HLB Option Advance Primer

I. Product Information

History

Beginning in 1996, the Federal Home Loan Bank of Boston (the Bank) introduced the HLB Option advance, and it soon became one of the most successful products in Bank history. It has enabled members to borrow at lower rates than would typically be available to them.

Available Structures

Final maturities of current offerings generally out to 20 years, with the advance being cancelable by the Bank after a lockout period of three months to 10 years. The Bank offers “Bermudan” structures, cancelable on a quarterly basis after the lockout period, and “European” structures, which are cancelable on a one-time basis after the lockout period. Cancellation dates, whether Bermudan or European, are mutually agreed upon at the commencement of the HLB Option advance. An HLB Option advance with a 10-year maturity and a lockout period of one year is referred to as a 10-year non-call one-year advance (10/1). As the number of options sold increases, the advance rate declines. A 10/1 advance would be priced lower than a 10/5 advance because the member is selling more options.

II. Risks Associated with the HLB Option Advance and other Considerations

The HLB Option advance involves the sale of options to the Bank. When selling options, it is important to understand the inherent risks and evaluate them as part of the member’s entire balance sheet. Members are familiar with selling options on the asset side of the balance sheet. Almost every loan on members’ balance sheets can be prepaid or called without penalty. Many investment portfolios also contain callable bonds. As interest rates change, members should be aware that any strategy involving prepayable or callable assets funded with HLB Option advances could result in margin pressures and requires active funds management. The sale of options on both sides of the balance sheet results in opposite call profiles for the instruments. When interest rates rise, mortgage prepayments would likely slow and the portfolio would likely extend. Likewise, callable bonds also would extend because issuers would not exercise their call options. At the same time, the HLB Option advance would likely be canceled. If the Bank exercises its option to cancel, the member must repay the advance but may replace it with a new advance. The new advance may be for any structure and term to maturity agreed upon between the member and the Bank, subject to the Bank's Products and Solutions Guide. The rate on the new advance will be that in effect at the time the new advance is taken.

In a falling interest rate environment, the exact opposite would be likely to occur. Mortgagors, anxious to reduce their monthly payments, would likely prepay and refinance at lower rates. Furthermore, the issuers of callable bonds, who are using these instruments to hedge their own mortgage portfolios, would call the bonds from investors. The HLB Option advance would likely remain outstanding at higher than market rates and again, the member's margin could be compressed.

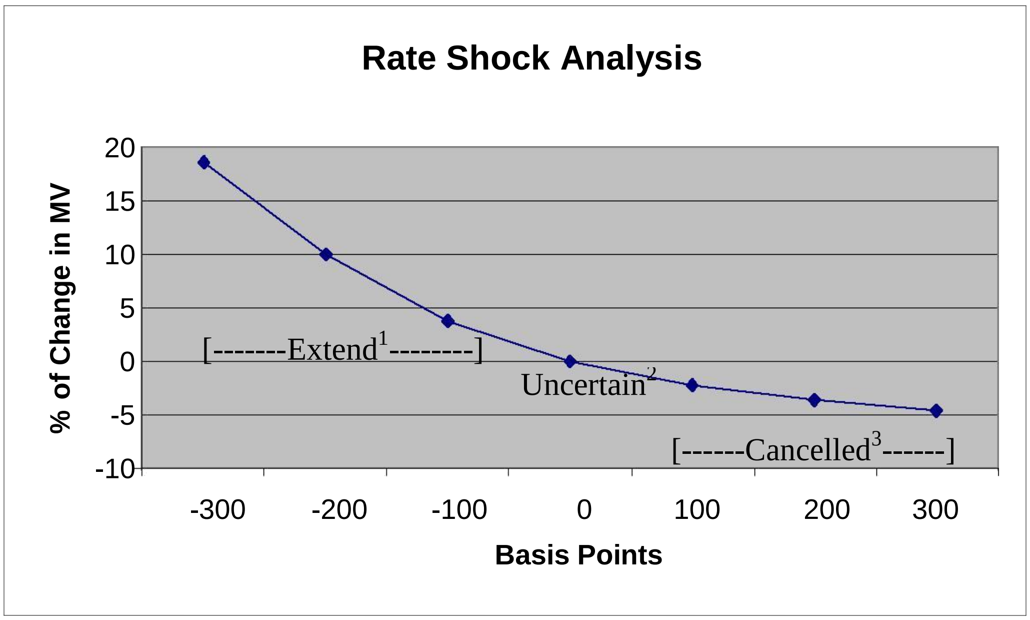
Members generally are attracted to the HLB Option advance in a flat yield curve environment to lower their cost of funds. While this results in a lower advance rate than otherwise could be achieved, it is important for members to quantify the effects on their net interest margin. HLB Option advances also require active management as interest rates change. Contact your asset/liability or financial advisor for strategies you could employ in different interest rate environments. As usage of this product increases, members should be able to quantify how changes in market rates would impact their net interest margin.

The HLB-Option advance is prepayable in full or in part at any time, subject to a fee. Partial prepayments may be in amounts as small as $100,000 and in intervals of $100,000 thereafter.

This statement does not purport to disclose all of the risks and other material considerations associated with the HLB Option advance. 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 the HLB Option advance, and should refrain from entering into the HLB Option advance unless they have fully understood its terms and risks.

Parallel-Shift Sensitivity Analysis

The following chart is intended to help you understand the risks of taking out an HLB Option advance. The chart illustrates the approximate market values (MV) of a recent HLB Option advance in several interest rate environments along with the expectations for behavior in those interest rate environments. However, the chart is not intended to be an indication of the future performance of the HLB Option advance or of future interest rate trends associated with the HLB Option advance.



[1] As interest rates decline, the value of the HLB Option advance to the Bank increases and the advance would likely extend.
[2] If interest rates are unchanged, it is uncertain whether the Bank would cancel the advance.
[3] As interest rates rise, the value of the HLB Option advance to the Bank falls and the Bank would likely exercise its option to cancel the advance.