Knockout Advance Primer

I. Product Information

History

Beginning in 2000, the Federal Home Loan Bank of Boston (the “Bank”) introduced the Knockout advance, and it soon became popular as an alternative to the HLB Option advance. It enables members to have a clearer understanding of the events surrounding the cancellation of the advance.

Available Structures

Final maturities are available for terms out to 20 years with a lockout period of three months to 10 years. Members can tailor the final maturity, lockout period, index, and knockout level of that index (the “Strike Rate”) to meet their funding and interest-rate risk management requirements. The Knockout advance will be canceled prior to final maturity if the index (generally one- or three-month LIBOR) equals or exceeds the specified Strike Rate on specified dates. Typically, the Strike Rate is indexed to one- or three-month LIBOR (London Interbank Offered Rate), the rate that most major international banks dealing in Eurodollar currency charge each other for large loans. The Bank offers “Bermudan” structures, where the advance would be cancelable on a quarterly basis after the lockout period (assuming the index equals or exceeds the Strike Rate on the specified day in the relevant quarter) and “European” structures, which are cancelable on a one-time basis after the lockout period (assuming the index equals or exceeds the Strike Rate on the specified day). A Knockout advance with a 10-year maturity and a lockout period of one year and a Strike Rate of 6.50 percent is referred to as a 10-year non-call 1-year Knockout advance with a 6.50 percent strike (10/1, 6.50% KO). In this example, the advance can only be called if three-month LIBOR equals or exceeds 6.50 percent on any of the call dates. As the number of options sold increases in a Bermudan structure, the advance interest rate declines. A 10/1, 6.50 percent Knockout advance would be priced lower than a 10/5 6.50 percent Knockout advance because the member is selling more options.

The Knockout advance has a fixed term and rate throughout the term of the advance and is non-amortizing. Principal repayment is due at maturity or cancellation. The interest on a Knockout advance is calculated on an actual/360-day basis and is payable on the second business day of the month. Typically, Knockout advances can be requested until 1:00 p.m. and will disburse two business days after the trade date. Knockout advances have a $2 million minimum, but smaller requests may be aggregated during special offerings conducted by the Bank from time to time. Knockout advances are prepayable subject to a fee. Partial prepayments may be in amounts as small as $100,000 and in intervals of $100,000 thereafter.

II. Risks Associated with the Knockout Advance and other Considerations

The Knockout 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 Knockout 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 Knockout advance would likely be canceled if rates rise too much and the Strike Rate is reached or exceeded. If the Knockout advance is canceled, the member must repay the advance, but may replace the advance with a new advance. The new advance may be for any structure and term as agreed upon between the member and the Bank, subject to the Bank's Products and Solutions Guide. However, the rate on the new advance will be that in effect at the time the new advance is taken.

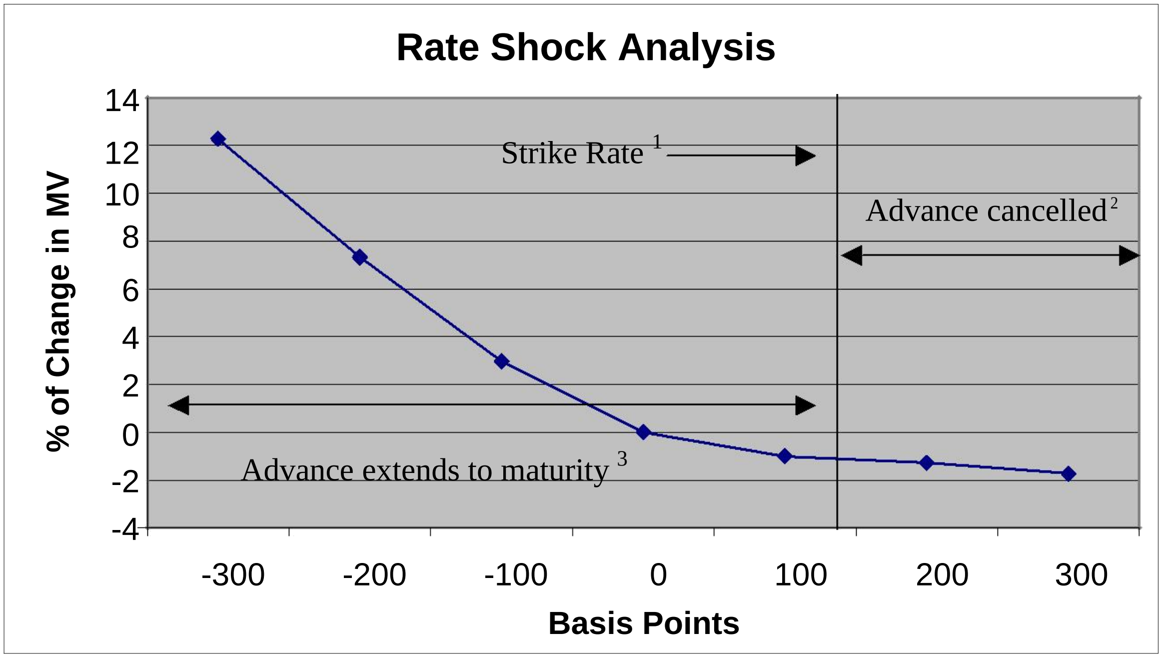
In a falling interest rate environment, the exact opposite would be likely to occur. Mortgagors, anxious to reduce their monthly payments, would likely prepay and refinance at lower rates. Furthermore, the issuers of callable bonds, who are using these instruments to hedge their own mortgage portfolios, would call the bonds from investors. The Knockout 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 Knockout advance in a flat yield curve environment to lower their cost of funds. While this results in a lower advance interest rate than otherwise could be achieved, it is important for the member to quantify the effects on their net interest margin. Knockout 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. Members may have to purchase additional activity capital stock in some cases when they take a Knockout advance. The activity stock capitalization requirement on a Knockout advance is 4.5 percent.

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

Parallel-Shift Sensitivity Analysis

The following chart is intended to help you understand the risks of taking out a Knockout advance. The chart illustrates the approximate market values (MV) of a recent Knockout 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 Knockout advance or of future interest rate trends associated with the Knockout advance.



[1] The Knockout advance depicted in this chart contains a six percent strike on three- month LIBOR. At time of take down, three-month LIBOR was 4.61 percent or 1.39 percent below the level where the Bank would automatically cancel the advance.

[2] The Bank will automatically cancel the Knockout advance if three-month LIBOR equals or exceeds six percent on any specified cancellation date.

[3] If three-month LIBOR never equals or exceeds six percent on any specified cancellation date the Knockout advance will extend to final maturity.