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A Critical and Powerful Management Tool

Easy Steps to Evaluate Marginal Cost of Funds

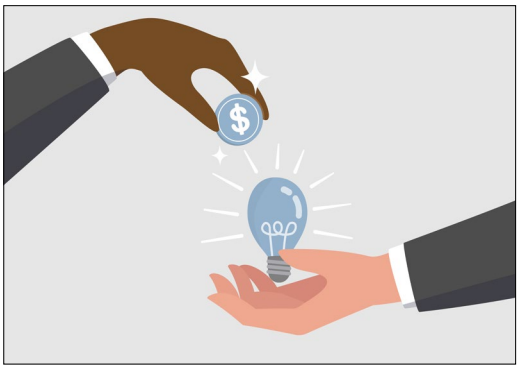
Monetary policy has pivoted out of a rising rate cycle.

A long-lasting inverted yield curve, emergence of non-traditional competitors — such as online banking & fintechs — and a shift in consumer behavior has challenged the traditional operating landscape for community banking, especially the deposit funding environment.

The playing field has changed, and you may wondering where do we go from here? Do we need to rethink our funding strategy?

The deposit remix fueled by heightened consumer rate awareness amid the March 2023 mini-bank crisis put considerable pressure on funding costs and margins as non-maturity accounts migrated into short-term CD funding. Not only were time deposits cast back in the spotlight, but non-maturity deposits became more rate sensitive.

The ability for depositors to move money quickly, improvements in the digitalization of banking services and growth in attractive investment alternatives added additional layers of difficulty to deposit growth and retention strategies. Deposit base stability was called into question and has become a more critical component to liquidity stress assumptions and focus among regulators.



If you're considering new funding strategies in the current climate, cost calculations may show you are better off borrowing stable, wholesale funding like FHLBank advances.

Depositories face waves of upcoming maturities. Some competitors have started lowering rates on accounts while others are playing defense by holding higher rates. With an evolving rate outlook and a "higher for longer" environment still on the table, marginal cost analytics remains relevant.

Continued on the following page

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Higher interest expense on repricing maturing shares/deposits has an adverse effect on the ability to manage spread.

Conducting marginal cost analysis has the ability to show the impact of restructuring the cost components of the deposit portfolio and the related inter-portfolio movement of funds as well as the ability to compare retail funding strategies with wholesale funding strategies or a blend thereof. Consider the following strategy options:

- Reduce rates on all accounts with little to no run-off expected. This strategy may be especially relevant if the institution feels that they may be overpriced today and sees limited risk of rate sensitive accounts leaving the institution.
- Reduce rates on all accounts with run-off and not replace funding, not overly concerned with matching competitor's rates to reposition the balance sheet.
- Lower rates on non-rate sensitive accounts and maintain higher rates on at-risk accounts.
- Drop rates on non-rate sensitive accounts and replace at-risk accounts with FHLBank funding.

As you navigate new territory in funds management, it will be critical to evaluate and use available customer data to your advantage. Your approach and use of customer data can aid in the successful execution of funding plans and optimize funding costs, regardless of the interest rate environment.

Institutions must be diligent in managing the rate structure of both non-maturity accounts and time deposits to better inform funding decisions. For instance —

- Research and segment your deposit base; know your competition.
- Measure the impact of various pricing strategies.
- Enable funding decisions to be based on analytical versus intuitive approaches.

The current CD repricing challenge lies in the assessment of the cost of foregoing a rate cut or potential risk of losing balances if the reprice is too low.

Dig into the details of your customer accounts. Are there single relationship or hot money accounts worth letting go? If so, preserve margin and reduce interest expense by letting these "at risk" accounts roll. And if a funding need remains, replace with stable, companion wholesale funding — such as FHLBank advances.

Cost calculations may show the institution is better off borrowing these funds rather than disrupting the cost structure of your existing deposit base. FHLBank advances are more efficiently priced and are likely to provide more favorable terms to support the bottom line and complement the funding mix.

The dividend benefit provides a return of funds that ultimately lands back in your institution to invest and support your community — something the brokered deposits don't provide.

Continued on the following page

Banks and credit unions face a unique funding environment resulting from new dynamics in the deposit space. The movement and migration of deposits over the past few years did behave "as expected."

However, we have seen a shift in consumer loyalty to their financial institutions with increased rate awareness, along with a generational transition in consumer behavior. Betas exceeded industry expectations and past cycle levels.

When considering the future funding mix, are retail time deposits a dying product? Have you considered how wholesale funding may fit into your overall liability funding plan and strategy going forward to target specific parts of the curve for ALM purposes? Marginal cost (or savings) analysis remains a very critical and powerful management tool to evaluate the impact of deposit growth and retention strategies in an ever-changing funding landscape.

How to Explore and Deploy These Strategies

- Meet with ALCO and your management team to discuss the marginal cost approach. If needed, contact your FHLBank account manger to assist with the discussion.
- Conduct a marginal cost (or savings) analysis prior to initiating a new strategy. You could do this internally or in partnership with FHLBank, utilizing tools created specifically to compare funding alternatives.
- Work with your team to formulate a plan to execute the strategy.
- If needed, contact your FHLBank account manager or the Lending Desk with any funding requests or questions you may have.
- Check in with your team regularly to evaluate the strategy post-deployment and make adjustments as necessary.

Let Us Complete Your Customized Analysis

With FHLBank Topeka's Marginal Cost of Funds and Deposit Portfolio Pricing Strategies tool, you can weigh the potential impact of these choices and build a strategy that's right for your institution. Our Member Solutions team wants to help with this analysis. If you are interested in a discussion on MCOF, please contact your FHLBank account manager or the Lending Desk.

Contact FHLBank Topeka today to discuss your advance solutions

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