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Summary:

Federal Home Loan Bank of Des Moines

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Summary:

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

Rationale

Standard & Poor's Ratings Services' 'AA+/A-1+' issuer credit ratings on the Federal Home Loan Bank of Des Moines (FHLB Des Moines) reflect the bank's strong asset quality, access to low-cost funding, and negligible exposure to risky private-label residential mortgage-backed securities (PLMBS). The ratings also reflect higher-than-peer average exposure to mortgage loans (which exposes the bank to earnings volatility), and a lower capitalization versus peers. The bank and its sister banks are also exposed to the potential for adverse regulatory changes related to the broader housing government-related entity (GRE) reform. Still, the ratings reflect a high likelihood of government support because of the high systemic importance of the Federal Home Loan Banks System (FHLB System) to the U.S. housing market and FHLB Des Moines' designation as a GRE. Under our criteria for GREs, we assign a one-notch uplift from the stand-alone credit profile (SACP) of FHLB Des Moines to equal it to the sovereign rating because of our view that extraordinary federal government support would be forthcoming, if needed.

FHLB Des Moines and FHLB Seattle recently announcement that they have entered an exclusivity arrangement regarding a potential merger. A merger would require approval from the Federal Housing Finance Agency (FHFA), as well as member-owners of FHLB Des Moines and FHLB Seattle. Should the merger proceed, we expect the combined institution, which would be headquartered in Des Moines, to benefit from its financial strength and geographic reach, as well as economies of scale and risk diversification. We expect FHLB Des Moines members to benefit from the organization's increased scale, enabling it to offer a wider array of products and services to the combined membership. We will continue to assess the ratings implications of the potential merger as further details become known. We also believe that this deal could lay the groundwork for further consolidation of the FHLB system, as the banks attempt to realize the benefits of scale in focusing on the needs of member institutions.

FHLB Des Moines is the sixth-largest of the 12 district banks in the FHLB System, with assets totaling nearly \$73 billion at March 31, 2014. It lends to members in Iowa, Minnesota, Missouri, North Dakota, and South Dakota. Advances totaled \$44.9 billion (or about 61.6% of total assets) at March 31, 2014. They almost doubled from the same period last year, rising 81% compared with an 18% increase for peers on average. The rise is almost entirely driven by lending to Wells Fargo Bank, N.A., which is its largest depository member. However, the future demand for advances should remain muted, reflecting continued availability of lower cost deposit funding and reduced demand for mortgage loans at member institutions. With the inclusion of Wells Fargo, banks now represent 61% of total member advances, up from 34% at March 2013. Despite declining to 34% from 61% last year, the contribution of insurance companies to total member advances remains higher than the system average of 13.1%. Advance balances to insurance companies have remained stable, reflecting their relatively longer tenure versus that of advances to banks. Moreover, FHLB Des Moines is one of three system banks that have thus far accepted memberships from captive insurance companies of

REITs, which typically invest in nonconforming jumbo mortgages. A systemwide, three-month voluntary moratorium was approved by the FHLB bank presidents to allow time to address the FHA-expressed concerns on potential credit risk. All of FHLB Des Moines' exposures are well collateralized and the insurance members, just like depository members, are subject to overall credit limits and periodic financial reviews. Our expectation for the system is that growth in advances would remain tepid and in pockets rather than broad based, depending largely on sustained improvements in consumer confidence, the housing market, and unemployment levels. According to Standard & Poor's economists, the U.S. economy should continue to see a gradual rebound, growing 2.5% in 2014 (from 1.9% in 2013) and 3.2% in 2015, accompanied by gradual improvements in the labor markets, an increase in real disposable income, and a softer recovery in the housing market through 2015.

FHLB Des Moines has one of the highest percentages of assets in mortgage loans, which it aggregates from its members; it is lower only to FHLBs Chicago, Topeka, and Indianapolis. We expect mortgage loans at FHLB Des Moines to continue to gradually shrink through 2014 (at March 2014, mortgage loans were down 4% from the prior year) as paydowns continue to outpace originations and refinance activity remains low. A high proportion of mortgages on the book increases the need for more complex hedging. It also results in higher earnings volatility.

With 1,179 members (at March 2014), FHLB Des Moines has the largest membership base of any bank in the system. Yet, approximately 60% (up from 39% last year) of total advances reside with the top five members. While this exposes the bank to meaningful concentration risk, it remains largely in line with the FHLB system average of 57%. The percentage of member concentration to advance balances at other FHLBs ranges between 26%-77%.

