FIXED INCOME INSIGHTS

AGENCY BONDS

Agency securities are debt obligations issued or guaranteed by two types of government-related entities:

1) U.S. Government Sponsored Enterprises (GSEs)
2) Financial corporations wholly-owned by the U.S. Government

Agencies are generally used to finance activities considered beneficial to the public good, such as housing creation, agricultural production, and higher education funding.

GSEs do not have explicit backing by the government, but have long been viewed as having "de facto" backing. The market generally recognizes an existing implicit guarantee of support and that the government would not allow such institutions to default. This proved to be the case during the 2008 financial crisis when the federal government stepped in to take control of Fannie Mae and Freddie Mac, and guaranteed their obligations.

REASONS TO CONSIDER

- ✓ High Credit Quality
- ✓ Variety of Structures
- ✓ Tax Status
- ✓ Generally Higher Yields than Treasuries

Main Types of Agency Bonds

Agency bonds are issued in a variety of structures, coupon rates, and maturities. The following table lists the most common government agencies which have a significant presence in the bond marketplace; it also briefly describes the business function each agency performs.

Agency	Common Name	Purpose	Tax Status
Federal Agricultural Mortgage Corporation	Farmer Mac	Provide mortgage and loan assistance to farming areas	Fully taxable
Federal Farm Credit Banks	Farm Credit	Provide mortgage and loan assistance to farming areas	State and local exempt
Federal Home Loan Banks	FHL Banks	Facilitate capital flow to mortgage market	State and local exempt
Federal Home Loan Mortgage Corporation	Freddie Mac	Facilitate capital flow to mortgage market	Fully taxable
Federal National Mortgage Association	Fannie Mae	Facilitate capital flow to mortgage market	Fully taxable
Tennessee Valley Authority	TVA	Provide economic assistance to the Tennessee valley region	State and local exempt

The most prominent GSEs are the **Federal National Mortgage Association** (**Fannie Mae**), **Federal Home Loan Mortgage Corp** (**Freddie Mac**) and the twelve **Federal Home Loan Banks**.

Federal National Mortgage Association (Fannie Mae)

Fannie Mae was established in 1938 by the National Housing Act. Fannie Mae is a GSE chartered by Congress to keep money flowing to mortgage lenders, in an effort to help strengthen the U.S. housing and mortgage markets, as well as to support affordable homeownership.

Fannie Mae's main business is to purchase pools of mortgages made by private lenders and use the cash flows to issue Mortgage-Backed Securities (MBSs). Fannie Mae raises funds to support its business by issuing direct unsecured debt. A large portion of Fannie Mae's funding needs are met through its short-term debt programs known as the Discount Notes and Benchmark Bills programs. These debt instruments offer investors highly liquid, high credit quality investments with maturities of 360 days or less.

During the financial crisis, Fannie Mae and its companion GSE, Freddie Mac, experienced severe financial strain and was eventually placed under conservatorship of the Federal Housing Finance Agency by Congress on September 7, 2008. While it remains under conservatorship, its legal status is currently closer to a government-owned entity rather than a GSE.

Federal Home Loan Mortgage Corporation (Freddie Mac)

Freddie Mac was chartered by Congress in 1970, to serve alongside Fannie Mae, in an effort to provide competition to its sister organization. Like Fannie Mae, it is a GSE and issues both direct unsecured debt to investors and also packages MBS products.

As previously noted, Freddie Mac, along with Fannie Mae, was placed under conservatorship of the Federal Housing Finance Agency on September 7, 2008.

Federal Home Loan Banks (FHL Banks)

FHL Banks have been the largest source of mortgage lending funding for nearly eight decades since established by the Federal Home Loan Bank Board (FHLBB) at the request of Congress in 1932.

The FHL Bank system consists of twelve regional cooperative banks that lending institutions use to finance housing and economic development in local communities. The banks are owned by over 7,600 regulated financial institutions from all 50 states, U.S. possessions, and territories. These institutions include community banks, thrifts, commercial banks, credit unions, community development financial institutions, and insurance companies.

