

Federal Home Loan Bank Convertible Advances



Summary of Key Points:

- All of the Federal Home Loan Banks offer convertible advances, which are funding vehicles that charge attractive interest rates but are callable after a lockout period; if called the advance automatically converts to a floating rate advance at the current market rate.
- Banks use convertible advances as part of their portfolio of funding sources with the intent of managing both net interest margin and asset/liability risk.
- Convertible advances substitute for core deposits as an important funding source for banks. They are used to fund home mortgages, small business and small farm loans, which serve as collateral for advances.
- The Federal Home Loan Banks provide all the information needed, on an ongoing basis, to allow users to monitor and manage rate risk.

A convertible advance (CA) is a form of advance or funding vehicle extended by a Federal Home Loan Bank (FHLB) to its member bank. All twelve of the FHLBs offer some form of CA, also termed puttable, callable and convertible select advances by the different FHLBs. CAs are part of the range of advances, swaps and other funding vehicles offered by the FHLBs. CAs carry attractive initial interest rates. However, a CA is subject to cancellation (call for repayment) by the FHLB on pre-determined dates. If the CA is cancelled then the borrower can either repay the loan or else convert the CA to a non-cancelable (non-convertible) floating-rate advance or to an alternative type of advance. In any case, the funding is not revoked unless the bank elects to cancel it.

Offerings differ among FHLBs, but in general the terms of CAs are as follows. These advances are available for terms ranging from one to fifteen years, but always with the condition that the FHLB may cancel prior to final maturity. There is an initial “lockout period” during which the FHLB cannot cancel. The borrower can select a lockout period from as little as one-to-three months, up to ten years – longer is more expensive for a given maturity. Cancellation is permitted quarterly or monthly thereafter until maturity. By special arrangement, CAs are available with only one cancellation date. In another variant, the CA converts automatically (not based on FHLB action) based on a market index rate (often LIBOR) relative to a contractual level, not based on the FHLB’s prerogative.

What role do convertible advances play in managing a bank’s interest rate risk?

Banks use CAs as part of their portfolio of funding sources with the intent of managing both net interest margin and asset/liability risk. For an institution that is weighted toward longer asset duration, CAs can help neutralize rate risk exposure. And because the interest rate is lower than that on fixed-rate advances of equivalent maturity – currently as much as $2\frac{2}{3}$ percent lower for a five-year maturity – this funding can widen the overall interest margin.

In the case of declining market interest rates, the bank would be no worse off in rate risk exposure than with a traditional, fixed-maturity advance. With either convertible or non-convertible advances, the bank would have to deal with prepayment risk. At least the CA is less expensive, helping to manage net interest margin. For example, the banks that locked into CAs a few years ago to fund mortgages have come out way ahead of banks that funded with non-convertible advances of like maturity simply because the interest rate was lower.

Are banks that use convertible advances taking reasonable interest rate risks?

Clearly, a CA involves a degree of interest rate risk for the borrowing bank. A CA is likely to be converted to a floating rate in a rising rate environment, while it would remain unconverted in a falling rate environment. The FHLB makes no representations as to the expectation of the average life of a CA. A user must expect

that CA funding will be converted to a higher rate advance if market interest rates rise, but will remain at the initial level if market rates decline.

While at first glance this appears to be a game rigged against the borrower, this is not at all the case. In fact, banks use CAs as an integral part their overall funding strategy to manage interest margin and rate risk. Users should carefully consider how CAs could affect their financial and/or business strategies under alternative interest rate scenarios. The FHLBs encourage users to review the risks and rewards of these advances and to consult investment advisors about investment strategies that suit their risk profile and liability-management policies.

Banks using CAs are assisted in risk management by the issuing FHLB. The FHLB provides all the information needed to allow users to monitor and manage rate risk on an ongoing basis. Before issuing a CA, the FHLB sends the bank full disclosure of the market characteristics of the instrument, including details on how it will perform under a range of potential interest rate environments. Once initiated, the FHLB provides daily updates on the position of the CA through a Web posting. Each month, the FHLB provides simulations on how the CA will perform under a range of potential interest rate scenarios (tailored to regulatory requirements).

How do the Federal Home Loan Banks hedge their risks associated with these advances?

There is not a high degree of interest rate risk exposure for the issuer of a CA. Nonetheless, the FHLBs completely hedge their CA balances, to the penny, with offsetting swaps.

The FHLBs manage the credit risk of CAs with exposure limits. Each FHLB has an established limit on CAs. For example, the FHLB of Atlanta limits CAs to 15 percent of total assets. The FHLBs have credit criteria with respect to the health and stability of the borrowing bank.

What public purpose do the Federal Home Loan Banks serve by offering convertible advances?

CAs became popular in the late 1990s because they satisfy a need for bank funding. Deposits flowed out of banks and into the stock market, raising loan-to-deposit ratios across the banking industry. Banks searched for deposit substitutes, and CA were developed as a reasonable substitute. Now CA are used to fund home mortgages, small business and small farm loans, which can serve as collateral on advances.

As a funding source, CA behave something like core deposits. At origination, the interest rate is attractive to the borrower. If market interest rates decline then interest rates on CAs and core deposits are “sticky.” If market interest rates rise then a lot of deposits run for higher rates. This is where CAs are superior to deposit funding: the bank can keep the CA funds, although the advance is converted to one paying a floating interest rate at the prevailing market level.

CAs are part of the funding menu that allow banks to meet specific balance sheet needs. However, the CAs offered by FHLBs are far from unique as bank funding sources. In fact, securities firms have long offered similar cancelable debt. Alternately, banks can synthetically create similar finding by borrowing short-term and simultaneously writing callable swaps. The key point for CAs is that they are offered by FHLBs, whose members’ interests are foremost concerns.

The volume of CAs has declined at some FHLB, and the growth rate has declined at others. CAs were most popular when market interest rates were higher and banks were more challenged for funds in the late 1990s. The popularity has waned somewhat lately. Nonetheless, CAs remain popular to institutions whose net interest margins have come under pressure due to the low level of market interest rates.