FHLBank Boston

Prepare Today for Investment Opportunities Tomorrow

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Summary

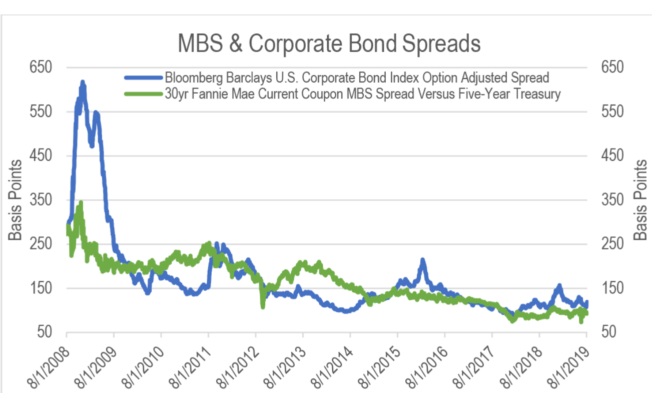
- *Investment spreads have been generally strong and have rewarded taking risk*
- *Increased interest-rate volatility may lead to widening investment spreads*
- *Be prepared with funding strategies when spreads become more attractive*

Inside Investment Portfolios

Investment portfolio decisions for both depositories and insurance companies tend to be driven by, and complementary to, other components on the balance sheet, particularly regarding interest-rate risk. For example, banks and credit unions construct their investment portfolio based off the flows and composition of their loan and deposit portfolios. Insurance companies, where investments make up the bulk of the asset side of the balance sheet, structure investments that fit with the asset liability and liquidity profile required, depending on the types of policies the company offers.

Advances from FHLBank Boston offer reliable funding and the ability to respond to the everyday needs of the balance sheet. In addition, advances allow you to be nimble as opportunities to enhance earnings, liquidity, and risk management emerge. As capital and risk tolerances permit, an "asset-driven" approach to investments can be selectively utilized as conditions become more favorable to spread-based investors like banks, credit unions, and insurance companies.

Fixed-income spreads have performed exceptionally well since the financial crisis. As the chart below shows, mortgage-backed securities (MBS) and corporate bond spreads have tightened significantly since 2008.



But with the Federal Reserve having recently cut rates for the first time in over a decade, it's possible that the outlook for investment spreads may be shifting as well. While investment spreads may not currently be at previous historic levels, it's useful to be prepared and ready to act when market volatility creates the opportunity. Here are three different investment strategies, funded efficiently with FHLBank Boston advances.

Strategy #1: Funding floating rate assets with floating rate advances

Asset-backed securities (ABS), such as collateralized loan obligations (CLO), are structured investments with a variety of coupon types, collateral, and credit exposures. While insurance companies are more likely than depositories to be ABS investors, 14 percent of FHLBank Boston bank members held ABS or structured products as of June 30, 2019, according to FDIC Call Report data. A typical CLO structure offers senior and mezzanine tranches that pay a variable rate of interest, usually at LIBOR plus a spread. Spreads on AAA-rated senior classes are often in excess of +100 basis points, and in periods of rising credit and/or liquidity concerns, those spreads can widen.

When looking to fund a potential floating-rate investment, variable-rate advances such as the Discount Note Auction-Floater Advance offer an efficient means of matching the term of the investment, while mitigating the liquidity and interest-rate risks and isolating the credit spread. For insurance companies, this can be advantageous as match-funded spread lending activities will most likely qualify to be treated as operating, rather than financial, leverage which supports balance sheet strength. For banks and credit unions, funding with a term floater improves liquidity metrics by reducing the amount of potentially volatile liabilities on the balance sheet, when compared with rolling shorter maturity advances to align with the resetting coupon.

