

# The New and the Old: Enhanced Letter of Credit Capabilities and the “Back-to-Basics” of Wholesale Funding

John P. Biestman, CFA  
Jonathan B. Hartley  
Brett L.A. Manning, CFA

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## Today's Agenda

### The Old: "Back to the Basics"

- Assessment of common funding risks
- Seattle Bank advance applications
  - Floating Rate Applications
  - Amortizing Rate Applications
  - Examples of common advance applications

### The New: Enhanced Letter of Credit Capabilities

- Current uses and applications
- Expanded uses and applications



# The Old: “Back-to-Basics” of Wholesale Funding

**SIVs**



**CLOs**



**CDOs**



**SPEs**

**QSPEs**



**CDS**

## Common Risk Considerations

- Basis Risk: “Apples to Apples, Not Oranges to Apples”
- Interest Rate Risk: “Know Thyself”
- Cash-Flow Risk: “Price Accordingly”



# Basis Risk: “Apples to Apples, Not Oranges to Apples”



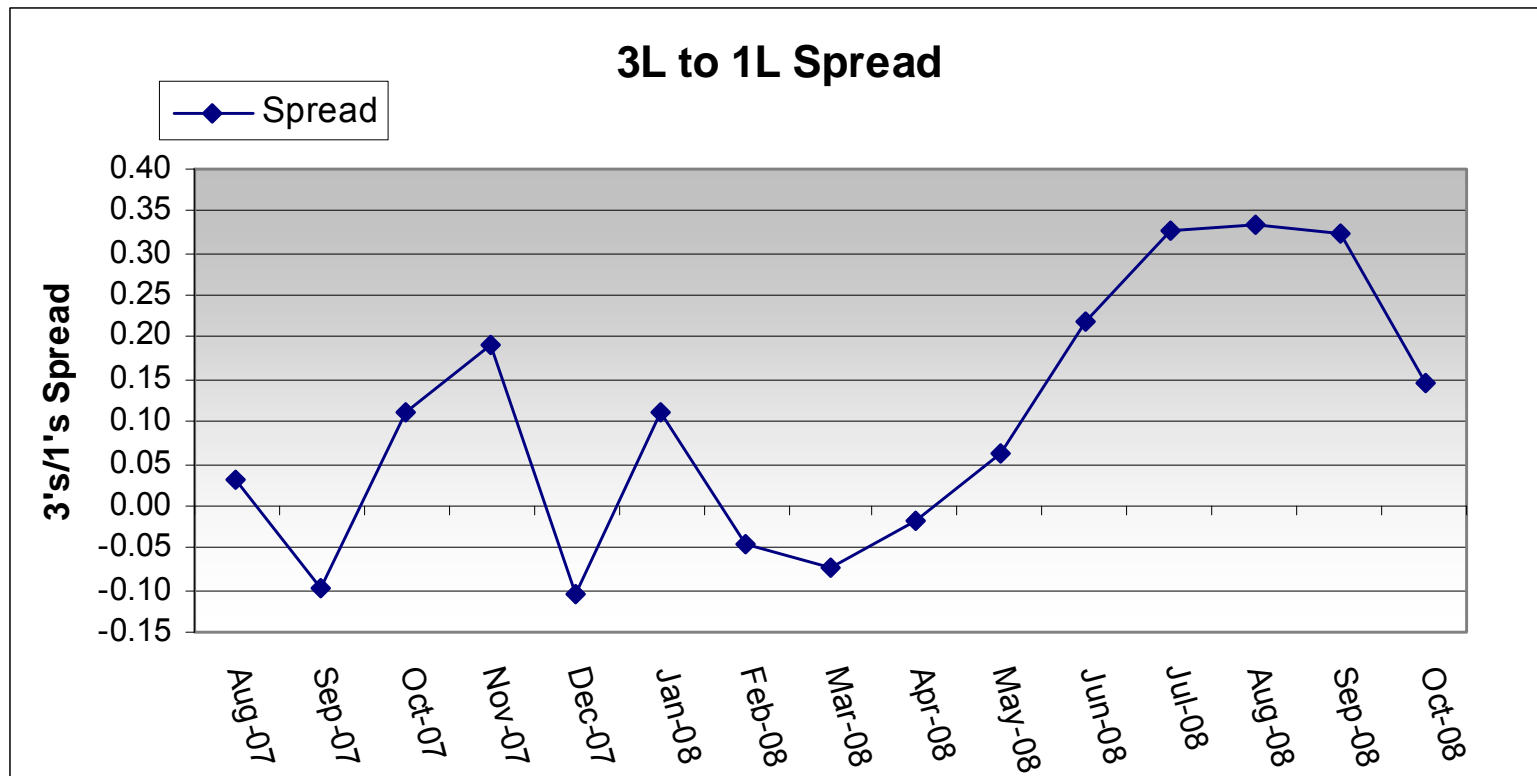
Basis Risk: baseline, or basis, index used to price assets and liabilities.

