

Understanding the Returnable Advance

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Web Seminar
August 22, 2006

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Agenda

1. Implications of a Prospective Decline in Interest Rates
2. The Returnable Advance: How it Works
3. Applications: “Fighting Fire with Fire”
4. Current Offerings

The Returnable Advance Complements the Seattle Bank's New Structured Advance Line

Product	Description	Application	Advantages
NEW PRODUCT: Capped Floater Advance	Adjustable rate capped at a pre-determined strike price Adjustable rate capped at a pre-determined strike price	Interest-rate risk management; matched funding for capped floating-rate loans & loans held in portfolio	Address potential dual-rate sensitivity; benefit from lower borrowing costs if interest rates decline
NEW PRODUCT: FFC Advance	Floating-rate advance that flips to fixed-rate unless the Seattle Bank cancels	Macro balance sheet management	Sub-LIBOR pricing in exchange for selling the right to convert to a fixed rate on a specified date
NEW PRODUCT: Returnable Advance	Subject to termination by the borrower on pre-determined dates	Funding specific assets not subject to prepayment penalty; loan and investment portfolio management; liquidity and balance sheet management	Addresses loan prepayment problem in situations without prepayment provisions; protects mortgage and MBS portfolio from accelerating prepayments

The Returnable Advance – How It Works:

- A fixed-rate, bullet advance with an option that gives the borrower the right to return the advance to the Seattle Bank:
 - *In a Declining Rate Scenario* – The return right enables the borrower to terminate an advance at a prescribed exercise date(s).
 - *In an Increasing Rate Scenario* – On an exercise date, the borrower would also have the option to allow the advance to continue at the pre-set rate.
- Cost of termination right is reflected in a coupon rate that is slightly higher than that of a standard fixed-rate advance.

The Returnable Advance – How It Works:

- Representative Indicative Terms:
 - Maturity: 4-years
 - Lock-out period: 2-years

- Option Structure:
 - Callable at the option of the borrower on a European, or one-time basis, at the end of the second year.
 - Price of the option includes: maturity, lock-out, assumed volatility, exercise frequency, yield curve shape, and absolute level of interest rates.

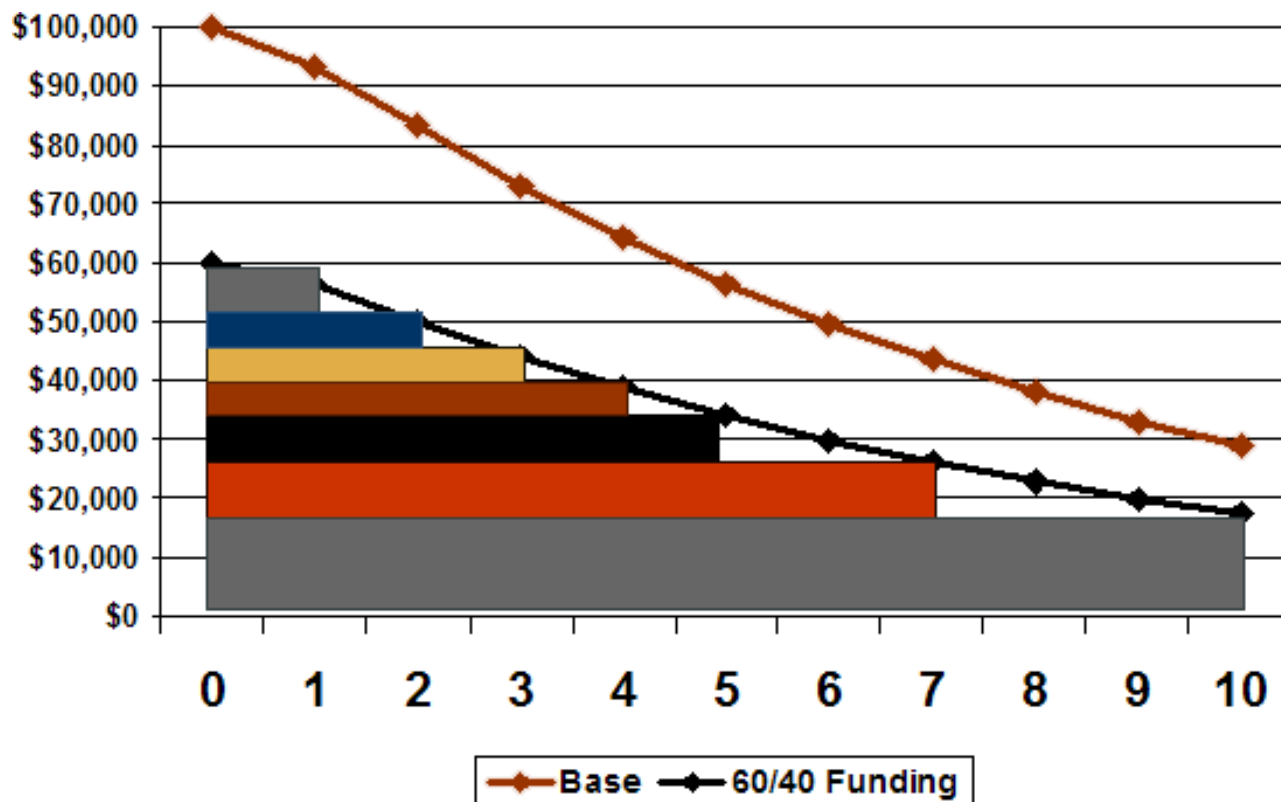
Implications of a Prospective Decline in Interest Rates – Some Questions:

