

## Fixed-Rate FHLB Dallas Owns the Option (FOTO) Advance

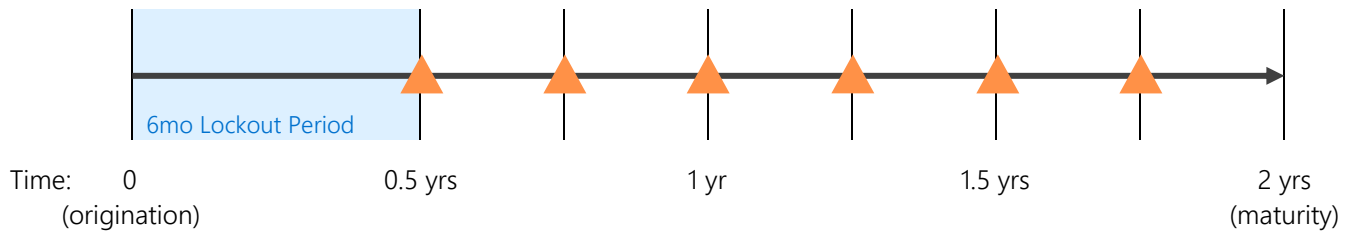
### What is a fixed-rate FHLB Dallas Owns the Option (FOTO) advance?

A fixed-rate FHLB Dallas Owns the Option (FOTO) advance is a fixed-rate, non-amortizing puttable advance that allows member institutions to take advantage of low-cost funding in a stable interest rate environment. The member institution sells FHLB Dallas (FHLB) options, at FHLB's sole discretion, to choose from specified option exercise dates, the date when the advance will terminate (and, if desired by the member, be replaced with another advance at then-prevailing market rates). In return for granting to FHLB the flexibility of choosing the termination date, the rate for a FOTO advance is typically lower than a like-maturity, fixed-rate, fixed-term (FRFT) advance.

### What are the general terms of the options?

The member sells FHLB options to terminate the fixed-rate FOTO advance at specified points in time (known as option exercise dates) prior to the stated maturity date. Typically, option exercise dates follow a specified lockout period at the beginning of the term when FHLB cannot terminate the advance. Thereafter, FHLB may terminate the advance on quarterly option exercise dates until maturity, as seen in a Bermudan structure.

Below is an example of a fixed-rate FOTO advance structure with a two-year term and a six-month lockout period ("2yr/6mo"):



**Lockout period:** FHLB cannot terminate (or put) the FOTO advance

**Option exercise dates:** Predetermined; FHLB has the option to terminate (or put) the FOTO advance

If FHLB exercises its option to terminate the advance at one of the specified option exercise dates, there is no termination/prepayment fee, and replacement funding will be available to the member at then-prevailing market rates, subject to FHLB's credit and collateral requirements.

### Why use a fixed-rate FOTO advance?

Fixed-rate FOTO advances are a low-cost, fixed-rate source of funding with maturities ranging from two years to 15 years. FOTO advances enable members to borrow at rates that are lower than what would typically be available to them, which may help members lower their cost of funds. This source of funding provides the greatest benefit to members when market rates are, and are expected to remain, relatively stable.

## Why is there a pricing advantage associated with fixed-rate FOTO advances?

The member pays a lower interest rate on the fixed-rate FOTO advance as a trade-off for giving FHLB the flexibility to choose a termination date earlier than the maturity date. The flexibility that the member gives to FHLB is very similar in principle to the flexibility that a mortgage lender gives a fixed-rate mortgage borrower to terminate the mortgage at the borrower's choosing. Another analogy for the advantage of the interest rate reduction is an insurance premium. For example, an automobile insurance firm collects a premium as compensation for taking on the risk of potentially having to pay the auto insurance policyholder's claim. Similarly, the member "collects a premium" (in the form of an interest rate reduction) for taking on the termination date uncertainty associated with a FOTO advance.

The size of the rate reduction associated with a fixed-rate FOTO advance increases with a longer maturity period, a shorter lockout period, a higher frequency of option exercise opportunities and a higher implied volatility in the rate markets. These factors may result in a member taking on more risk; therefore, the compensation to the member (via a lower interest rate) is higher.