Basis Comparisons			
	1M LIBOR	3M LIBOR	Prime
1M LIBOR	None	1s/3s Risk	1s/Prime Risk
3M LIBOR	3s/1s Risk	None	3s/Prime Risk
Prime	Prime/1s Risk	Prime/3s Risk	None

- No basis risk, margin locked in
- Basis risk introduces re-pricing error and possible margin compression

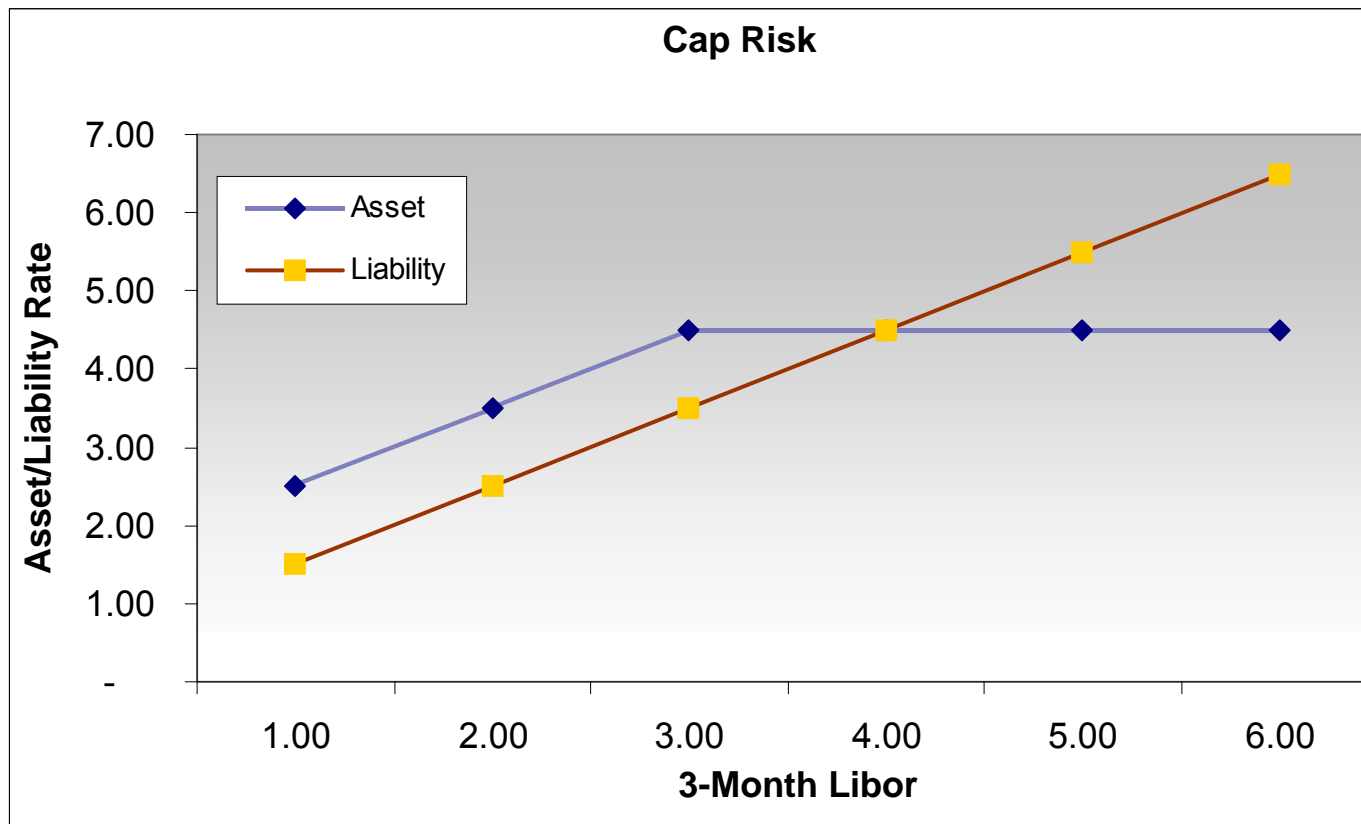
# Basis Risk and Spread Volatility

Basis risk introduces spread volatility and negative earnings impact.



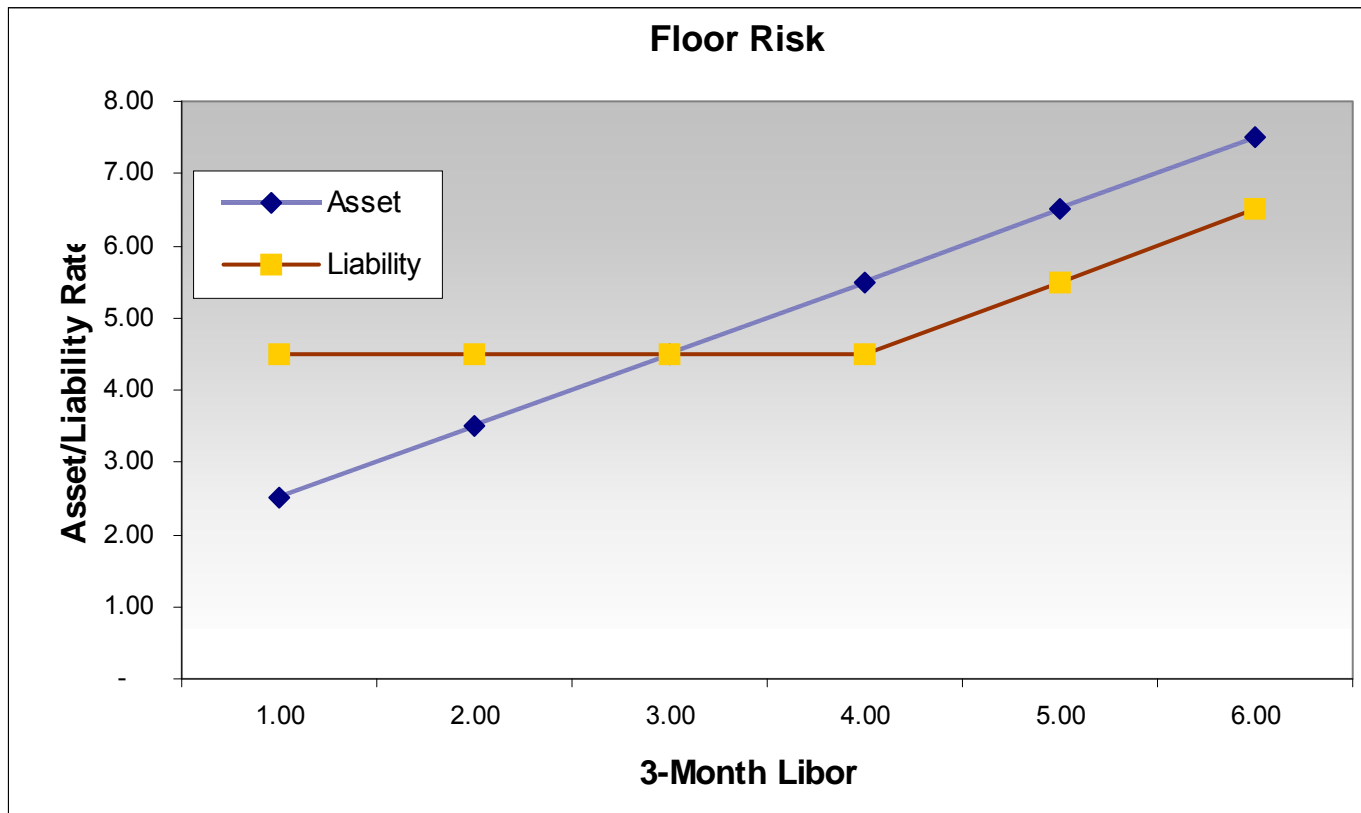
Basis Risk and Cap Risk: Risk that asset yields are fixed, but liability costs continue to rise.

