures, particularly on a risk-adjusted basis.

Capital

FHLB stock cannot be publicly traded. It can be issued, redeemed, or repurchased only at its stated par value of \$100 per share, unless the par value has been impaired. If a member exits the System, the FHLB must redeem its stock. In addition, members have the right to put their "excess stock" (i.e., any stock holdings in excess of a member's minimum capital stock requirements, as established by the FHLB's capital plans), and the FHLB has the discretion to repurchase excess stock from members.

Because of the puttable/redeemable nature of the common shares, they lack some characteristics usually associated with permanent equity capital. Moreover, there are mixed views about the ramifications for the System if any of the FHLBs were ever to suffer impairment that would "break the buck"—i.e., cause the par value of its stock to be lowered. Some notice is required for any member to put its shares to the FHLB. The Gramm-Leach-Bliley Act allows the FHLBs to have two classes of stock. Class A stock is conditionally redeemable on six months' written notice from the member, and Class B stock is conditionally redeemable on five years' written notice from the member, subject in each case to certain conditions and limitations. (Most of the FHLBs only have Class B stock. The FHLB Chicago still operates under the pre-Gramm-Leach-Bliley system.) Typically, though, the FHLBs redeem such stock more rapidly than is required. Also, the FHLB is not permitted to redeem shares if its capital would thereby fall below minimum required levels. There is some correlation between redemption requirements triggered by members exiting the system, or where excess stock is created due to a member's lowered advance activity, and asset levels at the FHLB. Still, we perceive there to be a significant difference in the quality of equity between the FHLBs' paid-in-capital and their retained earnings—and retained earnings typically have been thin.

One reason for this is that the government effectively confiscated the System's retained earnings in 1989 to cover costs associated with protecting thrift industry deposits. (Through their REFCORP assessments, the FHLBs continue to help the government defray related costs.) As a consequence, the FHLBs had been generally reluctant to rebuild retained earnings. Nonetheless, in recent years all of the FHLBs have been growing retained earnings somewhat as a means of providing capital support to their mortgage lending and investing programs. More rapid strengthening of the capital base has been precluded by the FHLBs' dividend policies: Each of the FHLB's net income is substantially paid out as dividends to its members. While this policy has restricted the retention of capital, the attractiveness of the dividend, along with the right to borrow at economic rates, has tied members to their FHLB.

The Gramm-Leach-Bliley Act codified a minimum capital-to-asset ratio of 4.0% (i.e., capital stock, retained earnings, and accumulated other comprehensive income divided by total assets at the end of the period). It also established additional safeguards to maintain the 4.0% measure: For example, members would be prohibited from making capital withdrawals if it would cause an FHLB to fail the 4.0% test, and under certain circumstances, members can be required to contribute additional capital so the FHLB meets this test. Within the framework of the Gramm-Leach-Bliley Act, each of the FHLBs was required to develop an individualized capital plan, to be approved by the Finance Board. Total combined capital rose to \$44 billion at year-end 2005, a 6% increase from one year earlier.

In March 2006, the Finance Board published proposed regulations that would accomplish the following:

- Establish a minimum amount of retained earnings for each FHLB equal to \$50 million plus 1% of a FHLB's nonadvance assets. If a FHLB is at any time out of compliance with the minimum retained earnings requirement, its dividend payout would be limited to 50% of the FHLB's quarterly net income, unless the FHLB received specific regulatory approval;
- Prohibit a FHLB from selling excess stock to its members and limiting the aggregate amount of excess outstanding to 1% of a FHLB's total assets; and
- Prohibit the payment of stock dividends.

The goal of the proposed regulation is to address the shortfall in retained earnings and thereby protect against potential impairment of the par value of a FHLB's capital stock. The regulation also addresses regulators' concerns about the reliance by some FHLBs on excess stock as a source of capital to fund longer-term assets-in particular fixed-rate mortgage loans purchased under the MPF and MPP. Nevertheless, by not discriminating between nonadvance assets based on risk characteristics, the proposed retained earnings guideline could discourage the FHLBs from holding investment assets that currently enhance their liquidity. Some of the FHLBs would fall significantly short of the stipulated minimum retained earnings, and so face dividend restrictions for an extended period—adversely affecting the economic value of participation in the System from the perspective of members, many of whom also prefer stock dividends over cash dividends, given the tax-deferred nature of stock dividends. The proposed regulatory changes have met with opposition on the part of the FHLBs, members, and other constituents. The Finance Board's timetable for further consideration of its proposals is not clear. (See also " Finance Board Proposed Retained Earnings Regulation Poses Challenges for FHLBs," published July 13, 2006, on RatingsDirect.)

Summary Financial Information

(Mil. \$)	--Year ended Dec. 31--					
	2006*	2005	2004	2003	2002	2001
Advances to members	615,000	620,000	581,000	514,168	489,598	472,732
Mortgage loans, net	104,000	105,000	114,000	113,438	60,554	27,643
Investments	273,000	266,000	220,000	189,516	206,355	190,064
Total assets	998,000	997,000	925,000	822,790	763,631	697,074
Advances + mortgage loans, net (% of assets)	72	73	75	76	72	72
Deposits and borrowings	N.A.	N.A.	N.A.	23,205	29,834	26,811
Consolidated obligations**	913,000	916,000	846,000	740,937	673,709	621,093
Capital stock***	45,000	44,000	42,000	37,702	35,187	33,289
Retained earnings	N.A.	N.A.	N.A.	1,327	1,190	932
Net income	620	2,400	1,900	1,640	1,799	2,154

*Data as of March 31. **The consolidated obligation totals for 2004 forward include estimated intra-Bank holdings. ***The capital stock totals for 2004 forward represent total capital. Data for 2004-2006 is unaudited. Data for 2001-2003 are in the process of being restated. They are included for historical purposes and will be updated once the restatements are complete. N.A.-Not available. Source: Office of Finance.

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