Federal Home Loan Bank Advances

December 2022

5-minute read

McQueen Financial Advisors

Liquidity is top-of-mind across the country as many institutions have seen simultaneous loan growth and deposit run-off. Investment portfolios are traditionally a source of liquidity. However, many portfolios are currently held with unrealized losses. Faced with liquidity needs, we don't typically recommend selling bonds at a loss. Local deposits, brokered CDs and FHLB advances are common liquidity options. FHLB borrowing offers the opportunity to quickly raise funds to enhance an institution's asset/liability mix and anticipated cash flow. We've written previously about various funding alternatives. Here, we will focus on FHLB advances and add a word of caution about structured borrowing options. The Federal Home Loan Bank offers several innovative options which are discussed below.

"Add a word of caution about structured borrowing options"

Advance	**Term**	**Benefit**	**Prepayment Terms**
Variable Rate	1 to 180 days	Short-term, market-rate funding	Prepayable at any time
Fixed-Rate Bullet	Up to 10 years	Fixed-rate to protect earnings in a rising rate environment	Subject to prepayment fees
Mortgage or Amortizing	3 to 12 years; up to 20 years amortization	Match the principal payment schedule to your anticipated cash flow	Prepayment beyond scheduled principal subject to prepay fees
Symmetrical Fixed-Rate Bullet Advance	1 to 10 years	Fixed-rate funding where the member can realize a gain from a rise in interest rates if the advance is prepaid	Early termination allows for possibility of prepayment credit, based on the mark-to-market value
Forward-Starting Fixed-Rate Bullet	2 to 5 years	Forward settlement up to one year, or longer in some cases	Subject to prepayment fees
Adjustable Rate	Up to 10 years	Tie your advance rate to one of a variety of indices	Ability to repay on reset date
Callable	1 to 10 years	Protection against prepayment risk in a falling rate environment	Allows members to prepay on predetermined call dates
Putable	2-10 years	A lower fixed rate, but the advance may be 'put' back to you after the lockout period if rates rise	Subject to prepayment fees unless FHLB Bank exercises put option

Additional Details

Many of the borrowing options on the prior page are familiar and easy to understand. However, some of the less common options deserve additional discussion.

- **Symmetrical, Long-Term Fixed Rate Advances:** This is a long-term, fixed-rate bullet structure where the borrower will have an opportunity to realize a gain from a rise in interest rates when the advance is prepaid. If the advance rate is below current market rates relative to an advance with a similar maturity, the borrower would be eligible for a prepayment credit and could realize a gain when the advance is prepaid.

> ***Comments:*** *The rate paid will be higher than a standard fixed-rate advance in exchange for the right to receive a prepayment credit under certain market conditions. Of course, it is inherently difficult to predict interest rates. Not only will this structure have a higher cost, but the prepayment credit is possible only if the borrower's crystal ball has correctly guessed the timing and severity of interest rate increases.*

"Some of these less-common options deserve additional discussion"

- **Forward Starting, Long-Term Fixed Rate Advances:** This type of advance provides borrowers the opportunity to secure future, fixed-rate bullet advances at current forward rates. A rate can be locked in now for a borrowing that will occur later.

> ***Comments:*** *As an example, a forward starting advance could be used to secure new funding at favorable rates to replace an advance currently on the books that we know will roll over later. The forward rate locked in today may be higher or lower than the prevailing market rate on the start date. Forward-starting advances also involve interest rate predictions.*

- **Callable Advance:** This is a long-term, fixed-rate structure with the option to prepay the advance on certain predetermined dates without incurring a prepayment fee. The ability to prepay early gives the borrower the opportunity to take advantage of falling interest rates.

> ***Comments:*** *This type of structure will have a higher interest rate than a standard advance and may be appropriate when rates are expected to fall. If rates fall, the borrower will have the opportunity to prepay the advance without penalty and book a replacement advance at a lower rate.*

Additional Details (continued)

- **Putable Advances:** In many ways, a putable advance has characteristics that are the opposite of callable advances. This type of structure will have a lower rate than a standard advance. The option to cancel early is held by the FHLB. The interest rate remains fixed for a predetermined amount of time (lockout period), after which the FHLB has the option to call the advance. If rates rise, the FHLB is more likely to cancel the advance, giving the borrower the option to prepay or obtain replacement funding, which would be at then-available market rates. There is a risk that replacement funding may carry a higher rate than the original putable advance. If rates fall, the FHLB will be less likely to cancel the advance, leaving the original terms in place.

Comments: *Putable advances give the FHLB the option to cancel the borrowing if interest rates rise. The risk with this structure is that the borrower will need to refinance at a higher rate with little protection. The market for these structures is very efficient. If interest rates increase even moderately, the FHLB will cancel the advance and force the borrower to refinance. Of all the options listed here, putable advances offer the least benefit in the form of a lower initial rate and the greatest risk that the borrower will need to replace the called advance at a higher rate.*

"Significant impact on an institution's risk profile"

Other Structured Borrowing Considerations

A structured borrowing includes any advance with optionality, meaning that it can be canceled when interest rates change during the holding period. Depending on the type, the option to cancel early may be held by the FHLB or the borrower. Structured advances:

- Can have a significant impact on an institution's interest rate risk profile
- Will often benefit the borrower only when they have correctly guessed the timing and severity of interest rate moves
- May be subject to substantial prepayment penalties if paid off before maturity
- May receive extra examiner attention when they are used as part of leverage programs that focus on boosting short-term income
- Are inherently difficult to model and some ALM models may not have the capability

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Action Items
At the core, our industry's primary function is to fund illiquid assets (loans) with liquid liabilities (deposits). Liquidity stress has not been top-of-mind for many years, but the need for liquidity is changing. In the event of stress, there is no such thing as too much liquidity. Consider these action items as the economy and liquidity needs change.

"The need for liquidity is changing"

We suggest the following:
- Review all available funding options, even if there has been no reason to use them previously.
- Verify that counterparty borrowing agreements and brokered CD arrangements remain valid.
- Understand borrowing options and the associated interest rate risk with structured borrowings.
- Review ALM model capabilities and their ability to handle structured borrowings, if applicable.
- Review liquidity and contingency liquidity policies, and update if necessary.
- Review and update borrowing-related policy limits. A wholesale funding ratio over 15% may indicate an elevated level of risk.
- Encourage internal discussion about borrowing goals, costs and loan growth strategies.
- Thoroughly consider all options, including slowing lending activity to limit the need for expensive funding options.

McQueen Financial Advisors offers two liquidity management tools:
- Liquidity Stress Testing, which identifies 'normal' liquidity needs, then applies moderate and severe stress over a wide range of scenarios and time periods
- Our 24/7 On Demand ALM Simulator can be used to quickly run what-if scenarios related to deposit run-off, new borrowings to fund loan growth, and other scenarios

We encourage you to talk to your McQueen advisor about your specific borrowing plans and liquidity needs.