

RESEARCH

Summary: Federal Home Loan Bank of Boston

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Credit Rating: AAA/Stable/A-1+

Rationale

The ratings on the Federal Home Loan Bank of Boston (FHLB-Boston) reflect the wholesale bank's low credit risk profile, strong liquidity, and acceptable risk-adjusted capitalization. The bank's stable financial performance and credit risk profile in part reflect the advantageous funding position it derives from its government-sponsored enterprise (GSE) status. The FHLB system is one of the housing GSEs in the U.S., and the FHLB-Boston is a member of the FHLB system. The bank's business is primarily funded with the low-cost, consolidated obligation debt issued by the Office of Finance on its behalf.

Credit risk exposures remain low. FHLB-Boston's strong asset quality results from the strict policies of overcollateralizing advances made to its members and the purchase of high-quality, short-term, money-market investments and highly rated MBS. Credit risk within the MBS portfolio is minimal, as the bank invests in agency and highly rated investment-grade mortgage assets.

In addition to advances made to its members to provide them with liquidity for mortgage-related assets, FHLB-Boston participates in the Mortgage Partnership Finance (MPF) program. This has increased the bank's exposure to interest-rate risk due to the increase of investment in fixed-rate residential mortgage loans. At March 31, 2006, the FHLB-Boston held \$4.8 billion of MPF mortgages on its balance sheet, compared with \$4.0 billion one year ago, representing 8% of balance-sheet assets. While MPF loans are a higher credit-risk exposure than are advances, the underlying loans are conventional or FHA loans and are structured to the level of 'AA' credit risk. Furthermore, given the small percentage of balance sheet assets, Standard & Poor's does not view this as a material weakening of the overall credit profile.

As a result of the bank's highly liquid and low credit-risk profile, risk-adjusted capital ratios are acceptable. Interest rate risk exposures are closely managed, as the bank continues to maintain a relatively short duration of equity. Profitability measures are low but adequate on a risk-adjusted basis. Return on average assets was a low 0.31% for the first three months of 2006, but up from 0.23% at year-end 2005.

The FHLBs are currently facing a proposed capital regulation that would boost retained earnings requirements and limit excess capital stock. This proposal would require each bank to hold \$50 million as well as 1% of their nonadvance assets in retained earnings, and will limit their cash dividend until this level is reached. While the proposal remains open for comment until July 13, 2006, the proposal is subject to change; Standard & Poor's will review and assess the final regulatory impact on each FHLB.

Outlook

The consistent operating performance of FHLB-Boston reflects the bank's conservative financial policies and practices and the unique charter that governs its business. While the bank's participation in the MPF program and investments in residential MBS assets have added incremental risk—specifically, interest rate, and, to a lesser degree, credit risk—the bank has been managing this successfully. Given the small percentage of balance sheet assets, Standard & Poor's does not view this as a material weakening of the overall credit profile.

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