Agency securities

Wealth Management

Agency securities are debt obligations issued by a U.S. federal agency or a government-sponsored enterprise (GSE). These securities are created to reduce borrowing costs for certain sectors, such as the mortgage market or agricultural sector. As of 2023, the agency bond market stands at over $2 trillion. Agency bonds are attractive to investors because of the safety, liquidity, higher yields relative to U.S. Treasury securities and—for some agencies—their state tax-exempt interest.

The Housing and Economic Recovery Act of 2008 granted the Federal Housing Finance Agency (FHFA) the direct responsibility for regulating and operating Fannie Mae and Freddie Mac. This decision was made because of concerns that increasing mortgage defaults had impaired the ability of the GSEs to both maintain their required capital reserves and continue to support mortgage lending efforts. The move strengthened the ties between the government and the GSEs.

The main agency issuers

The following are the government agencies that most commonly issue securities:

Federal Home Loan Bank (FHLB) — The FHLB system is composed of 12 regional banks and member institutions. The mission of FHLB is to enhance the availability of mortgage credit through its member organizations.

Federal National Mortgage Association (FNMA) — Publicly owned FNMA is dedicated to providing a secondary market for home mortgages through creating securities backed by an underlying pool of mortgages. They also issue direct obligation bonds with interest payments paid from operating revenues.

Federal Home Loan Mortgage Corporation (FHLMC) — Like FNMA, FHLMC is also publicly owned and dedicated to supplying liquidity to the residential mortgage market. FHLMC also issues both direct term debt and mortgage-backed obligations and pays term debt interest from its operating revenues.

Federal Farm Credit Bank system (FFCB) — The purpose of the FFCB is to facilitate credit and related services to the agricultural sector.

Tennessee Valley Authority (TVA) — TVA is the nation's largest electric utility serving a seven-state region in the southeast. The TVA funds its interest payments from its revenues.

Government National Mortgage Association (GNMA) — The purpose of GNMA is to provide liquidity to residential mortgages, specifically mortgages insured by the Federal Housing Administration or guaranteed by the Veteran's Administration, or the Farmers Home Administration. GNMA securities carry the backing of the full faith and credit of the U.S. government.

Advantages

Treasury bonds and agency bonds provide investors with a number of appealing features:

Safety

With the exception of GNMA, government agency bonds are not expressly backed by the full faith and credit of the U.S. government, but they do carry an implied backing due to the continuing ties between the agencies and the U.S. government. Due to the close relationship between the government and its agencies, it's nearly inconceivable that Congress would allow an agency to default on its obligations as such an event would threaten confidence in the government itself. Because of the high degree of confidence in this implied government backing, Moody's assigns agency debt securities a Triple-A rating, the highest credit rating available.

Liquidity

Because of the vast amount of available agency securities, there is a large and active secondary market for these instruments, providing investors with excellent liquidity.

State tax-exempt interest

Interest payments from certain government agencies are exempt from state income taxes. (See the chart at the last page of this fact sheet for a list of the agencies that issue state tax-exempt bonds.) For investors living in states with high income taxes, this increases their attractiveness on an after-tax basis when compared to other taxable bonds.

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 a discrete call) — 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.

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 5–10 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.

Securities issued by U.S. federal agencies and GSEs are a common holding in many investment portfolios. For more information, please see the last page of this fact sheet, or call your RBC Wealth Management financial advisor.

Security	Guarantee	Interest payment schedule	Maturity range	State and local taxes
Mortgage-backed securities				
Government National Mortgage Association (GNMA)	Full faith and credit of U.S. government	Monthly principal and interest	Average life varies for each security	No exemption
Agencies				
Federal Home Loan Mortgage Corporation (FHLMC)	Implied backing of U.S. government	Semi-annual	One to 20 years	No exemption
Federal National Mortgage Association (FNMA)	Implied backing of U.S. government	Semi-annual	One to 20 years	No exemption
Federal Home Loan Bank (FHLB)	Implied backing of U.S. government	Semi-annual	One to 20 years	Exempt
Security	**Guarantee**	**Interest payment schedule**	**Maturity range**	**State and local taxes**
Agencies				
Tennessee Valley Authority (TVA)	Implied backing of U.S. government	Semi-annual; Zeros at maturity	One to 50 years	Exempt
Federal Farm Credit Bank (FFCB)	Implied backing of U.S. government	Semi-annual	Three months to 20 years	Exempt

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