The investment portfolio, including held to maturity, available for sale, and trading securities, fell by 28% from one year ago to \$11.5 billion (the investment portfolio represented 16% of total assets at March 31, 2014). The decrease primarily reflected added U.S. government-guaranteed agency residential mortgage-backed securities, which constituted 78% of the total investment portfolio, while the riskier PLMBS formed a minuscule 0.25%. We believe that the investment portfolio should remain fairly steady as investments in MBS are capped at 3x the regulatory capital and also owing to a gradual rise in advances. The bank also increased its purchases of short-term secured money market instruments during fourth-quarter 2013 in an effort to manage liquidity and counterparty credit risk. Of the bank's total investments, 91% are held on a secured basis with more than three-fourths of them rated 'AA' and higher. Unsecured lending raises some concerns from a credit and liquidity standpoint; however, all of FHLB Des Moines' unsecured lending is investment-grade and consists of overnight federal funds sold to U.S. banks, as well as U.S. branches and agency offices of Canadian, Australian, and Norwegian banks.

FHLB Des Moines' overall profitability has been lower than the average of the peer group. The bank reported net income of \$37 million in first-quarter 2014, up from \$27 million for the same period in 2013. The earnings growth primarily reflected the growth in advances, which offset the impact of persistently lower interest rate environment. Losses from derivatives and hedging activities were offset by gains on trading securities. The net interest margin declined 14 basis points (bps) year-over-year to 0.30%, reflecting lower yields on interest-earning assets, which offset the benefits of reduced funding costs. During first-quarter 2014, the bank paid a cash dividend of \$18.9 million, or 2.8% annualized. The quarter's return on average assets of 0.21% is within the range of the peer group (0.12% to 0.48%) while return on average equity (of 4.37%) is lower than the peer average. The bank's efficiency measured by the ratio

of operating expenses to total assets is comparable with the system average. We expect FHLB Des Moines' advances to stabilize through 2014. We also expect the mortgage book to continue to shrink in 2014 and for MBS to be held relatively steady at, or near, 3x capital. We expect the current level of non-mortgage investments to remain even and for operating expenses to increase modestly.

Managing assets and liabilities is not a particular concern for FHLB Des Moines, as the bank's position from an interest rate risk perspective is risk neutral. The bank also targets a risk neutral position from a duration standpoint. There is some convexity in the book of business due to prepayments. FHLB Des Moines uses callable debt or derivatives to hedge optionality. In accordance with its policies, the bank caps the impact on the change in market value of capital stock to 5% from a 100-basis point parallel upward shock in interest rates.

FHLB Des Moines' capitalization fell from last year, though it is still acceptable. The bank's regulatory capital-to-assets declined to 4.63% as of March 31, 2014, from 5.46% a year earlier. While capital stock increased 36%, the decline in the regulatory capital ratio mainly reflects growth in assets, and the repurchases of excess capital stock. The bank did not have any excess capital stock as of March 2014. Its risk-based capital metrics were satisfactory, with total capital of nearly \$3.5 billion compared with a risk-based capital requirement of \$613 million. The capital cushion reflects the bank's lack of large exposure to PLMBS, unlike several other FHLBs. The bank is in compliance with all of the Federal Housing Finance Agency liquidity requirements under scenarios of run-off and non-accessibility to capital markets to a set period of time.

On the regulatory front, the GSE reform has been slow to take shape and the impact on FHLBs remains largely uncertain. However, beginning in 2014, each FHLB is subject to the annual Dodd-Frank Act Stress Testing (DFAST) and is required to assess the potential impact of certain sets of economic and financial conditions, including baseline, adverse, and severely adverse scenarios, on its earnings and capital. Under the severely adverse economic scenario, FHLB Des Moines' regulatory capital ratio exceeded the minimum requirement of 4.0% throughout the nine-quarters of the stress test horizon. As of Dec. 31, 2015, FHLB Topeka's regulatory capital ratio was 5.6%, compared to the combined ratio of 6.9% for the FHLB Bank system.

Outlook

The outlook on FHLB Des Moines is stable, which reflects the stable outlook on the rating on the U.S., as well as stable operating trends. If we changed our ratings or revised our outlook on the U.S., we would likely reflect that change in our ratings on FHLB System debt and individual FHLBs, including FHLB Des Moines, according to our GRE criteria. Furthermore, if legislation or regulatory developments had an adverse effect on the FHLB System and resulted in less implicit government support, we could lower our ratings. We expect FHLB Des Moines to maintain its strong SACP, given its comprehensive and conservative governing policies.

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Rating Finance Companies, March 18, 2004
- Finance Company Ratios, March 18, 2004

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