



Moody's Investors Service

## Credit Opinion: Federal Home Loan Bank of Dallas

Global Credit Research - 19 Jun 2009

Texas, United States

### Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Aaa/P-1
<b>Parent: Federal Home Loan Banks</b>	
Outlook	Stable
Senior Unsecured	Aaa
Other Short Term	P-1

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### Key Indicators

#### Federal Home Loan Bank of Dallas

	[1]2009	2008	2007	2006	2005	2004
ROAA (%)	0.35	0.11	0.22	0.20	0.37	0.11
ROAE (%)	8.96	2.52	5.15	4.97	9.70	2.49
Net Interest Margin (%)	-0.12	0.20	0.40	0.37	0.34	0.36
Advances (\$bil)	56.40	60.92	46.30	41.17	46.46	47.11
Investments (\$bil)	11.78	13.70	16.40	13.43	17.16	15.81
Assets	68.66	78.93	63.64	55.65	64.85	64.61
Equity (\$bil)	3.13	3.50	2.61	2.44	2.48	2.52
Liquid Assets/ST Debt (%)	1.44	10.49	22.16	35.39	34.51	36.15

[1] For the quarter ended March 31, 2009

### Opinion

#### SUMMARY RATING RATIONALE

Federal Home Loan Bank of Dallas' (FHLBank) Aaa/Prime-1 long- and short-term deposit ratings reflect the combination of the following factors: 1) a stand-alone Baseline Credit Assessment (BCA) of 5 (on a scale of 1 to 21, where 1 represents the lowest credit risk), 2) very high cooperative support from the FHLBank System, 3) very high support from the U.S. government (Aaa debt rating).

The FHLBank of Dallas' BCA of 5, which is an A1 equivalent on Moody's long-term debt rating scale, reflects Moody's opinion about the FHLBank's intrinsic or stand-alone financial strength and excludes extraordinary support. The rating incorporates the FHLBank's stable risk-adjusted profitability, sound liquidity and excellent asset quality. Both the FHLBank of Dallas' risk-adjusted profitability (ROAA as a percentage of the standard deviation of ROAA) and liquidity (deposits plus debt maturing within one year less liquid assets (cash, interest bearing deposits, fed funds, trading securities and available-for-sale securities as a percentage of total assets) is in the lower end relative to other FHLBanks. However, asset quality at the FHLBank is at the upper end relative to other FHLBanks. The FHLBank of Dallas' exposure to private-label residential mortgage-backed securities is not sizable. Moody's believes the expected loss on the FHLBank's \$642 million private-label residential mortgage-backed securities is low.

The FHLBank of Dallas' BCA of 5 does not benefit from support from the FHLBank System given the FHLBank System's BCA of 5 (A1 equivalent). On the other hand, Moody's very high U.S. government support assumption lifts the FHLBank of Dallas' deposit ratings to Aaa.

#### Credit Strengths

Joint and several liability reduces default risk of Systemwide liabilities

Central role as liquidity provider for banks and other financial institutions

Excellent asset quality reflects conservative underwriting standards and quality-monitoring policies

### **Credit Challenges**

Narrow charter and bank consolidation constrain growth and profitability

Substantial borrower concentrations

### **Rating Outlook**

Moody's stable outlook for the FHLBank of Dallas' rating reflects the FHLBank's consistent returns and its low exposure to private-label MBS. Moody's expects the FHLBank of Dallas to conservatively manage its business in achieving a modest but stable risk adjusted return.

In addition, Moody's expectation is that the FHLBank System will continue to receive strong bipartisan political support, and that there will be minimal changes, if any, to its government sponsored enterprise (GSE) status over the long - term

### **What Could Change the Rating - Up**

Factors that would lead to an upgrade of the FHLBank of Dallas' baseline credit assessment include capital levels well in excess of regulatory requirements (e.g., capital-to-assets ratio consistently 50 bps above the regulatory requirement - currently 4.0%), consistent risk-adjusted returns while maintaining strong asset quality.

### **What Could Change the Rating - Down**

Factors that could lead to a downgrade of the Aaa/Prime-1 long- and short-term deposit ratings and baseline credit assessment include a material decline in profitability (quarterly net losses over four quarters), significant asset-liability mismatches, or material changes in asset quality.