- In the event of a rate decline, would your institution be damaged by:
 - Your “A” credits demanding no prepayment provisions?
 - A rapid increase in prepayments within your fixed-rate mortgage portfolio?
 - Resulting residual funding at older, higher rates that are matched against lower-yielding assets?

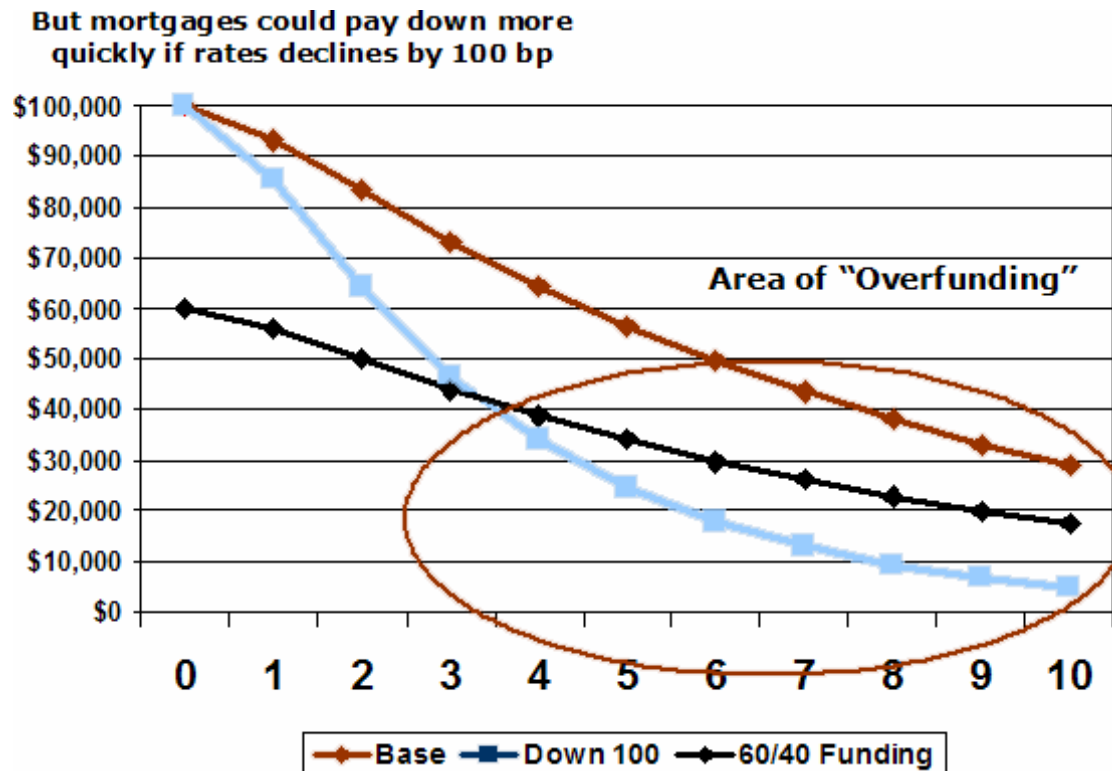
Implications of a Prospective Decline in Interest Rates – Some Observations:

