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Ratings

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Federal Home Loan Bank of Cincinnati

Primary Credit Analyst:
Jennifer Panger, New York + 1 (212) 438 2276; Jennifer.Panger@spglobal.com

Secondary Contact:
Samuel W Sheppard, New York 212-438-9018; samuel.sheppard@spglobal.com

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Federal Home Loan Bank of Cincinnati

Major Rating Factors

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

Strengths:

- Important to the implementation of U.S. government housing policy
- Important funding source for the U.S. banking system
- Very strong risk-adjusted capitalization
- Solid loan asset quality, and super-lien position vis-à-vis depository institutions that has historically prevented any losses on advances

Weaknesses:

- Concentrated exposure to the U.S. mortgage market
- Geographically restricted to a limited region of the U.S.
- Uncertainty regarding the impact of potential legislative changes
- Earnings decline when advance demand is low, though profitability is not a priority of the Federal Home Loan Banks

Outlook

The stable outlook on Federal Home Loan Bank (FHLB) of Cincinnati indicates our expectation that the bank will maintain stable operating performance, provide liquidity and manage funding needs, build retained earnings, and support the U.S. housing sector over the next 24 months. The stable outlook also reflects S&P Global Ratings' stable outlook on the U.S.

Downside scenario

If we change our rating or outlook on the U.S., we would likely reflect that change in our ratings on the FHLB System's debt and our ratings on FHLB Cincinnati. Although less likely, we could also lower the rating in the next two years, if, in the context of government-sponsored enterprise (GSE) reform, the role of the FHLB System in housing finance was diminished, thereby reducing its importance to the government.

Upside scenario

An upgrade would likely be contingent upon a higher rating on the U.S. government.

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Rationale

S&P Global Ratings' issuer credit rating on FHLB Cincinnati is based on the wholesale bank's government-supported role in providing liquidity to member institutions, strong loan-asset quality and capitalization, low funding costs, and conservative risk management. It also reflects the bank's regulated status, overseen by the Federal Housing Finance Agency (FHFA).

The rating on FHLB Cincinnati includes a one-notch uplift from the bank's stand-alone credit profile (SACP) of 'aa' because we expect there is a very high likelihood of the bank receiving extraordinary government support given the FHLB System's importance to the U.S. housing market and banking system.

Anchor: Adjusted for the FHLB because of regulated status, strong competitive position, and favorable funding

Our starting point--or anchor--for our ratings on U.S. finance companies that we rate under our nonbank financial institutions criteria is 'bb+'. Because of FHLB Cincinnati's public policy role and its regulated status, we adjust its anchor to 'bbb+', three notches above our anchor for other finance companies and equal to that of U.S. banks. This is to account for the FHFA's regulatory oversight, the favorable funding an FHLB enjoys through its close relationship with the U.S. government, its strong competitive position alongside other housing-related government-related entities (including Fannie Mae and Freddie Mac) in the U.S. housing finance market, and its statutory priority of liens in a member wind-down situation.

Business position: Stable business model and public policy role, though business is concentrated

FHLB Cincinnati has an established market position, recurring business volumes, and public policy role, which, in our view, offset some of the risks associated with its relative lack of business diversity.

The FHLBs are wholesale lenders that assist the financing of the U.S. housing industry. They provide secured loans, known as advances, to their members, which include commercial banks, savings and loans, credit unions, and insurance companies.

The COVID-19 pandemic illustrated the FHLB System's underlying importance to the U.S. banking sector in times of uncertainty and economic dislocation. During first-quarter 2020, advances swelled to $806.9 billion, up 26% from the prior quarter, as member companies shored up liquidity to manage the stress. This was the peak since the 2008 financial crisis. In the following quarters, actions by the Federal Reserve and the CARES Act fostered substantial liquidity in financial markets and led to an increase in low-cost deposits at member banks. Consequently, advances fell at all FHLBs throughout the remainder of 2020 and continued lower this year. Net interest income contracted with falling demand for advances, a trend we expect will continue into 2022 as elevated liquidity persists.

FHLB advances ended the first quarter of 2021 at $399.1 billion, down around 50% year over year. The decrease in advances was more distinct for commercial bank members than insurance companies. Commercial banks contracted to 39.7% of total advances from 63.3% year over year, while insurance companies (excluding captive insurance companies) grew to 30.6% from 16.2%.

With total assets of $60.6 billion, including advances of $24.4 billion, FHLB Cincinnati is the seventh-largest bank in

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the FHLB System as of March 31, 2021. Advance volume increased 70% at the onset of the COVID-19 pandemic to support members' liquidity needs (the greatest increase of the FHLBs) but subsequently declined and has remained depressed because of increased liquidity in U.S. financial markets and elevated deposit balances at member institutions.

The sharp increase in advances and subsequent decline (49% between year-end 2019 and first-quarter 2021) reflects the earnings and capital risks of a portfolio concentrated in in a couple of key borrowers. U.S. Bank and JPMorgan Chase accounted for 39% of advances at year-end 2019. U.S. Bank's advance balance declined nearly 70% in 2020, and JPMorgan no longer has outstanding advances as of first-quarter 2021. As of March 31, 2021, 55% of FHLB Cincinnati's advances are with the top five borrowers, close to the peer average.