In addition, any regulatory or statutory changes to the System's mission or GSE status that alters the FHLBank's risk profile could also impact the ratings. However, Moody's views these potential events as highly unlikely to occur.

### **DETAILED RATING CONSIDERATIONS**

FHLBank of Dallas lends to member institutions in the form of advances, a substantial amount of which are short-term and all are over-collateralized, minimizing the credit risk on these loans. Moody's baseline credit assessment represents our opinion of the likelihood that the institution will require extraordinary support from an external party. The high BCA of 5 reflects FHLBank of Dallas' strong credit culture, stable, though moderate, profitability, and the benefits associated with the joint and several liability of the FHLBank System. Below are the detailed rating factors that influence the FHLBank's ratings and outlook.

#### **Baseline Credit Assessment**

##### **Profitability**

FHLBank of Dallas' modest but consistent profitability (as measured by ROAA) reflects primarily the low risk profile of its asset base. ROAA was 0.35% for the three months ended March 31, 2009, compared to 0.11% and 0.24% for years end 2008 and 2007, respectively. At March 31, 2009, the five-year standard deviation of ROAA was 0.11%, which was well below the 0.40% standard deviation for banks rated Aa and higher.

Similar to many other FHLBanks, the FHLBank of Dallas has significant borrower concentration: its top ten advance borrowers represented 66.8% of advances outstanding as of March 31, 2009. Within the top ten advance borrowers, the top two account for 54.2% of the FHLBank's total advances outstanding at March 31, 2009. Also, bank consolidation reducing demand for advances will further constrain the FHLBank of Dallas' profitability.

##### **Capital Adequacy**

FHLBank of Dallas is required by legislation to maintain a minimum regulatory capital level of 4% of its total assets. At March 31, 2009, the Dallas Bank's capital ratio was 4.71%. In Moody's view, capital levels reflect the low risk profile of the FHLBank's asset base which is largely comprised of advances to member banks (82% of total assets as of March 31, 2009).

##### **Interest Rate Risk Management**

The FHLBank of Dallas conservatively manages its interest rate risk exposures through the use of debt with similar characteristics to the FHLBank's assets, as well as derivatives. The FHLBank's primary asset is advances (82% of total assets), which come in a variety of types, including fixed rate, variable rate, callable by the FHLBank as well as puttable advances. With a puttable advance, the FHLBank purchases a put option from the member that allows the FHLBank to terminate the fixed rate advance on specified dates and offer, subject to certain conditions, replacement funding at prevailing market rates. Prepayment fees, which mitigate interest rate risk, are also a common feature of advances.

Although the FHLBank's short-term securities portfolio is small relative to the investment portfolio (6% of the investment portfolio of \$11.8 billion is fed funds and interest bearing deposits), a large component of the investment portfolio is variable rate CMOs (92%) which reduces the FHLBank's risk exposure.

The Bank's internal policy limits interest rate risk to a change in the market value of equity of 15% assuming a simulated 200 basis point change in interest rates. The percentage decrease in the estimated market value of equity exceeded the FHLBank's policy limit of 15% on December 31, 2008, January 31, 2009, and February 28, 2009, and remained relatively high but within the limit as of March 31, 2009. The percentage changes for market value of equity losses in +200 basis point interest rate shock scenario were -20.57% at December 31, 2008, -17.27% at January 31, 2009, -15.60% at February 2009, and -14.19% at March 31, 2009. The high level of the FHLBank's market value of equity sensitivity has been driven by the low estimated values of its MBS portfolio. The

sensitivity of the portfolio to interest rate changes is generally attributable to non-interest rate risk related factors stemming from the poor financial market conditions. Also, Moody's believes the FHLBank has the ability to hold the securities to maturity and the FHLBank has expressed the intent to do so. The exceptions to the policy limit are viewed as temporary.