- **It's a mistake to match fund mortgages and other pre-payable assets strictly on the basis of duration.**
 - Duration-based funding ignores the risk of negative convexity because of the temptation to extend liabilities in order to match assumed asset durations.
 - During the 2001 – 2003 rate decline, institutions that duration-funded pre-payable assets found themselves in an over-funded situation and suffered reduced margins once rates started to increase.
- ***Wouldn't it be great if...*** you could protect yourself against prepayment risk by having the option to terminate unneeded funding and replace that funding at a cheaper level should rates decline?

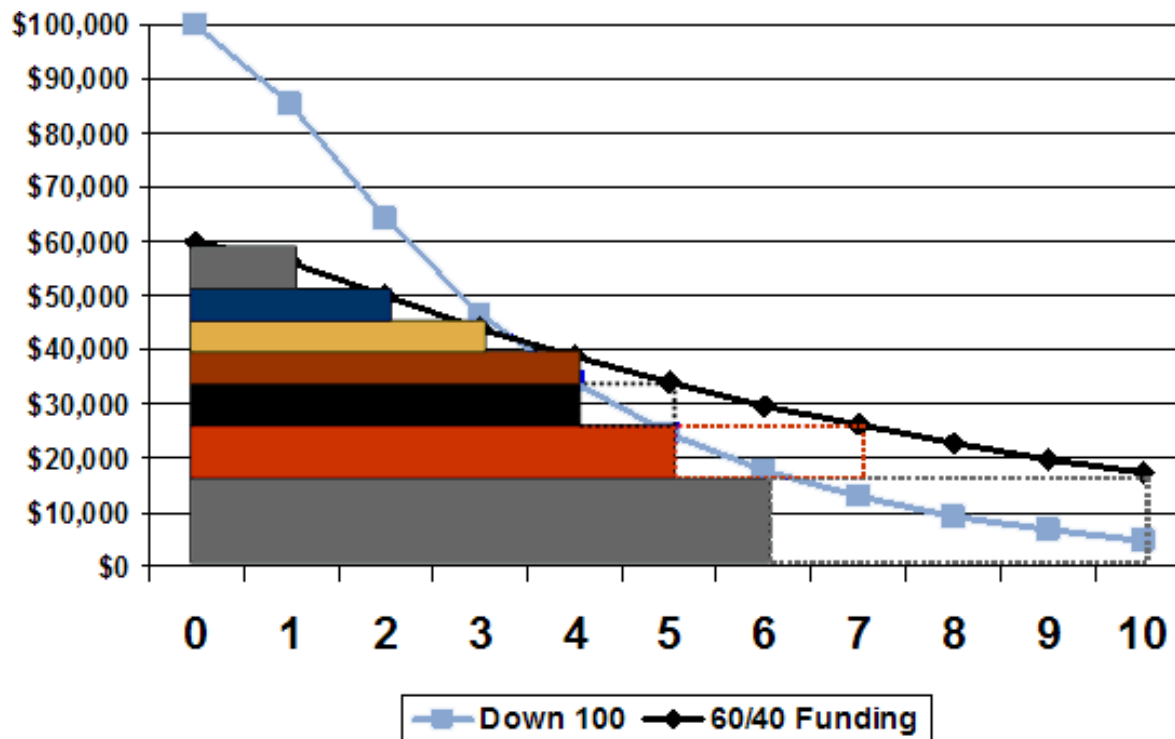
Assume a pre-payable asset that is 60%-funded with layers of wholesale advances.



Assume a pre-payable asset that is 60%-funded with layers of wholesale advances....and rates decline by 100 bps.



