

Corridor Advance Primer

I. Product Information

Background

The Federal Home Loan Bank of Boston (the “Bank”) offers the Corridor advance, a floating-rate advance containing two embedded interest-rate caps. This enables members to create a cost-effective solution to hedge an increase in short-term interest rates until interest rates exceed an upper cap

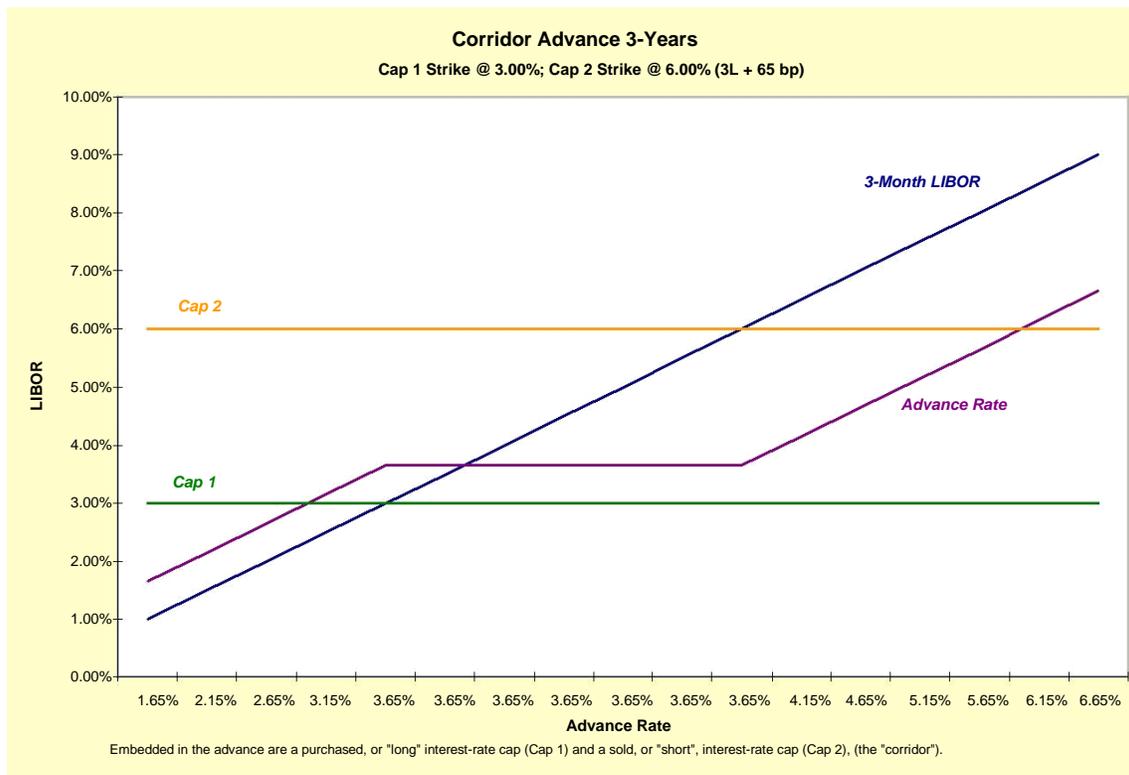
Characteristics

The Corridor advance is a floating rate, nonamortizing advance containing a combination of two interest-rate caps. Embedded in the advance are a purchased, or “long,” interest-rate cap (Cap 1) and a sold, or “short,” interest-rate cap (Cap 2) with a higher strike rate, (together, the “corridor”). The advance rate will float until rates reach Cap 1, it will be fixed between Caps 1 and 2, and will revert to a floating rate when rates exceed Cap 2. Embedded Cap 2 reduces the net cost of the corridor advance, but exposes the member to rising interest rates if the London Interbank Offered Rate (LIBOR) climbs above the strike rate of Cap 2. Keep in mind, even if LIBOR has breached Cap 2, Cap 1 is still in effect, and although members give up some of the protection against extremely high rates, the advance rate will generally be less than LIBOR, depending on the structure of the corridor. (See below, “How it Works”).

The Corridor advance adjusts to either one- or three-month LIBOR. Corridor advances are available in terms from one to 10 years. Interest on a Corridor advance is calculated on an actual/360-day basis and is payable on rate-reset dates. The principal on the Corridor advance is due at maturity. Typically, Corridor advances can be requested until 1:00 p.m. on a Boston and London business day for disbursement and funds will be available two business days after the trade date. Corridor advances have a \$2 million minimum but smaller requests may be accommodated in special offerings, which the Bank may offer from time to time. The advance is prepayable subject to a fee.

