FHLBank Boston

Restructuring Advances to Improve Margin

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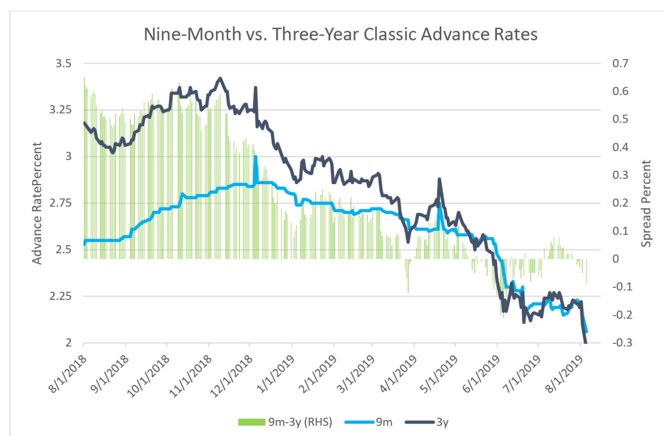
Summary

- *Rates have moved lower, but in an uneven fashion across the yield curve*
- *Opportunities exist to restructure existing advances*
- *Members may be able to immediately lower interest costs without incurring prepayment fees*

The Current Environment

In the current environment, where margins are under pressure from both the asset and liability sides of the balance sheet, an advance restructuring can be a valuable tool to help preserve earnings. For fixed-rate/fixed-term products like the Classic Advance, market rates moving lower than the advance rate will lead to a potential fee if you elect to prepay the advance. However, recent moves in the yield curve have created an opportunity to employ a restructuring strategy, which would allow your institution to avoid prepayment fees while lowering interest costs at the same time.

Rates fell at an uneven pace through the first part of 2019. As the graph below highlights, the nine-month Classic Advance rate has decreased by just 47 basis points compared to a year ago, while the three-year rate has decreased by 121 basis points, leading to a flattening and inversion of the yield curve.

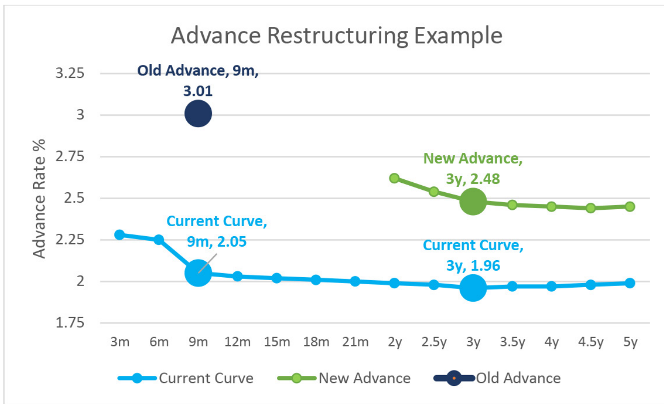


An advance restructuring strategy can look particularly attractive in a flat or inverted yield curve environment, because prepayment fees are relatively muted on advances with remaining maturities that have had smaller decreases in rates (such as the nine-month Classic Advance). Targeting parts of the curve that have dropped more aggressively (such as the three-year) allows for the reduction of interest costs. Like an investment strategy rotating out of an overvalued sector into an undervalued one at an opportune time, the advance restructuring moves away from the costlier tenor to a lower-priced one.

Advance Restructuring Example

Consider the example below of a Classic Advance taken in 2018, with a remaining term of nine months, at a rate of 3.01 percent. Estimated prepayment fees for this advance would be 0.72 percent. Since that time, advance rates have moved lower, leading to the prepayment fee. However, by executing an advance restructuring, you **can immediately lower your cost of funds**, without waiting nearly a year for the advance to mature. Plus, there's **no prepayment charge at the time of the transaction**, as the projected fee is blended into the new advance rate.

Depending on the maturity of the new Classic Advance selected, the blended rate (and savings) will vary, but a benefit of the flat/inverted yield curve is that significant liability extension is not needed to capture savings. If your institution is asset sensitive but also focused on improving net interest margin, this could be a viable strategy.



In the above example, the member can restructure its outstanding Classic Advance with nine months remaining at 3.01 percent into a three-year Classic Advance at 2.48 percent, lowering interest expense by 53 basis points. Additional savings can be captured by participating in long-term advance specials, regularly offered by the Money Desk. The term on the new advance can be tailored to balance asset/liability management needs as well as the targeted amount of immediate interest expense relief, as highlighted in the table on the right.

SAVINGS VS. OLD ADVANCE RATE						
2yr	2.5yr	3yr	3.5yr	4yr	4.5yr	5yr
0.39	0.47	0.53	0.55	0.56	0.57	0.56

Our Financial Strategies team has developed tools to identify where restructuring opportunities may exist in your advance portfolio. We can 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 more details.