The bank's mandate limits the diversity of its business. FHLB Cincinnati's member borrowing needs are all highly correlated to the housing market given the bank's mission to support housing finance and community development. Furthermore, it operates exclusively in Ohio, Kentucky, and Tennessee, so the local economic conditions significantly affect the bank's business. FHLB Cincinnati has some diversity across its 625 member institutions, which consist of commercial banks, credit unions, savings institutions, insurance companies, and community development financial institutions.

The fully collateralized nature of the lending business mitigates much of the concentration risk. Furthermore, the bank's advance volume and, therefore, revenue are typically countercyclical because members rely more on the bank in times of stress as a reliable source of funding.

Capital and earnings: Collateralized lending to financial institutions limits risk

In our assessment, FHLB Cincinnati's capital is very strong based on its member-capitalized co-op structure and low-risk collateralized lending business. Also, we expect its risk-adjusted capital (RAC) ratio to remain comfortably above 15% over at least the next two years, regulatory capital measures exceed all regulatory requirements, and earnings are stable, though modest.

The FHFA requires FHLBs to keep capital in excess of 4% of assets and a leverage ratio above 5%. As of March 31, 2021, it had a 6.72% regulatory capital-to-assets ratio and leverage of 10.07%.

Given that a significant portion of its assets are advances, which carry a relatively low risk weight in our analysis because all of the exposure is to financial institutions, capital on a risk-adjusted basis is stronger than the regulatory ratio. As of March 31, 2021, FHLB Cincinnati's RAC ratio was 20.5%. Over the next two years, we expect the bank's RAC ratio to remain relatively stable and comfortably above our 15% threshold for a very strong capital and earnings assessment considering members must scale their capital contribution to support their borrowings. Over the years, and even during the height of COVID-19, FHLB Cincinnati's capital ratios remained in a relatively tight band.

We expect the FHLB to maintain or grow retained earnings each year and remain modestly profitable. The bank lowered its dividend from 4% at year-end 2019 to 2.5% in the first quarter of 2020 and to 2.0% in the third quarter, to support retained earnings growth.

Supporting earnings are low loan loss provisions, due to high underwriting standards, and relatively low noninterest

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expenses. The FHLB derives the bulk of its net income from interest earned on advances, its portfolio of mortgage loans purchased from members as part of the Mortgage Purchase Program, and its investment portfolio. Net income for 2020 was flat with the prior year. Lower interest income (most significantly from lower advance balances) was largely offset by lower interest expense on consolidated obligations. In first-quarter 2021, net income declined 76% compared with the first quarter of 2020, primarily because of unrealized losses on investment securities as well as the gain from the sale of swaptions in the first quarter of 2020. Net interest income declined only 7.6%.

We expect subdued demand for advances, as well as low interest rates and banks retaining excess liquidity, to weigh on FHLB Cincinnati's earnings over the next few years. However, we don't believe the absolute level of earnings is an important ratings consideration because of the bank's strong capital level and its co-op structure, the latter of which ensures that profit maximization is not a goal. Since the FHLBs return most of their profits to members in the form of dividends, and they price their advances to be competitive with the relatively low rates banks pay on deposits, the FHLBs have lower profitability than do their banking members.

Since profit maximization is not a priority and each district has somewhat unique needs, we do not anticipate any further consolidation in the system over the next 12-24 months. In 2015, FHLB Seattle merged with FHLB Des Moines, the only consolidation in the FHLB System in its 80-plus year history.

Risk position: No losses on member advances, low interest rate risk, and low risk from peripheral activities

FHLB Cincinnati's risk position is characterized by its very high credit quality lending portfolio, history of never having suffered a loss on a collateralized advance to a member, and low interest rate risk.

The bank follows strict underwriting standards and credit requirements from borrowers. All advances to member institutions are collateralized by loans and securities with an estimated value significantly in excess of loans extended. The company monitors the financial condition of its members, advance rates, and security agreements to further mitigate credit risk. FHLB Cincinnati uses a proprietary credit scoring model to implement a risk-based approach to underwriting and monitoring. In addition, the FHLB has a super-lien position vis-à-vis depository members. For advances to nondepository members, the FHLB relies on stricter borrowing limits and collateral guidelines to mitigate its risk, for which it is not guaranteed priority status in liquidation.

Additionally, a member must own FHLB's capital stock based on its total assets as a condition of membership, and is required to purchase additional activity-based capital stock as it engages in certain business activities with an FHLB. As additional security for a member's indebtedness, an FHLB has a statutory lien on that member's stock.

The bank purchases residential mortgage loan products from participating financial institutions under the Mortgage Purchase Program. As of March 31, 2021, the bank has the second-highest exposure to these mortgages of its peers--14.2% of total assets. These mortgages carry very limited credit risk because they are either government guaranteed or credit enhanced by the member institutions from which FHLB Cincinnati purchases them.

As of March 31, 2021, the investment securities portfolio totaled $18.8 billion, about 31% of total assets. Investments include $9.0 billion of agency mortgage-backed securities. FHLB Cincinnati has no exposure to private-label mortgage-backed securities.

