

Understanding Government Agency Securities

A Closer Look at Callable Agencies

OVERVIEW

The agency debt market consists of highly creditworthy debt obligations issued by various U. S. Government agencies for the purpose of funding public missions. As of the beginning of the millennium, the agency market stood at \$1.4 trillion. The largest issuers of Agency debt support the home mortgage market and include:

- Federal Home Loan Mortgage Corporation (FHLMC or “Freddie Mac”)
- Federal National Mortgage Association (FNMA or “Fannie Mae”)
- Federal Farm Credit Bank (FFCB)
- Federal Home Loan Bank (FHLB)

BENEFITS OF AGENCY BONDS

Government Agency bonds provide investors with a variety of appealing features, such as:

- Safety
- Liquidity
- Enhanced spread over Treasury securities
- State Tax Exempt — Federal Farm Credit Bank (FFCB) and Federal Home Loan Bank (FHLB) issues

CALLABLE AGENCIES

Callable agency securities contain a provision that allows the issuer to repurchase the bond from the investor prior to the stated maturity. In other words, the issuer has the right, but not the obligation to call the bond within a specific period of time at a pre-

determined price. At issuance, the issuer states the amount of time from inception during which the bond cannot be called (the lockout period) and the specific period of time (callable window) or date that the bonds may be called prior to maturity. Investors who purchase a callable agency are compensated with additional yield compared to the same maturity agency bullet (non-callable).

WHAT TYPES OF CALL OPTIONS EXIST?

- *American Call Option (also known as a continuously callable bond)* — a bond with an American call option can be called at any time after the lockout period until the maturity date.
- *European Call Option* — a bond with a European call option is callable only on one pre-determined date after which the bond becomes non-callable.
- *Bermuda Call Option (also known as discretely callable)* — a bond with a Bermuda call option is callable after the lockout period according to a pre-determined schedule (usually on interest payment dates), until maturity.
- *Canary Call Option* — a bond with a Canary call option is callable after the lockout period according to a predetermined call schedule until a specific date after which the bond becomes non-callable.



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HOW ARE CALLS EXERCISED?

Typically agency issues are called in full, but depending on the terms of the issue, may be called in part. As set forth according to the terms of the contract, notice of redemption is communicated to the investor when an issue is called. Call notice is also posted on Bloomberg. In the case of mandatory redemption, notice is generally not required.

Most callable agencies are issued with discrete call dates. Generally, a 5- to 10-business day notification of a call must be given. Redemption of principal is always made on a business day. Interest on the principal amount redeemed is paid up until the final redemption date. The one exception is if the interest payment date occurs on a non-business day, which is also the call date. In this event, interest is paid through the last business day before the redemption date.

WHEN ARE BONDS CALLED?

The decision to call a bond is based on the current level of interest rates and the outlook for interest rates. When rates fall, issuers are likely to call the bond, pay off the debt, and issue a new bond at a lower interest rate. Conversely, when rates rise, the call would likely not take place because the security price would be below the call price.

HOW ARE CALLABLE AGENCY BONDS TAXED?

All government agency securities are subject to federal taxes. Corporations and individuals are taxed differently at the state level. For individuals, all Federal Home Loan Bank and Federal Farm Credit Bank bonds are exempt from state and local taxes. Corporations may be exempt from taxes at the state and local level, subject to blue sky laws (state laws). When the bonds are not taxed at the state level, the effective yield is actually higher than the stated yield. The difference depends on the investor's tax bracket.

Investors should consult their tax advisor with specific tax questions.

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