Assume a pre-payable asset that is 60%-funded with layers of wholesale advances... and rates decline by 100 bps... **and the advance structure supported returnable features in the 5, 7, and 10-year sectors.**



Source: Roy Hingston, "Fighting Fire with Fire." *What Counts*. Federal Home Loan Bank of Seattle. July 2006

Current Returnable Advance Offering – European Structure / Final Maturity Date: 09/01/2010

Structure:	4-year/non-call 2 years (European)
Indicative Spread:	4-year Treasury + 89 bps (4-year Treasury 4.75% as of 8/21/06)
Indicative Interest Rate:	5.64%
Order Deadline and Minimum:	10:00 a.m. Pacific Time 8/24/06, \$2 million per transaction, \$5 million per collective order subscriptions
Settlement:	8/24/06
Call Option Exercise:	Member may exercise option to terminate the advance, on a one-time basis, with no pre-payment fee, at the end of the lockout (9/01/08)
Maturity Date:	9/1/10
Interest Payment Dates:	Monthly, beginning 9/1/06, and at maturity
Day Count:	Actual/360
Repayment:	Bullet at maturity or upon exercise of the termination option
Prepayment Fee:	Subject to “Structured Advance Prepayment” calculation if prepaid in advance of the lockout date

Current Returnable Advance Offering – European Structure / Final Maturity Date: 09/10/2010

Structure:	4-year/non-call 2 year (European)
Indicative Spread:	4-year Treasury + 89 bps (4-year Treasury 4.75% as of 8/21/06)
Indicative Interest Rate:	5.64%

Returnable Advance Sensitivity Analysis as of 8/21/06:

Structure	Maturity	First Call (1X)	Coupon	-300	-200	-100	0	100	200	300
4-yr/non-put 2-yr (European)	9/1/10	9/1/08	5.75%	106.40	104.40	102.36	100	97.21	94.16	91.06

Current Returnable Advance Offering – Bermudan Structure / Final Maturity Date: 09/01/2011

Structure:	5-year/non-call 3 years (Bermudan)
Indicative Spread:	5-year Treasury + 84 bps (5-year Treasury 4.77% as of 8/21/06)
Indicative Interest Rate:	5.61%
Order Deadline and Minimum:	10:00 a.m. Pacific Time 8/24/06, \$2 million per transaction, \$5 million per collective order subscriptions
Settlement:	8/24/06
Call Option Exercise:	Member may exercise option to terminate the advance, on a quarterly basis, with no pre-payment fee, at the end of the lockout (9/01/09)
Maturity Date:	9/1/11
Interest Payment Dates:	Monthly, beginning 9/1/06, and at maturity
Day Count:	Actual/360
Repayment:	Bullet at maturity or upon exercise of the termination option
Prepayment Fee:	Subject to “Structured Advance Prepayment” calculation if prepaid in advance of the call dates

Current Returnable Advance Offering – Bermudan Structure / Final Maturity Date: 09/10/2011

Structure:	5-year/non-call 3 year (Bermudan)
Indicative Spread:	5-year Treasury + 84 bps (5-year Treasury 4.77% as of 8/21/06)
Indicative Interest Rate:	5.61%

Returnable Advance Sensitivity Analysis as of 8/21/06:

Structure	Maturity	First Call	Coupon	-300	-200	-100	0	100	200	300
4-yr/non-put 2-yr (European)	9/1/11	9/1/09	5.75%	109.52	106.50	103.38	100	96.40	92.71	89.06