Table 1: Laddered Advances to Fund a Five-Year Investment															
Months	1	2	3	4	5	6	9	12	18	24	30	36	48	60	Total Cost	Avg. Life (yrs)
Rate	2.36	2.34	2.29	2.24	2.20	2.15	1.98	1.96	1.94	1.88	1.85	1.82	1.80	1.79	**1.98**	**1.98**
Amount	5%	5%	5%	5%	5%	5%	5%	5%	10%	10%	10%	10%	10%	10%		

**Rates as of 8/28/19*

Table 2: Laddered Advances to Fund a Five-Year Investment – Six Months In																
Months	3	6	12	18	24	30	42	43	44	45	46	47	48	54	Total Cost	Avg. Life (yrs)
Rate	1.98	1.96	1.94	1.88	1.85	1.82	1.80	1.73	1.73	1.73	1.73	1.73	1.73	1.79	**1.82**	**2.68**
Amount	5%	5%	10%	10%	10%	10%	10%	5%	5%	5%	5%	5%	5%	10%		
Difference vs. Original Funding															**-0.16**	**0.70**

Strategy #2: Using laddered funding to benefit from a flat and inverted yield curve

On July 31, the Fed cut the benchmark rate for the first time since 2008. While Fed Chairman Jerome Powell commented that this was a “mid-cycle adjustment” as opposed to the start of a new easing cycle, the bond market remains steadfast that further weakness may be ahead for the economy. With Treasury yields so low, it may seem counterintuitive to take interest-rate risk given the low nominal rates.

But if the Fed continues cutting short-term rates while intermediate and longer rates stabilize, then adding asset duration will produce benefits — especially for asset-sensitive depositories that have felt the impact of margin and earnings contraction over the last year as the yield curve flattened.

For example, consider a strategy of using a ladder of advances to fund agency MBS with strong prepayment protection characteristics like a Fannie Mae DUS bond, Freddie Mac K-Deal, or a conventional pass-through with features like low loan balance collateral. Constructing a ladder of advances from one month to five years would produce an average life just under two years, at a cost of 1.98 percent (see Table 1 above).

As the short funding begins to roll off, you have great flexibility in how to replace it. Interest expense could be reduced by rolling short advances if front end rates drop as expected, or even by allowing the wholesale funding to roll off due to organic deposit growth.

Additionally, if your institution is inclined to gradually move towards a more interest-rate risk neutral exposure, you could replace the maturing short advances with longer terms. Due to the inverted yield curve, reducing the duration mismatch could be achieved while lowering interest cost and expanding the margin earned on the strategy.

For example, if over the first six months, assuming an unchanged yield curve, the maturing funding was replaced with four-year advances, and you took advantage of the Advance Renewal Discount Program, then the remaining exposure would carry an average life of 2.68 years and cost 1.82 percent. Funding costs would be lower by 16 basis points and the average life of the liabilities would be longer by 0.70 years (see Table 2 above).

Strategy #3: Funding credit investments with the Symmetrical Prepayment Advance

Corporate bonds are the predominant asset class in many insurance company portfolios. In addition, 49 percent of FHLBank Boston bank members held corporate bonds as of June 30, 2019. After weakness throughout 2018 amid concerns over increased leverage and a global economic slowdown, corporate bonds have rebounded in 2019.

When a widening of spreads creates the possibility for an investment strategy that would increase earnings and be accretive to Return on Assets (ROA), the Symmetrical Prepayment Advance can be a useful method of funding. The Symmetrical Prepayment Advance is a fixed-rate, fixed-term advance like the Classic Advance, with one key difference: in a rising-rate environment, you can prepay the advance at any time at its approximate market value and potentially generate a gain.

If a corporate bond is purchased when spreads are wide and funded with a Symmetrical Prepayment Advance and market conditions improve, you could sell the bond and collapse the funding, potentially realizing a gain on both components of the strategy as interest rates rise and credit spreads tighten. Alternatively, electing to hold onto the match-funded investment would allow your institution to continue earning the high spread captured during the favorable period independent of any other challenges that may be impacting the balance sheet.

Get Strategies for Every Phase of the Economic Cycle

Quickly adapting to changing conditions in the investment and funding markets can help you navigate your balance sheet through all phases of the economic cycle. Our Financial Strategies 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 your relationship manager for more details.