

Discount Note Auction-Floater Advance

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Summary of the Discount Note Auction-Floater Potential Benefits

- Gain exposure to the front end of the yield curve
- Improve liquidity ratios by extending the maturity date of the funding
- Maintain the flexibility to prepay, with no fee, at regular intervals

Whether you are a community bank, credit union, insurance company, or a large bank seeking Liquidity Coverage Ratio (LCR) relief, FHLBank Boston's Discount Note Auction-Floater Advance can be a valuable tool to manage liquidity, earnings, and interest-rate risk concerns on your balance sheet.

The [Discount Note Auction-Floater \(DNA Floater\) Advance](#) is a non-amortizing, fixed-term advance with an interest rate that adjusts periodically according to the FHLBank System's Office of Finance Discount Note Auction rates. You choose the final maturity of the advance (out to 20 years), as well as the reset frequency, either every four or 13 weeks. The rate you pay is the result of the four- or 13-week Discount Note Auctions, plus a small, fixed spread determined at initiation of the advance by FHLBank Boston.

The structure and usage of the DNA Floater Advance offers value in three primary ways: gain exposure to short-term interest rates, liquidity-friendly extension of liabilities, and flexibility to prepay at regular intervals.

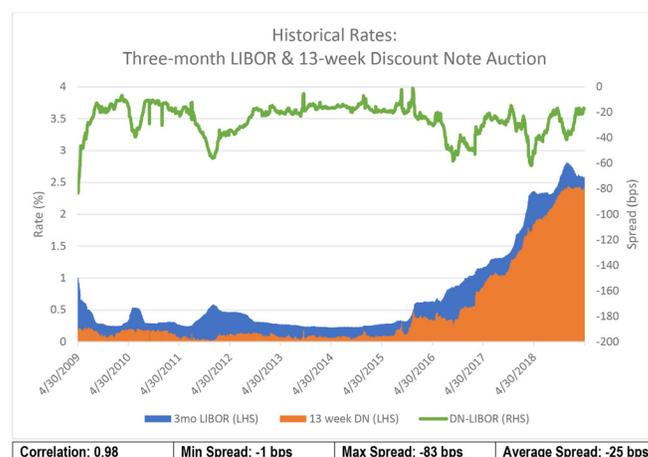
Let's look closely at each benefit.

Gain Exposure to Short-Term Interest Rates

The flattened yield curve has presented a challenge for balance sheet managers. Falling long-term rates create the opportunity to [lock in long-term funding](#) at little to no premium compared to short-term rates. On the other hand, markets are hinting that the Fed could possibly pause rate hikes, or even cut rates.

Depending on your institution's balance sheet profile, it could be prudent to establish exposure to the short end of the yield curve via wholesale liabilities. The DNA Floater Advance offers that exposure, as the reference index is either a four- or 13-week rate, which historically has been lower than, and exhibited a very strong correlation to one-month and three-month LIBOR, respectively. That allows for the mitigation of interest-rate risk, by match-funding floating rate loans or investments.

Additionally, for members utilizing short-term advances as part of an interest-rate swap funding strategy, the DNA Floater Advance affords the ability to fund the swap while more closely lining up both the reset and maturity dates.



The chart shows the 10-year history of three-month LIBOR and the 13-week Discount Note Auction. Over that period, the two rates track closely, with the Discount Note Auction consistently lower than LIBOR—the average spread is -25 basis points. Where the spread widens, it is because LIBOR became more volatile and spiked, while the Discount Note Auction remained stable. That's a twofold positive result for the income statement, as (DNA Floater) funding costs remained low as (LIBOR-based) asset yields repriced higher.

Liquidity-Friendly Extension of Liabilities

While having exposure to the front end of the yield curve may be beneficial from an interest-rate risk perspective, it may present issues from a liquidity standpoint. Liquidity management has been a hot topic for multiple regulators, specifically the amount of potentially volatile liabilities, and their impact on the dependency ratio—the relationship between long-term assets and net short-term funds. Liabilities inside of contractual maturity dates of one year can potentially be volatile and could reflect negatively on your liquidity profile.

The DNA Floater Advance can solve that potentially volatile liabilities issue. Extending the term (for example, to 18 months or three years) would alleviate the pressure on the dependency ratio, but the rate paid on the advance would be driven by the short end of the curve, not the stated maturity. As compared to a strategy of continually rolling one-month, fixed-rate Classic Advances in a falling rate environment, utilizing the DNA Floater Advance would produce a similar adjustment lower in interest costs, but with more favorable liquidity treatment along the way.

Flexibility to Prepay at Regular Intervals

As conditions change on either side of the balance sheet, the need (amount or structure) for wholesale funding may change. The DNA Floater Advance allows you to prepay the advance at the four- or 13-week reset date(s) with no fee. Here are some situations where prepayment is an advantage:

- **Deposit/premium growth:** Whether in a rising- or falling-rate environment, if deposit or premium inflows exceed expectations, then prepaying the DNA Floater Advance is an efficient means of supporting margin without necessarily expanding the balance sheet.
- **Asset paydowns:** With an uptick in prepayments from either mortgage-backed securities or loans, prepaying the DNA Floater Advance affords the ability to shrink the balance sheet.
- **Managing interest-rate risk:** If conditions in the market and/or the balance sheet warrant changes to the liability profile, prepaying the DNA Floater Advance and quickly redeploying into an advance with a different yield curve exposure or desired structural features can be an efficient solution.

Summary

Juggling interest rate, liquidity, and earnings risks can be challenging. Taking steps to support one goal often impairs another. FHLBank Boston's DNA Floater Advance can help you navigate and balance competing risks.

Our strategy team can work with you to provide customized funding strategies based on your institution's overall sensitivity position, objectives, and other needs. Please contact me at 617-292-9644 or andrew.paolillo@fhlbboston.com or contact your relationship manager for details.