*Solution: Capped Floater Advance (2/05 & 2/06 What Counts)*



Basis Risk and Floor Risk: Risk that asset yields float, but liability costs are fixed.

*Solution: Floored Floater Advance (12/06 What Counts)*



## Interest Rate and Cash Flow Risk: “Know Thyself and Price Accordingly”

- Interest Rate Risk: Variable value of an interest-earning asset due to the variability of interest rates.
  - Know your interest rate risk profile; how do interest rate moves impact your institution?
  - Price accordingly to manage cash flows.

Interest Rate Risk Profile	Effect of Rising Rates on Earnings	Effect of Rising Rates on Market Value
Asset Sensitive (A)	↑↑↑	↑
Liability Sensitive (L)	↓↓	↓↓↓
Neutral (N)	↔	↔

## Seattle Bank Funding Solutions

Floating Rate Advances	Indices	Natural Hedge Vehicles	Primary Benefit
Prime Floater	Prime Rate	Consumer and Commercial Loans	Reduce basis and repricing risk
LIBOR Floater	LIBOR Indices (1 and 3 months)	Consumer and Commercial Loans	Reduce basis and repricing risk, exposure to LIBOR funding markets
Auction Floater	Seattle Bank Auction Funding	Commercial Loans	Reduce basis and repricing risk, exposure to GSE funding markets

## Commercial Loan Examples

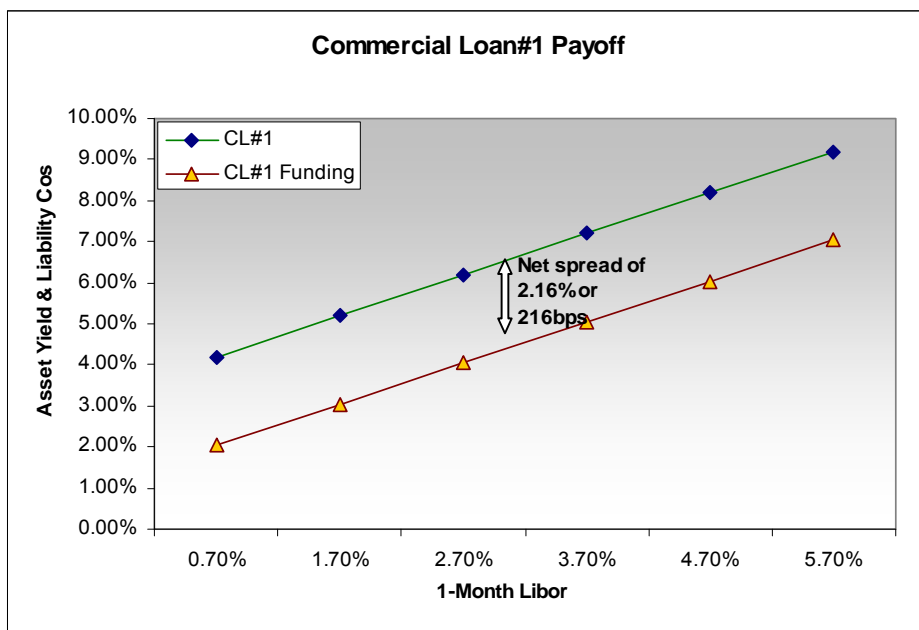
*GOAL: Hedge Basis Risk*

Loan Type	Index	Spread	Term
Commercial Loan #1 (CMCL#1)	1M LIBOR	+3.50%	3 year
Commercial Loan #2 (CMCL#2)	3M LIBOR	+3.75%	5 year

