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FHLBI Insider

Bullet Advances:

The Beauty of Simplicity

> ***In character, in manners, in style, in all things, the supreme excellence is simplicity.***
> ***—Henry Wadsworth Longfellow***

The bullet advance is one of the oldest FHLBank credit offerings. Over the years, the Federal Home Loan Bank of Indianapolis (FHLBI) has provided members with a variety of funding structures, such as advances with floating rates, fixed rates, amortizing terms, prepayment options, and interest rate caps. With increasing complexity, it would seem that the "plain vanilla" bullet advance would go the way of the buggy whip; yet, simplicity, flexibility, and a lack of optionality make the bullet advance a funding manager's favorite tool.

Bullet advances can be used to target any maturity up to ten years. Since the advance involves monthly payments of interest and principal at the end of the term, bullets are the wholesale equivalent of certificates of deposit (CDs). This similarity provides financial institutions with both benchmarks and discipline for pricing retail deposits.

Minimizing funding costs is essential to maximizing profitability. Optimal deposit pricing must consider the relative costs of all potential funding sources across the maturity spectrum. For FHLBI members, CD pricing must consider the cost of the bullet advance alternative. If adequate retail funding cannot be generated economically in the desired maturities, bullet advances can fill any remaining maturity gaps after retail opportunities have been maximized.

Bullet advances are the perfect fallback position because they are always available in the exact amount and maturity needed and at market rates. Unlike CDs, bullet advances do not give the lender (in this case, the FHLBI) the option of early withdrawal. When a financial institution uses a bullet advance, the FHLBI cannot break the contract or renegotiate the rate prior to maturity. This lack of optionality can provide funding managers with a sure thing in uncertain times.

During early 2004, interest rates were hovering near historic lows. While this may be good for fund-

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Exhibit 1
Rate increase necessary to achieve early withdrawal break-even rate
(Based on a six months' interest penalty)

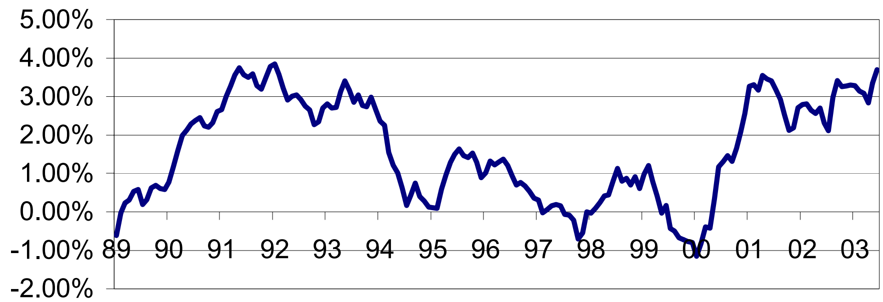
	Current CD Rate						
CD Term	2.00%	2.50%	3.00%	3.50%	4.00%	4.50%	5.00%
1 year	1.03%	1.30%	1.57%	1.84%	2.12%	2.40%	2.69%
2 years	0.52%	0.66%	0.80%	0.94%	1.09%	1.23%	1.39%
3 years	0.35%	0.44%	0.54%	0.64%	0.74%	0.84%	0.95%
4 years	0.27%	0.34%	0.41%	0.49%	0.57%	0.65%	0.73%
5 years	0.22%	0.27%	0.33%	0.40%	0.46%	0.53%	0.60%

ing costs, it has reduced the value of early withdrawal penalties, especially for long-term CDs. Exhibit 1 details the rate increase necessary before depositors benefit from early withdrawal and reinvesting the proceeds in a new CD.

Since CD yields are at historic lows, the cost of early withdrawal is as well. For example, the six months' interest penalty on a 3% five-year CD imposes a cost of 1.5% on early withdrawal. If the interest penalty is annualized over the life of the CD, rates would need to increase only 33 basis points before a depositor could pay the penalty, reinvest the proceeds, and still break even. While it is unlikely that all CD holders will exercise withdrawal options efficiently, the presence of the option should not be ignored in risk management and pricing decisions.

From a pricing perspective, financial institutions need to capture value from the options they provide. Common sense dictates that higher withrawal penalties should be assessed on longer term CDs. If this is not possible, longer term CDs should be priced less aggressively to reflect the value of the withdrawal option. However, either of these measures could make long-term CDs more difficult to sell, forcing the consideration of other funding options.

Exhibit 2
Spread between 10 year Treasury and fed funds
(December 1989-May 2004)



Playing Offense and Defense

The rate environment of early 2004 presented both opportunities and risks. In addition to low interest rates, by most metrics, the yield curve was also historically steep. Exhibit 2 shows the spread between the 10 year treasury and fed funds rates during the past 15 years.

Since August 2003, the spread between the 10 year treasury and fed funds has generally exceeded 300 basis points. The steep yield curve presents an opportunity to pick up spread by purchasing longer term assets with shorter term funding. Put another way, the opportunity cost of excess liquidity has been very high recently.

While the cost of carrying liquidity is high, the shape of the yield curve suggests investors expect interest rates to rise. The last time the yield curve was this steep was back in late 1993. At that time, the "hottest" portfolio managers had relatively long portfolios to capitalize on the steep curve. Unfortunately, when the fed funds rate increased 300 basis points over the next year and the yield curve flattened, so did their positions.

Instead of remaining on the sidelines, long term bullet advances can be combined with short term funding to fund long term assets. This "barbell" approach has several advantages. First, the strategy can be customized to meet any asset/liability need. Since it takes advantage of existing liquidity funding sources, it is efficient and economical. Finally, barbell strategies have had a long and successful track record through a variety of interest rate environments.

When interest rates rise, managers will need to play good defense to keep funding costs low. Whether the competition is running kamikaze CD specials or improving equity market results in deposit outflows, bullet advances are a valuable resource in the funding toolkit.