How it Works

Consider a Corridor advance with a three-year term, indexed to three-month LIBOR, with a 3.00 percent strike on Cap 1 and a 6.00 percent strike on Cap 2, or a corridor of 300 basis points. The advance is priced at three-month LIBOR plus a spread of 65 basis points. The spread of 65 basis points includes the cost of the funding and the net cost of the corridor. The following chart illustrates how an advance with these terms reacts at different LIBOR levels.



In this example, when LIBOR does not exceed the strike rate of Cap 1 (3.00 percent) the rate on the advance will equal LIBOR plus 65 basis points. Protection from rising rates begins as soon as LIBOR exceeds Cap 1. Provided that LIBOR remains within the corridor of 3.00 and 6.00 percent, Cap 1 will limit the advance rate to 3.65 percent (Cap 1, or 3.00 percent, plus the spread of 65 basis points). If LIBOR exceeds the value of Cap 2, in this example 6.00 percent, then the advance rate will be LIBOR plus the spread of 65 basis points less the corridor of 300 basis points. Assume a LIBOR set of 9.00 percent on a rate reset date. The spread of 65 basis points is added to the LIBOR set of 9.00 percent to arrive at 9.65 percent, but then the rate is adjusted for the impact of Caps 1 and 2. This rate is reduced by the difference between Cap 2 and Cap 1, or 9.65 percent is reduced by 300 basis points (6.00 percent less 3.00 percent) to arrive at an adjusted rate of 6.65 percent, or 235 basis points below LIBOR. Note that, in this example, whenever LIBOR is greater than Cap 2, the advance rate will always be 235 basis points less than LIBOR (300 basis points difference between Caps 2 and 1, less 65 basis points spread).

The preceding chart is for illustrative purposes only and is not representative of actual pricing for the Corridor advance. Furthermore, the chart is not intended to be an indication of the future performance of the Corridor advance or of future interest rate trends associated with the Corridor advance.

Additional Characteristics

A Corridor advance disburses in two business days after the trade date. The initial interest rate of the advance is quoted as a spread to LIBOR, which is fixed for the term of the advance. The cost of the term funding and the net cost of the embedded corridor feature are included in the spread. Members specify the term, index, and strike rates on Caps 1 and 2 based on their own interest-rate risk management objectives.

The initial interest rate is based on one- or three-month LIBOR, depending on which designated maturity is elected by the member, two days prior to disbursement. As an example, if a member calls on Monday for a two-year Corridor advance adjusting to one-month LIBOR, it will disburse on Wednesday. The advance rate will be Monday's one-month LIBOR rate plus the spread. A Corridor advance will reset on the anniversary of its disbursement (monthly or quarterly, equal to the term of the LIBOR), if it is a Boston business day. If the date is not a business day, the advance will reset on the next business day. The interest rate for each reset date will be based off a two-day look back period, i.e. the Bank will use LIBOR two days prior to each reset date plus or minus the spread. If you would like to find out more about the Corridor advance or have additional questions, please call the Money Desk at 800-357-3452.

Members may have to purchase additional activity stock in some cases. The activity stock capitalization requirement on a Corridor advance is 4.5 percent.

Uses

Members exposed to rising interest rates use Corridor advances to manage/mitigate their interest-rate risk as rates increase. While embedded Cap 2 reduces the net cost of the Corridor advance, it also limits the benefit members can receive from extremely high interest rates. Corridor advances are therefore useful as hedges for short time frames since the probability of severe rate increases over a short time frame is generally less than for longer periods. In general, the Corridor is a good tool to manage short-term balance-sheet interest-rate sensitivity within a certain interest rate "corridor."

The Bank has financial strategists who can help members decide what type of funding meets their specific needs. If you would like a strategist to produce an analysis, please call the strategists at 800-357-3452 or via email at strategies@fhbboston.com.

A member should review the [Products and Solutions Guide](#) prior to taking an advance so as to understand the terms of the contract and the prepayment provisions.

This statement does not purport to disclose all of the risks and other material considerations associated with Corridor advances. Members should not construe this disclosure statement as business, legal, tax, or accounting advice from the Bank. Members should consult with their own business, legal, tax, and accounting advisers with respect to Corridor advances and should refrain from using a Corridor advance unless they have fully understood the terms and risks of the Corridor advance.