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**ONCE-ENTICING FUNDING NOW HAUNTS SOME**  
by Alissa Schmelkin

Throngs of banks that earned a high spread on convertible advances they borrowed from the Federal Home Loan banks and the repo market in the late 1990s thought they had found a clever route to cheaper funding.

The deals worked like this: Banks would get the advances from the FHLBs or the repurchase market at rates lower than prevailing rates and lock them in for as long as 10 years. The lender could call in the advances after a certain period, so if interest rates rose the advances could be re-lent at higher rates.

Many used the advances to buy mortgage-backed securities or callable bonds. Borrowers, often at the suggestion of advisers, sold options on both sides of the transaction, which created an artificially high spread.

The trouble is that interest rates fell instead of rising. The lenders did not call in the advances, refinancing depressed the market for mortgage-backed securities, and the bonds were called. Banks that thought they were being smart got caught with some pretty expensive funding.

Though observers will not name banks that are eating losses from advances, it is clearly a broad group. Of the Federal Home Loan banks' \$470 billion in advances outstanding as of June 30, 31.7% is in convertible advances, also called putable advances, much of which was borrowed in the late 1990s, before rates started to fall.

All 12 Federal Home Loan banks have convertible advances outstanding, and the Atlanta, Des Moines, and Pittsburgh banks top the list.

The arrangements made sense for banks at the time. Given how high rates were and how flat the yield curve was, taking the call risk was one of the few ways to get lower-cost funds, according to Raymond E. Chandonnet, a senior vice president and co-head of the bank specialist group at Lehman Brothers.

The banks in this situation range from community organizations to large outfits, Mr. Chandonnet said. "It is the most common financial management problem we work on."

Mac Sutherland, Mr. Chandonnet's partner, added: "For the most part, that's what keeps bank executives up at night."

Bruce S. Goldstein, a partner in the Short Hills, N.J., office of Milestone Advisors LLC, a Washington-based firm that consults with banks on their liabilities, said that having high-

cost, callable funding on the balance sheet is not a huge problem, "but it's clearly a nuisance to many banks who can't find a way to remove it."

For example, Mr. Goldstein said, in some evaluations of a client's merger or acquisition prospects, a key consideration is the negative valuation on a callable home loan advance. It would not stop a deal from going through, he said, but it would probably reduce the price.

Rates have been falling since January 2001, but for a while borrowers held out hope that they might reverse course. Some banks were "more willing to sit on the sidelines" and wait it out, said Mr. Chandonnet, a former strategist with the Boston Federal Home Loan Bank.

The rate cut last December was the final piece of bad news, he said. Borrowers began reaching the point where they were concerned about margins -- especially with the possibility that rates might drop further -- and looking for ways to get out.

But Mr. Goldstein said the negative mark-to-market and the way the Federal Home Loan banks structured the product make this "a very difficult transaction to unwind."

The Atlanta bank, which started offering the advances in 1997, gets inquiries from borrowers about paying them off "from time to time," said Wes McMullan, its senior vice president of sales and member trading.

A borrower's cost to unwind varies according to factors such as the length of time until maturity and how many options are on the advance, Mr. McMullan said. The solutions vary as well, depending on which bank made the advance, because each has its own policy.

Borrowers can ask their lenders to restructure the advance in a way that lowers the rate without incurring a loss, Mr. Chandonnet said. Other strategies include using a swap to convert the funding to the floating rate, he said.

Some banks, especially those with portfolio gains to offset losses from the advances, have chosen to simply unwind and take the hit, he said. But he added that some are compounding their difficulties by buying more speculative investments to get a higher yield than the rate on the original funding -- a tactic that can add dangerous levels of risk to a portfolio.

Home Loan banks still offer the product, and some even found that demand rose slightly in the first half. But it is doubtful there will be a rush of new borrowers.

"A lot of banks learned their lesson," Mr. Goldstein said. "Especially with current rates so low, my expectations are that this won't be a problem going forward, because banks will be more reluctant to take out this type of funding."