We will entertain *Customized Reverse Inquiries.*

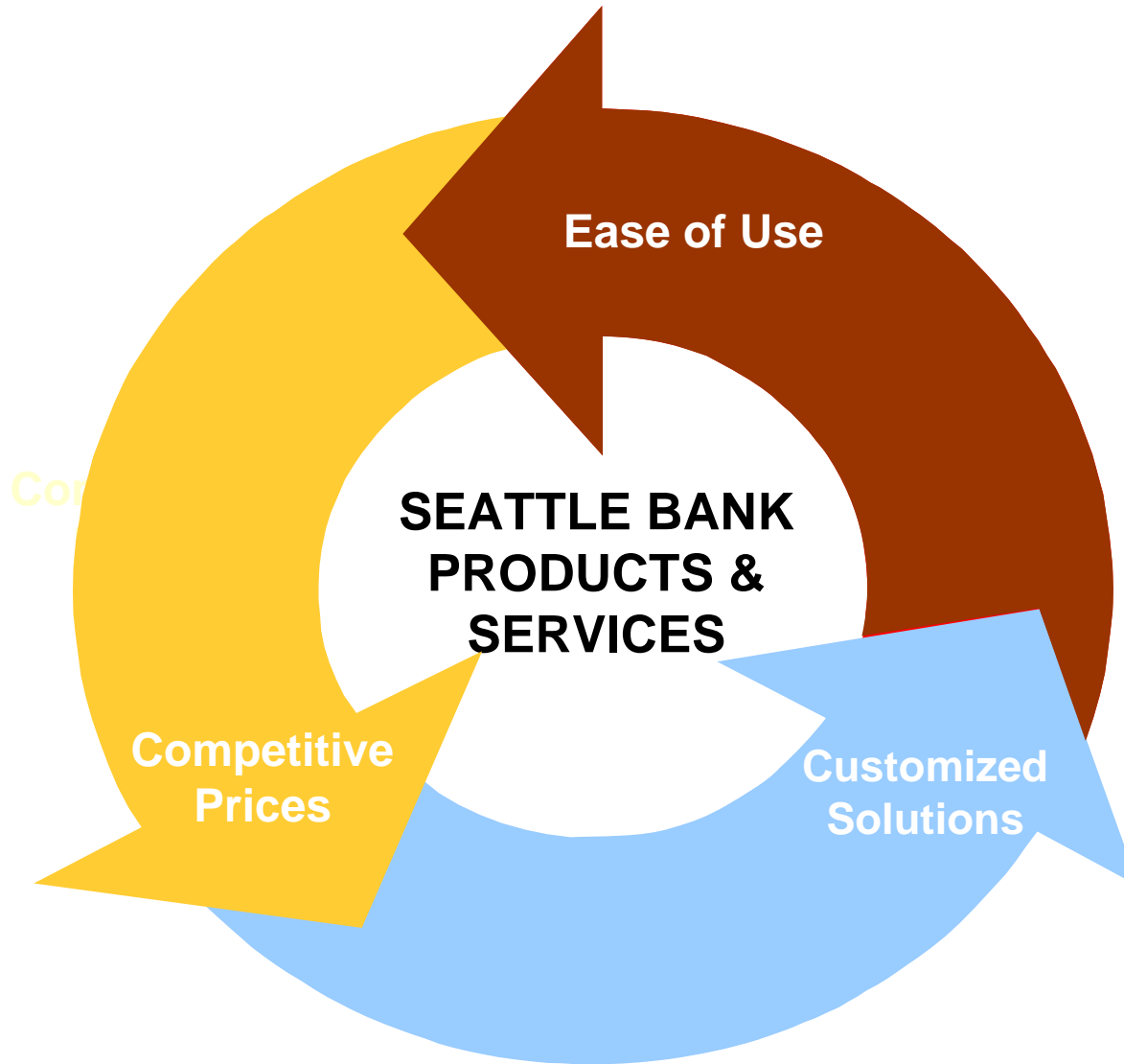
Indicative Returnable Advance Rates (8/21/06)

Bermudan Structure		European Structure	
5NC 1YR:	6.030	5NC 1YR:	5.907
5NC 2YR:	5.790	5NC 2YR:	5.760
7NC 1YR:	6.197	7NC 1YR:	6.001
7NC 2YR :	5.986	7NC 2YR:	5.909
10NC 1YR:	6.409	10NC 1YR:	6.109
10NC 2YR:	6.245	10NC 2YR :	6.069

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Why Consider the Returnable Advance?

- Historically, in a flat yield curve environment, *the cost of returnable advances is low.*
- *Returnable advances offer pre-payment provisions;* mortgages and certain commercial loans may not come with adequate pre-payment provisions.
- Insurance is often far more expensive when the claim needs to be filed! *Where will you be when rates drop?*



Federal Home Loan
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