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The bank is exposed to interest rate risk primarily from the effect of interest rate changes on its interest-earning assets and on the funding sources that finance these assets. However, it manages the risk using various derivatives.

Funding and liquidity: Stable and cheap funding supports the business model

The FHLB System's diverse and global investor base, as well as the system's ability to issue debt (consolidated obligation bonds and discount notes) at a small spread to U.S. Treasury obligations, benefits FHLB Cincinnati's funding and liquidity. During times of stress, investors often buy FHLB debt as a safe harbor investment. Based on the availability of funding for the system in the 2008 credit crisis and March 2020 COVID-19-related market volatility, we believe that access to funding is unlikely to be difficult in stress scenarios. The FHLB regularly conducts stress tests on its funding and liquidity.

In our view, FHLB Cincinnati and its sister banks were able to sufficiently meet their mandate of supporting the funding and liquidity needs of their members brought on by the pandemic in early 2020, funded through the system's issuance of consolidated obligation bonds and discount notes. The bank was also able to scale back quickly once the spike in demand for funds subsided.

We consider FHLB Cincinnati's liquidity adequate compared with its potential cash flow requirements over the next 12-24 months. The FHFA currently requires 20 days of liquidity to cover a temporary inability to issue consolidated obligations. (This target was lowered briefly at the height of the pandemic.) In March 2020, the FHFA lowered its three- and 12-month funding gap limits to -25% and -40% respectively, until further notice. Despite market stress early on in the pandemic, FHLB Cincinnati maintained sufficient liquidity to meet regulatory guidance. Furthermore, we think FHLB Cincinnati is adequately prepared to remain compliant with enhanced requirements.

Comparable ratings adjustment: None

We don't include an adjustment in our rating on FHLB Cincinnati based on comparison with peers.

External influence: Very important to U.S. housing policy

In our opinion, there is a very high likelihood that the U.S. government would provide the bank with timely and sufficient extraordinary support in the event of financial distress. Therefore, our issuer credit rating on the bank includes one notch of uplift from our SACP.

Our view of government support in our assessment of FHLB Cincinnati reflects the following factors:

- Very important role providing low-cost funding to support housing and community development in the U.S., which we think are key economic and political objectives of the U.S. government; and
- Very strong link with the U.S. government, because a financially distressed or defaulted FHLB could significantly affect the government's reputation, and we believe the government has the administrative capacity and mechanisms (via the FHFA) for responding to an FHLB's financial distress in a timely manner.

Moreover, we view the government as having a track record of providing very strong and timely credit support to the FHLBs, such as their inclusion in a U.S. Treasury GSE credit facility created in September 2008.

We continue to monitor legislative proposals and judicial decisions that could affect the FHLBs, which are regulated by the FHFA. That said, we do not anticipate any meaningful reform over the next 12-24 months.

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In June, the U.S. Supreme Court ruled that the president can replace the director of the FHFA at will, effectively giving the president influence over the regulatory and enforcement priorities of the agency. Following the ruling, FHFA Director Mark Calabria resigned, and President Joe Biden appointed Sandra Thompson as acting director. Separately, in May, Sen. Catherine Cortez Masto, D-Nev, introduced the Federal Home Loan Bank Mission Implementation Act. The proposed bill, among other things, includes an increase in the annual amount set aside for Affordable Housing Program obligations to 30% of net income, from 10% currently. If passed, the FHLBs could experience earnings pressure from the increased expense related to these programs.

Ratings Score Snapshot

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

SACP: aa

Anchor: bb+

- Entity-Specific Anchor Adjustment: +3
- Business Position: Strong (+1)
- Capital, Leverage, and Earnings: Very Strong (+2)
- Risk Position: Very Strong (+2)
- Funding and Liquidity: Average and Adequate (0)

External Influence: +1

- Government Influence: +1
- Group Influence: 0
- Rating Above the Sovereign: 0

Additional Factors: 0

Related Criteria

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Financial Institutions | General: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014
- Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And

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Assumptions, July 17, 2013

- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Ratings Detail (As Of August 2, 2021)*	
Federal Home Loan Bank of Cincinnati	
Issuer Credit Rating	AA+/Stable/A-1+
Issuer Credit Ratings History	
10-Jun-2013	AA+/Stable/A-1+
08-Aug-2011	AA+/Negative/A-1+
15-Jul-2011	AAA/Watch Neg/A-1+
Sovereign Rating	
United States	AA+/Stable/A-1+
Related Entities	
Federal Home Loan Bank of Atlanta	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Boston	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Chicago	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Dallas	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Des Moines	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Indianapolis	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of New York	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Pittsburgh	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of San Francisco	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Bank of Topeka	
Issuer Credit Rating	AA+/Stable/A-1+
Federal Home Loan Banks	
Senior Unsecured	AA+
Senior Unsecured	AA+/A-1+
Senior Unsecured	AA+/Stable
Short-Term Debt	A-1+
Short-Term Debt	AA+/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and

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Ratings Detail (As Of August 2, 2021)*(cont.)

debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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