Advance Solutions in Volatile Markets

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Highlights

- *The impact of the COVID-19 virus has led to significant changes in the yield curve, as well as in equity and credit markets*
- *The sudden shifts have potentially affected earnings and interest rate and liquidity profiles for many members*
- *Flexibility and efficiency offered by advances can help manage changes in balance sheet exposures*

Balancing Liquidity & Interest-Rate Risk

The magnitude and pace of the economic fallout due to the spread of the COVID-19 virus has been unprecedented. The long end of the yield curve fell precipitously in a matter of weeks, with the entire Treasury curve pricing below 1.00% for the first time in history. Equity markets fell sharply from all-time highs, moved into bear market territory, and triggered daily circuit breakers. Fixed-income sectors like corporate bonds and mortgage-backed securities, saw spreads blow out wider and liquidity in the secondary market dry up.

These challenging conditions can materially shift the risks on both the asset and liability sides of the balance sheet. Accelerated asset prepayments, elevated credit risk, and a new paradigm for deposits can lead to earnings, interest rate risk positioning, and on-balance sheet liquidity ratios that look quite different than the previous quarter.

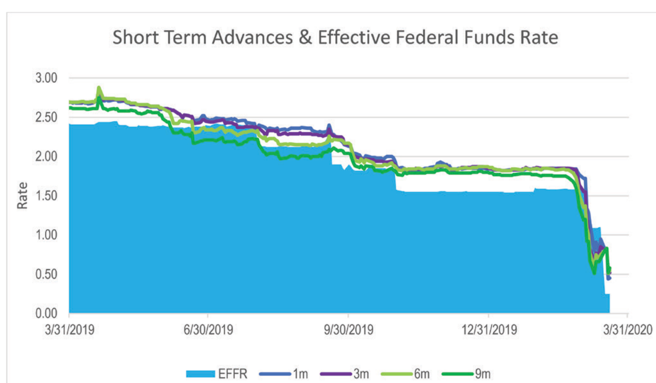
Several advance solutions can help members recalibrate interest-rate and liquidity risk and successfully manage through volatile markets.

	Short-Term Liability Need	Long-Term Liability Need
Immediate Need	Short-Term Classic Advance	Symmetrical Prepayment Advance
Future Need	Forward Starting Advance	Forward Starting Advance

Classic Advance: Short Duration Liability to Meet Immediate Liquidity Needs

Short-term Classic Advances provide members with quick, efficient access to converting available borrowing capacity to on-balance sheet liquidity. Since the beginning of 2019, the overall market sentiment has gone from the expectation of rising rates, to a shift towards rate cuts, to a period of stabilization, and finally to seeing unprecedented accommodation leading to a return to a zero-bound Fed Funds rate.

As the chart below shows, short-term advance rates have moved along with the changes in Fed Funds; the one-month advance rate has exhibited a correlation of over 0.96 to the Effective Fed Funds Rate. As uncertain market conditions create an immediate need for liquidity at the front end of the curve, short-term Classic Advances can be the straightforward solution.



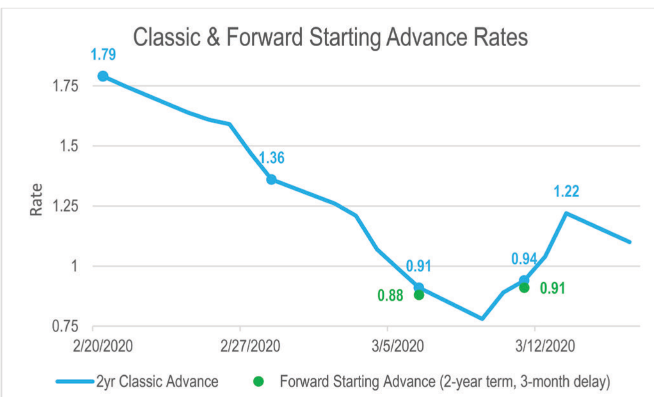
Forward Starting Advance: Short or Long Duration Liability to Meet Future Liquidity Needs

The need to mitigate interest-rate risk may not necessarily always be aligned with that of liquidity risk. The current level of rates may present an opportunity to target a desired duration liability at a favorable cost, but the balance sheet may not require the immediate uptick of liquidity.

The Forward Starting Advance allows members to delay the funding of a Classic Advance by up to two years — with the same range of available short and term maturities — while locking in the rate today. In addition, utilization of borrowing capacity and the purchase of activity stock are not required until the advance is disbursed.

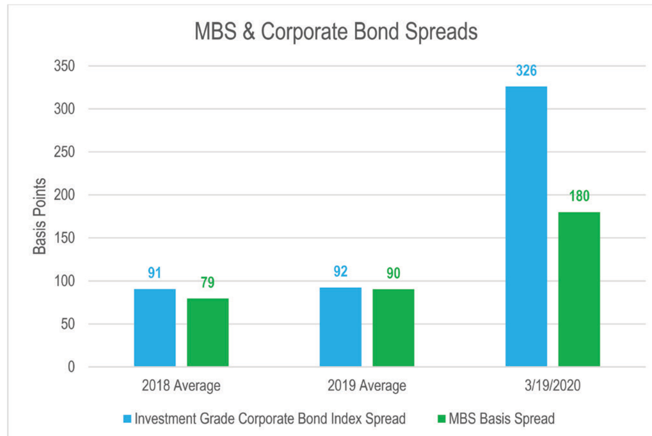
The chart below shows the path of the two-year Classic Advance as rates began to drop in late February into March. In just over two weeks, the rate fell by nearly 100 basis points.

The Forward Starting Advance would allow a member who wanted to take advantage of these new lower rates, but preferred to delay the disbursement in order to line up with maturing advances in June, or possibly hedge against deposits from a maturing certificate of deposit, to design the funding profile fit for their needs.



Symmetrical Prepayment Advance: Long Duration Liability to Meet Immediate Liquidity Needs

As mentioned above, the fixed-income markets experienced considerable stress of late, as spreads have widened, and liquidity conditions have weakened. As the table below outlines, the current level of spreads on agency mortgage-backed securities and high-quality corporate bonds are significantly wider than the majority of 2018 and 2019.



As we noted in "Prepare Now for Investment Opportunities Tomorrow", the Symmetrical Prepayment Advance can be a useful tool to fund investments that have widened to attractive spreads.

The Symmetrical Prepayment Advance affords the member the ability to collapse the funding and potentially realize a gain in a rising-rate environment. Typically priced at just two to three basis points above comparable maturity Classic Advances, the Symmetrical Prepayment Advance is particularly valuable when used to mitigate the interest-rate risk of longer-term assets, while retaining the flexibility to efficiently control the need for funding in the future.

Recent market conditions have created many new challenges for FHLBank Boston members. Our Financial Strategies group can work with you to identify the funding solutions that best fit the unique needs of your balance sheet. Please contact me at 617-292-9644, andrew.paolillo@fhlbboston.com or your relationship manager for more details.