#### Asset Quality and Credit

Moody's believes that the asset quality of the FHLBank of Dallas is exceptional. The FHLBank's primary business is advances, which represent 82% of total assets as of March 31, 2009, while the FHLBank's investment portfolio represents 17%. Advances are over-collateralized and the FHLBank has never incurred a loss on an advance in its 76-year history. However, Wachovia, the top advance borrower, represented 39.9% of FHLBank of Dallas advances outstanding as of March 31, 2009 heightening its counterparty credit risk. The FHLBank ceased purchasing mortgage loans through the MFF program in mid 2003. The FHLBank of Dallas has less than 0.5% of its total assets in mortgage loans.

The FHLBank of Dallas' \$11.8 billion investment portfolio consists primarily of Agency MBS (\$10.2 billion), and private-label RMBS and CMBS (\$834 million). About \$310 million or 50% of its private-label RMBS were rated Aaa and \$68 million or 11% were rated single B as of March 31, 2009.

#### Liquidity and Funding

Historically, the FHLBanks' GSE status enabled it to fund its obligations at very tight margins to U.S. Treasury securities. More recently, investor concerns regarding the U.S. housing and mortgage markets have affected the FHLBanks' debt pricing and funding. In addition, U.S. government actions in support of banks by guaranteeing their debt issuance has negatively impacted the FHLBanks' debt spreads. During 2008, demand for term agency debt weakened considerably. The decline in demand for debt issuances with maturities between one year and 30 years resulted in a dramatic widening of the spread between the FHLBanks' debt and U.S. Treasury debt. Moreover, increased demand for short-term agency debt (i.e., debt with maturities of less than one year) resulted in lower yields on the FHLBanks' discount notes. As a result, the FHLBanks' funding needs were being met primarily through the issuance of discount notes, floating-rate notes, short-term callable bonds and short-term bullet bonds during the third quarter of 2008.

In September 2008, the FHLBanks entered into a lending agreement with the U.S. Treasury, which established the Government Sponsored Enterprise Credit Facility (GSECF), a secured lending facility, to serve as a liquidity backstop. The GSECF expires on December 31, 2009, but will remain in effect as to any loans outstanding on that date. Any funding to FHLBanks under the GSECF will be provided by the U.S. Treasury in exchange for eligible collateral consisting of advances issued by FHLBanks and MBS issued by Fannie Mae or Freddie Mac. Collateral haircuts will be determined by the U.S. Treasury (the haircut on advances is 13%). Loans under the GSECF are intended to be for short durations of between one week and one month. Interest on borrowings will be set by the U.S. Secretary of the Treasury.

In November 2008, the Federal Reserve announced a plan to purchase up to \$400 billion of direct debt obligations of Freddie Mac, Fannie Mae and the FHLBanks, as well as \$1.25 trillion of MBS guaranteed by Freddie Mac, Fannie Mae and Ginnie Mae. The Federal Reserve announced this action in order to reduce the cost and increase the availability of residential mortgage credit. Moody's believes these actions reduce the FHLBank's funding risk. The FHLBank's access to the term debt markets has improved during 2009.

The FHLBanks' internal sources of liquidity are modest. The FHLBanks are mandated by regulation to maintain a minimum of five days of liquidity without access to the capital markets (a tiny amount), though individual FHLBanks have the discretion to maintain longer periods of liquidity without access to the capital markets and generally do so. Internal sources include the FHLBank's short-term investments, as well as the FHLBank's investment portfolio.

As of March 31, 2009, the FHLBank of Dallas had approximately \$47.9 billion in short-term consolidated obligations, which includes discount notes and bonds maturing within a one year period. In total, short-term debt comprised about 75.1% of total debt - a very high figure. This amount remained high over the past year due to the limitations with long-term funding in the agency market. Liquid assets include cash, cash equivalents, interest-bearing deposits, federal funds as well as a portfolio of available-for-sale investment securities. These assets are of high quality, with the investment securities portfolio comprised of U.S. Treasury and agency securities, state and local housing agency obligations and MBS. Nonetheless, liquid assets were low relative to short-term debt (approximately 1.5% of short-term debt) as of March 31, 2009.

#### Support and Dependence

The FHLBank's high dependence and support levels are based on the importance of the System to its member institutions, and their ability to support housing finance and community development.



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