### *Seattle Bank Advance Pricing*

Advance Term	1M LIBOR	3M LIBOR	Prime
1-year	+1.09%	+.84%	-.61%
3 year	+1.34%	+1.26%	-.98%
5-year	+1.50%	+1.46%	-.91%

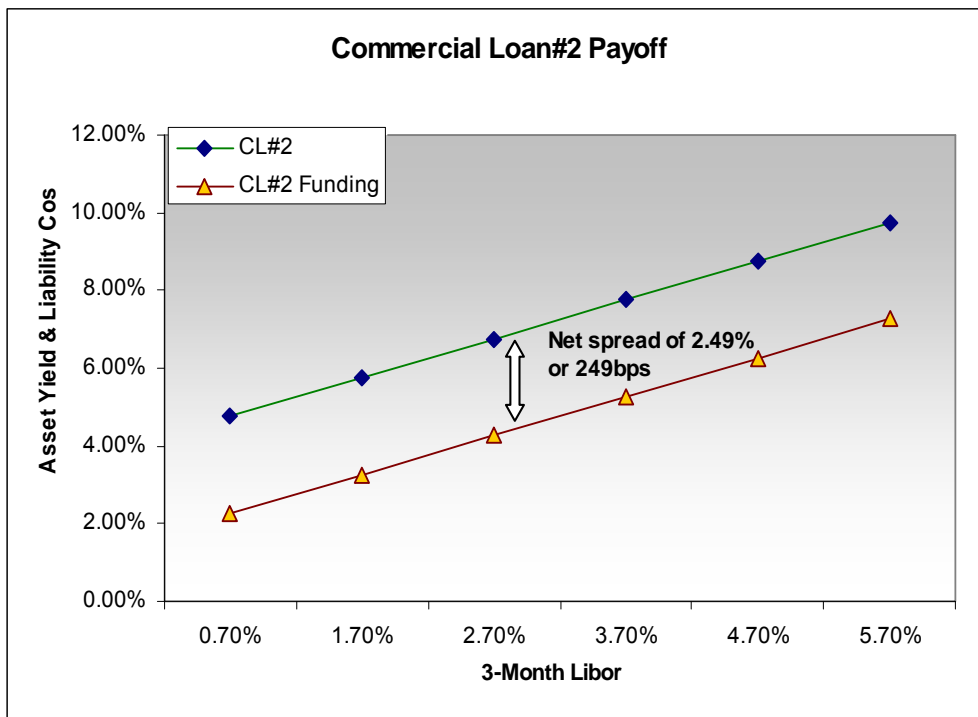
# Commercial Loans: Protect and Maintain Margins



1M LIBOR	Asset Yield	Liability Cost	CL#1 Spread
0.70%	4.20%	2.04%	2.16%
1.70%	5.20%	3.04%	2.16%
2.70%	6.20%	4.04%	2.16%
3.70%	7.20%	5.04%	2.16%
4.70%	8.20%	6.04%	2.16%
5.70%	9.20%	7.04%	2.16%

- Initial spread of 216 bps is maintained throughout life of loan, as basis risk is eliminated. Pricing assets to 1-month LIBOR and funding via a 1-month LIBOR-based advance eliminates both basis and repricing risk.

# Commercial Loans: Protect and Maintain Margins



3M Libor	Asset Yield	Liability Cost	CL#2 Spread
1.00%	4.75%	2.26%	2.49%
2.00%	5.75%	3.26%	2.49%
3.00%	6.75%	4.26%	2.49%
4.00%	7.75%	5.26%	2.49%
5.00%	8.75%	6.26%	2.49%
6.00%	9.75%	7.26%	2.49%

- Initial spread of 249 bps is maintained throughout life of loan, as basis risk is eliminated. Pricing assets to 3-month LIBOR and funding via a 3-month LIBOR based advance eliminates both basis and repricing risk.