## Does the member pay a fee to prepay a fixed-rate FOTO advance?

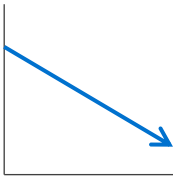
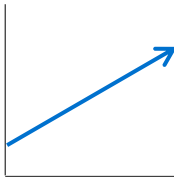
If a member requests prepayment of a fixed-rate FOTO advance prior to maturity, FHLB would charge the member a prepayment fee. If rates have increased since the origination of a fixed-rate FOTO advance, the member would typically pay a lower prepayment fee, or if rates have decreased since origination, the Member would typically pay a higher prepayment fee.

The size of the prepayment fee may be influenced by the maturity period, lockout period, frequency of option exercise opportunities and implied volatility in the rate markets. These factors influence the level of risk the member is taking on and the value of the flexibility given to FHLB to terminate the advance prior to maturity, and therefore, these factors also influence the cost to unwind an advance if a member prepays.

If FHLB exercises its option to terminate the advance, the member institution returns funds borrowed with no prepayment or termination fee.

## What should members consider before using a fixed-rate FOTO advance?

Changes in market rates or implied market volatility may provide both advantages and disadvantages for member institutions.

		 <p><b>If rates fall...</b></p>	 <p><b>If rates rise...</b></p>
<b>Advantage</b>	<b>Benefits</b>	Funding usually does not have to be replaced, as the fixed-rate FOTO advance duration typically extends to the stated maturity	Members potentially enjoy comparatively cheaper funding in a higher interest rate environment <u>until</u> FHLB exercises its option to terminate the advance on an option exercise date
<b>Disadvantage</b>	<b>Duration of FOTO Advance</b>	Extends, potentially to stated maturity	Shortens, as FHLB may choose to terminate the advance
	<b>Cost for Member to Prepay FOTO Advance</b>	Generally increases, since the discount rate declines and the fixed-rate FOTO advance duration extends. The market value of the FOTO advance increases in favor of FHLB (and not in favor of the member)	Generally declines, since the discount rate increases and the fixed-rate FOTO advance duration shortens
	<b>Member Funding Cost</b>	An existing fixed-rate FOTO advance may be more expensive than then-prevailing market rates for new funding	Potentially higher: The fixed-rate FOTO advance will likely not last until the maturity date, as it will likely be terminated by FHLB at the next option exercise date. If the FOTO advance is terminated, replacement funding at then-prevailing market rates will likely be more expensive for the member than the terminated FOTO advance

## Available Structures

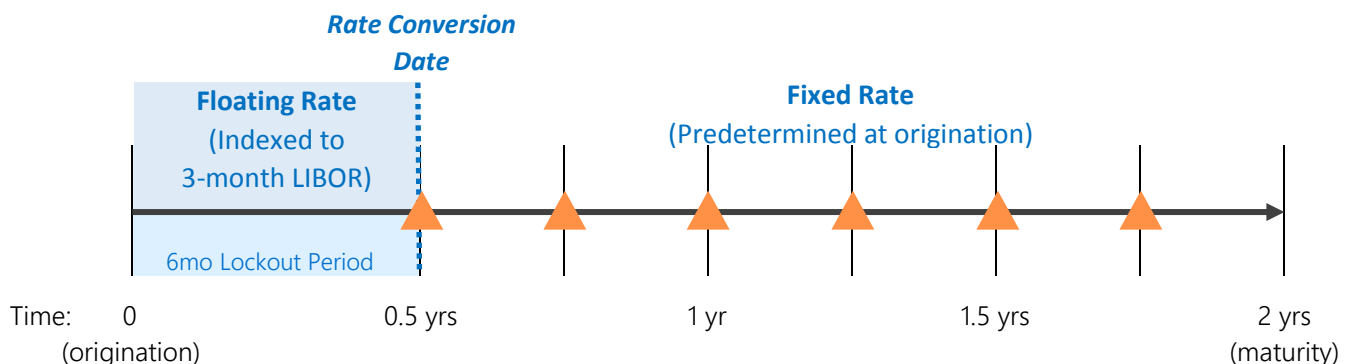
Fixed-rate FOTO advances may have final maturities ranging from two years to 15 years, with various lockout periods. After the lockout period, FHLB's option to put the advance (i.e. terminate the advance and require prepayment in full) may be exercised on any quarterly option exercise date prior to stated maturity. This advance is subject to FHLB's standard credit and collateral policies. Please contact Member Services at 844.FHL.BANK (844.345.2265) for additional information.