Funds are raised for member-lending mortgage programs and other balance sheet needs through the sale of a wide variety of debt securities (called consolidated obligations) in the global capital markets. FHL Banks are jointly and severally liable for the payment of consolidated obligations.

FHL Banks issue debt in the form of short-term discount notes and longer-term bonds.

Features and Benefits

Agency bonds offer a combination of advantages which can make them very attractive investments.

Safety: Agency debt is either explicitly backed by the government, or, in the case of GSE debt, has long been viewed as appreciating an implicit guarantee.

Higher Yields: Agency bonds can trade at a yield premium above comparable Treasury bonds.

Liquidity: The market for agency debt is large and liquid. It is second only to the U.S. Treasury market in terms of overall size of outstanding issues and trading volume. Note the size of the market and individual features of each security will affect liquidity. For example, some agency bond issues have features that make the bond issues more "structured" and complex, which can reduce liquidity of these investments and make them unsuitable for certain investors.

Tax Treatment: The interest from most, but not all, agency bond issues is exempt from state and local taxes. Some of the biggest issuers, such as Freddie Mac and Fannie Mae, are fully taxable. It is important to consult with a qualified tax professional as individual circumstances may vary.

Wide Variety of Characteristics: While most agency bonds pay a fixed rate of interest or fixed coupon rate semiannually, agencies offer a wide range of investment options, coupon rates, and maturities in both the primary and secondary markets.

- ***Non-Callable:*** Most agency bonds are non-callable or bullet bonds.

- ***Callable:*** Callable agency bonds that have a preset coupon rate, or "step-up" feature, provide for increases in interest rates or coupon rates as the bonds approach maturity to minimize the interest rate risk for investors over time. Step-ups are often called by issuers at a time of declining interest rates. Declining interest rates may accelerate the redemption of a callable bond, causing the investor's principal to be returned sooner than expected. As a consequence, an investor might have to reinvest principal at a lower rate of interest.

- ***Variable Rate:*** Also known as "floating rate" or "floaters," variable rate agencies have interest rates that adjust periodically. Adjustments are usually linked to an index such as U.S. Treasury bond yields or LIBOR and are based on a predetermined formula (with limits on how much the interest or coupon rate can change).

Buying and Selling Agency Bonds

Buying a bond from a government agency is like making a loan to Fannie Mae or Freddie Mac. When you invest in any bond, the issuer pays you a set interest rate and agrees to pay back the loan on the maturity date. The maturity dates typically range from one to 40 years.

Agency bonds are bought and sold through a broker. Issue price and secondary trade data is available through a broker and data vendors.

Potential Risks

Market Risk/Interest Rate Risk: As with any tradable investment product, agency securities carry the risk that it may be worth more or less at any point in time than what the investor paid, either due to interest rate risk, liquidity risk, credit risk, or some other market-based impact on security value.

Like all bonds, agency bonds are sensitive to changes in interest rates: when interest rates increase, agency bond prices generally fall and vice versa.

Reinvestment Risk: This is the risk type in which any returns from an investment – whether coupons or principal – may need to be reinvested, but a comparable investment sharing similar yield and risk characteristics may not be available.

Credit Risk: The chance an issuer might not be able to pay interest and/or principal on a timely basis. Widely recognized rating agencies such as Moody's, Standard & Poor's, and Fitch Ratings offer their assessment of an issuer's creditworthiness. U.S. Treasury securities are considered the safest investment as they are backed by the full faith and credit of the U.S. Government. The government guarantee – explicit or implicit – of agency debt could be modified or revoked in the future, leaving the bonds more susceptible to default.

Call Risk: Many agency securities, step-ups in particular, carry call provisions that allow the issuer to pay prior to the bond's maturity date, typically when interest rate drop, leaving opportunity to reinvest at lower prevailing rates.

NEXT STEPS

To learn more about agency bonds, contact your financial professional who can answer questions and provide access to current offerings, as well as assist you in structuring a portfolio that meets your individual investment goals and risk tolerance.

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