## Consumer Loan Example

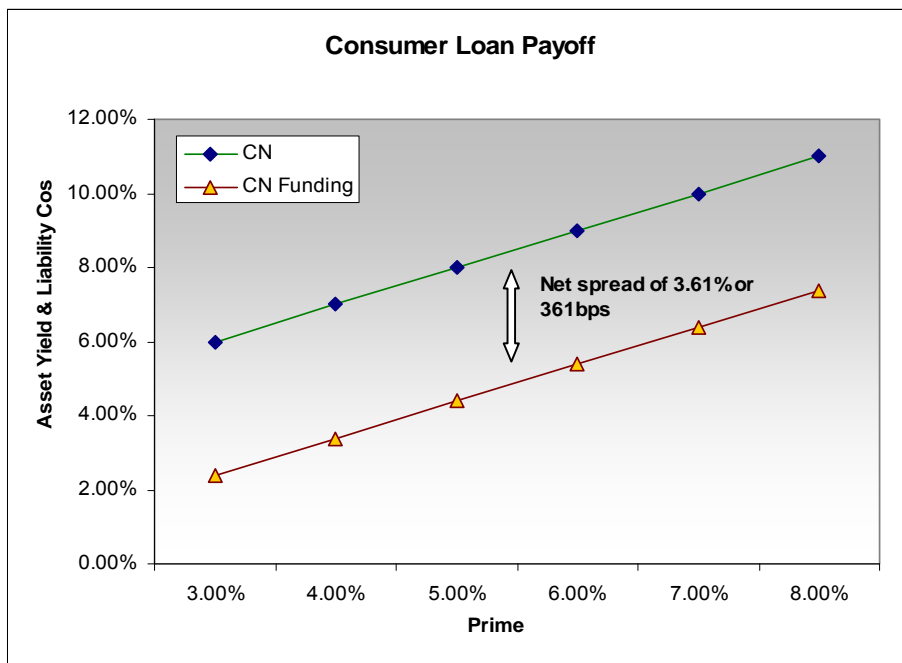
*GOAL: Hedge Basis Risk and Manage Credit Risk*

Loan Type	Index	Spread	Term
Consumer Loan	Prime	+3.00%	1 year

### *Seattle Bank Advance Pricing*

Advance Term	Prime	Adv Spread	Adv Rate
1-year	4.50%	-.61%	6.89%
3-year	4.50%	-.98%	6.52%
5-year	4.50%	-.91%	6.59%

# Consumer Loans: Protect Margins, Manage Risk



Prime	Asset Yield	Liability Cost	CN Spread
3.00%	6.00%	2.39%	3.61%
4.00%	7.00%	3.39%	3.61%
5.00%	8.00%	4.39%	3.61%
6.00%	9.00%	5.39%	3.61%
7.00%	10.00%	6.39%	3.61%
8.00%	11.00%	7.39%	3.61%

- Initial spread of 361 bps is maintained throughout life of loan, as basis risk is eliminated. Pricing assets to Prime and funding via a Prime-based advance eliminates both basis and repricing risk.

# Amortizing Advances: Cash Flow Management

## *Benefits:*

- Hedge both interest rate risk and cash flow risk
- Cater to specific borrower requests, match funding terms

### 15-Year Straight-Line Amortizing Advance Specs

Principal	\$1,000,000
Rate	6.05%
Principal Payment	\$5,555.56
Monthly Term	180 months
Amortization Term	180 months