Minimum Transaction	\$5 million; may not exceed 33 percent of a member's total advances outstanding immediately following execution.
Interest Rate	Actual/360
Principal and Interest Payments	<ul style="list-style-type: none"> <li>• Interest is due monthly and is debited monthly on the first business day of the month for the amount accrued through the last day of the previous month</li> <li>• Principal and remaining accrued interest is due at maturity</li> <li>• New York Banking Days are used</li> </ul>
Availability of Funds	<ul style="list-style-type: none"> <li>• FOTO advance availability is subject to the FHLB's discretion and in no event shall exceed the members' unused borrowing capacity</li> <li>• Requests for FOTO advances should be transacted by 3:30 p.m. CT for best execution</li> </ul>
FOTO Advance Agreement	<ul style="list-style-type: none"> <li>• The agreement must be executed and on file prior to execution of a trade</li> <li>• FOTO Advance Request for Quote with certification of the completion of mandatory education is also due prior to execution</li> </ul>
Pricing	Available upon request

## Additional Features

Upon request, the [flipper feature](#) can be added to a FOTO advance. A FOTO advance with the flipper feature has a floating rate for the duration of the lockout period. This floating rate will automatically convert to a fixed rate (agreed upon at issuance) at the end of the lockout period on the rate conversion date. This fixed rate will then apply for the remaining duration of the advance.

Below is an example of a FOTO flipper advance structure with a two-year term and a six-month lockout period ("2yr/6mo"):



- **Lockout period:** FHLB cannot terminate (or put) the FOTO advance
- ▲ **Option exercise dates:** Predetermined; FHLB has the option to terminate (or put) the FOTO advance

## Accounting Considerations

For U.S. GAAP purposes, FHLB views the fixed-rate FOTO advance as a financial instrument that contains embedded derivatives (options) that are considered clearly and closely related to the host contract (the advance) and therefore does not require bifurcation.

However, for US GAAP purposes, FHLB views the combination put, floor and flip feature of the flipper feature as an embedded interest rate derivative which must be assessed under the “clearly and closely related” criterion under ASC 815-15-25-26 (the “double/double test”). As an alternative, ASC 815-15-25-4 allows the election of the fair value option at issuance with all fair value changes recorded in earnings for financial instruments that would otherwise require bifurcation of an embedded derivative.

FHLB does not provide accounting advice. If you are uncertain as to potential implications, please seek your counsel and/or accountant’s advice prior to entering into a FOTO advance.

## What are the risks associated with fixed-rate FOTO advances?

The put options embedded in a FOTO advance may adversely impact the borrower in a variety of ways under different market conditions. The adverse impact to the borrower resulting from the put options embedded in a fixed-rate FOTO advance will generally take the form of the borrower having a higher cost of funds than if the borrower had not chosen to include such put options in the advance. The potential negative consequences to the borrower’s cost of funds include, but are not limited to, the following: 1) if interest rates rise, FHLB may choose to exercise its right to terminate the FOTO advance before its maturity date and replacement funding will likely be at a higher rate, and 2) if interest rates decline, a FOTO advance with a fixed coupon may remain outstanding at above market rates. Other factors, including the volatility of interest rates and changes in the shape of the yield curve, may also affect FHLB’s decision to exercise its option to terminate the FOTO advance.

When selling options, it is important for members to understand the risks involved and evaluate them as part of their institution’s balance sheet and financial strategy. FOTO advances have a complex risk profile and may be an unsuitable funding vehicle for some institutions. This document does not purport to disclose all of the risks and other material considerations associated with a FOTO advance. FHLB Dallas does not act as a financial advisor. Member institutions should evaluate the risks and suitability of a FOTO advance, including consulting your own experts and professionals, as needed. FOTO advances are subject to prepayment fees from the time of origination until maturity of the advance. Please refer to the [Member Products and Credit Policy](#) for further information.

## Contacts

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