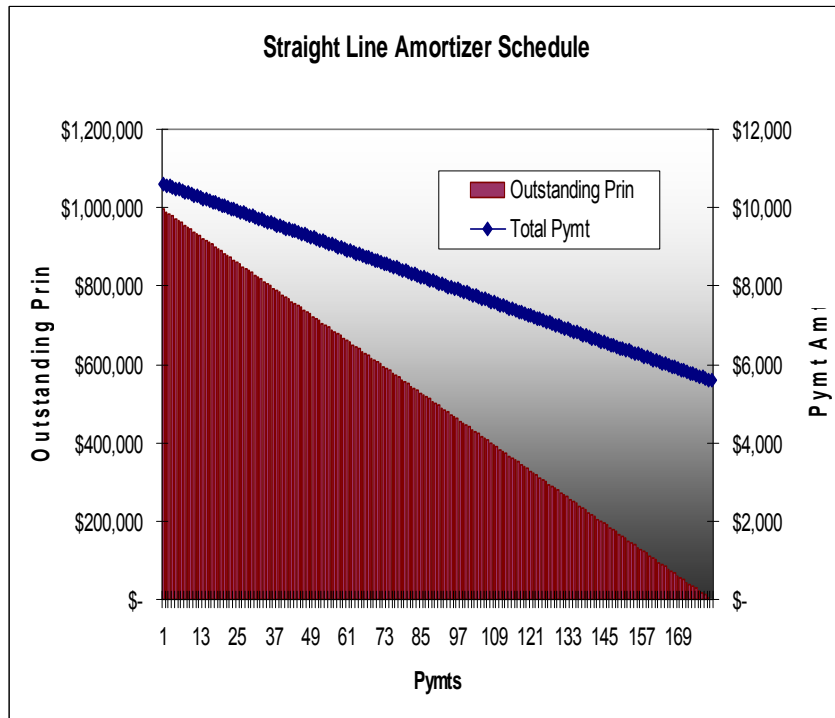
### 30-year, Due in 15 Years Customized Amortizing Advance Specs

Principal	\$1,000,000
Rate	6.38%
Principal Payment	Increases over time
Monthly Term	180 months
Amortization Term	360 months

# Amortizing Advances- Cash Flow Management

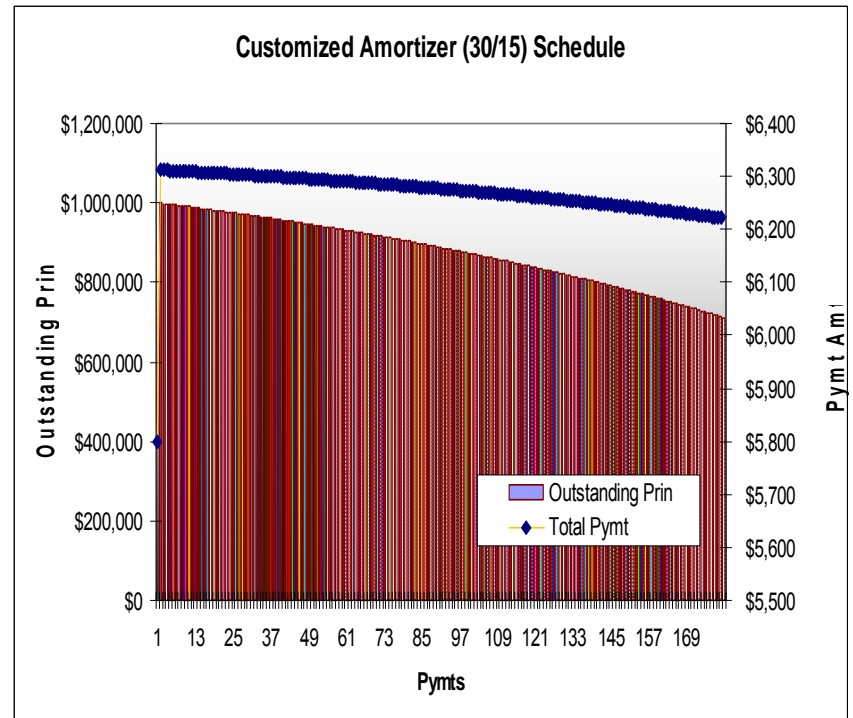
## Straight Line:

- Equal Principal Payments
- Higher Total Payment
- Fully Amortized at Maturity



## Customized Amortizer:

- Customized Payment Schedule
- Lower Total Payment
- Balloon Payment at Maturity



## Seattle Bank Amortizing Options

- The Seattle Bank can customize flexible payment terms for amortizing advances, including:
  - Interest-only periods.
  - Balloon payments (30/5, 30/7, etc.)
  - CIP/EDF pricing can be applied to customized structures.
- Straight-line structures and CIP/EDF pricing are an efficient means to match fund loans.

Maturity	Rate	CIP/EDF
3 year	4.30	4.00
4 year	4.68	4.38
5 year	4.96	4.66
7 year	5.39	5.09
10 year	5.77	5.47
15 year	6.05	5.75
20 year	6.20	5.90
30 year	6.34	6.04

As of 10/16/08

# The New: Enhanced Letter of Credit Capabilities

## Standby Letters of Credit: Current Offerings

- The Seattle Bank may issue a Standby LOC or confirm a member's Standby LOC in favor of a third-party beneficiary.
- Payment is made by the Seattle Bank to the beneficiary upon presentation of specific documentation.
- Seattle Bank Standby LOCs are:
  - Top-tier rated
  - Irrevocable
- Seattle Bank Standby LOCs are not a commercial letter of credit.

## The New: Enhanced Letters of Credit Capabilities Current **Seattle Bank Standby LOC Uses**

	Residential Housing	Community Lending	Asset/Liability Management	Liquidity and Other Funding
Examples	Completion or performance, credit enhance tax-exempt housing bonds	Completion or performance, credit enhance taxable bonds	Improve Interest rate swap counter party profile	Public deposits, lack investment securities for guarantee
Terms	Up to 20 years	Up to 10 years Up to 20 years for housing	Up to 10 years Up to 20 years for interest rate swaps	Up to 10 years

## The New: Enhanced Standby LOC Capabilities

### *Additional Seattle Bank Standby LOC Uses:*

The Housing and Economic Recovery Act of 2008 (HERA)

	<b>Residential Housing</b>	<b>Community Lending</b>
Examples	SBLOC for confirming tax-exempt housing bonds  *Reduced if CIP/EDF-eligible	SBLOC for confirming tax-exempt community development bonds  *Reduced if CIP/EDF-eligible
Terms	Up to 20 years For eligible housing purposes	Up to 10 years Up to 20 years for housing

## Standby LOCs as Credit Support for Tax-Exempt Bonds: Applications

- Eligible purposes for community development and residential housing could include: hospitals, schools, housing developments, and other community developments projects.
- Typical application:
  - Development businesses and other customers of Seattle Bank members team-up with non-profit agencies to issue tax-exempt bonds.
  - Standby LOC requested to guarantee P&I on the bonds in order to provide a required bond rating (“Aaa/AA+”) (Positive/Stable).

## Standby LOCs as Credit Support for Tax-Exempt Bonds: Mechanics

- Procedurally, a Standby LOC would be issued by a member in favor of the bondholders – likely unrated.
- In order to accord the LOC a rating, a confirming letter of credit would be issued in favor of the bondholders.
- The confirming LOC would be drawn in the event the primary issuer of the LOC (i.e., the Seattle Bank member) was not able to satisfy a draw request precipitated by issuer default.
- Notional amount of the LOC would require usage of a member's eligible collateral, which may or may not already be pledged to the Seattle Bank. No stock requirement is entailed with LOC issuance.

## Standby LOCs as Credit Support for Tax-Exempt Bonds: Terms

- Fees scaled by maturity.
- Payable annually, in advance, on anniversary dates of issuance.
- Depending on degree of additional research, unique documentation or use of outside counsel, the Seattle Bank would retain the right to assess additional fees.
- No refunds of LOCs made for any payments made in advance of an LOC's anniversary date.
- LOC amount may be adjusted at each annual anniversary date.

## Questions?

Seattle Bank Funding Desk:

800.340.3452

206.340.8691

John Biestman

206.340.2473

[johnbi@fhlbsea.com](mailto:johnbi@fhlbsea.com)

Jonathan Hartley

206.340.2474

[jonathanh@fhlbsea.com](mailto:jonathanh@fhlbsea.com)

Brett Manning

206.340.2472

[bmanni@fhlbsea.com](mailto:bmanni@fhlbsea.com)

## Upcoming Events

### ***“The Year the Earth Shook: An Overview of the Credit and Liquidity Crisis”***

- October 30: Spokane, WA
- November 6: Seattle, WA
- November 20: Salt Lake City, UT

**Federal Home Loan**  
 **Bank Seattle**