Could a Pre-Funding Strategy Help Your Institution as Rates Fall?



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What a wild ride 2025 has been.

Before the year began, there were multiple projected rate cuts by the Fed, but it took until August before rates were finally cut.

During this time, market participants were in a state of paralysis. Despite positive declines in inflation since 2023, growth in 2025 remained strong, and the labor market was seemingly healthy. The Fed's dual mandate was at a crossroads until August when its tone turned dovish and the focus pivoted from inflation concerns to waning job growth.

According to the most recent Challenger survey, layoffs in October reached the highest level since 2003, a 65% increase from the same period this past year. The terminal low in the fed funds rate remains to be seen, but all signs point to the beginning of an easing cycle.

So that begs the question — How should financial institutions manage their balance sheets in the face of the Fed's easing policies? Institutions certainly welcome the recent steepening in the yield curve as it should improve margins. If history is any indication, those margins will be short-lived as assets priced on the longer end of the curve are re-priced lower due to longer-term rates falling. Once the curve starts to flatten, the writing is on the wall. Loan demand slows, and margins tighten.

In looking at ways to hedge against the risks of a falling rate scenario, I spoke with Senior Vice President and Financial Strategist Dillon Wiedemann, who works for The Baker Group, a regional broker-dealer and ALM firm based out of Oklahoma City.

Ideas from Dillon Wiedemann

One strategy many institutions have been using to hedge against falling rates is called "pre-funding." It works by borrowing against future maturities (usually short-term) to buy bonds at current yields. As the original low-yielding bonds mature, their principal repays the borrowings, effectively swapping out old bonds for new, higher-yielding ones.

Let's say an institution has $10 million in principal cash flow projected over the next 12 months from bonds averaging a 3% yield. Every 50-bp decline in bond yields would cost the institution $50,000 a year in annual interest income on that $10

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Dillon Wiedemann works with The Baker Group clients on investment portfolio management, education, swap strategies and interest rate risk management. Dillon holds a bachelor's degree in finance from the University of Central Oklahoma.

	Start of Q1	End of Q1	End of Q2	End of Q3	End of Q4		
Payments on Borrowing	-	2,500,000	2,500,000	2,500,000	2,500,000		
Cumulative Cash Flow from Bond Portfolio	-	*2,693,397*	*5,343,487*	*7,910,665*	*11,052,080*		
Balance on Borrowings	10,000,000	7,500,000	5,500,000	2,500,000	**PAID OFF**		
Weighted Avg Rate on Borrowings	3.69	3.64	3.62	3.60			
Interest Expense by Quarter		92,125	68,250	45,188	22,500	228,063	Annual Interest Based on Payoff
New Purchases		**10,000,000**	**10,000,000**	**10,000,000**	**10,000,000**		
Bond Yield	4.50	4.50	4.50	4.50	**4.50**		
Interest Income by Quarter	187,500	112,500	112,500	112,500	112,500	450,000	Annual Interest Earned on Bonds
						221,938	**Net Interest Income**

million. Uncertain where yields will be in 12 months, the institution wants to lock in higher guaranteed yields today rather than wait. They could borrow $2.5 million at 3-, 6-, 9- and 12-month maturities for a total of $10 million. Using FHLBank Topeka's dividend adjusted rates, current borrowing rates would be:

- Three month: 3.82%
- Six month: 3.69%
- Nine month: 3.63%
- Twelve month: 3.60%

This allows the institution to borrow $10 million at a weighted average rate of 3.69% and then reinvest into bonds at 4.5%. The future 12-month bond cash flow has been effectively repriced from 3% to 4.5%, locking in higher market yields and reducing reinvestment risk. The institution also earns a positive spread of 81 bps from day one between the borrowings and the new purchases.

After three months, portfolio cash flow pays off the first three-month term borrowing at 3.82%, reducing the borrowed principal by $2.5 million and lowering the weighted average borrowing rate from 3.69% to 3.64%. As this process continues over the next 12 months, the institution has repriced $10 million in lower-yielding bonds, reduced reinvestment risk and picked up roughly $222,000 in additional interest income through short-term leverage.

By laddering out the borrowings in three-month terms, the institution can take advantage of the lower rates offered for 9- and 12-month terms while also remaining nimble to capture any short-term rate cuts by the Fed.

FHLBank Topeka Insights

The strategy Dillon has illustrated is often referred to as a "leverage strategy." We've seen an increasing number of our FHLBank Topeka members successfully utilize this strategy this year.

In prior easing cycles, it has proven to be an

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effective way to lock in asset yields ahead of potential margin compression. What our members need to consider is their balance sheet composition, interest rate risk profile, potential changes in the rate environment and whether they are asset-sensitive or liability-sensitive.

Most asset-sensitive financial institutions perform better in a rising rate environment. For these institutions, buying bonds utilizing FHLBank Topeka's advance rates provides a hedge against falling rates. However, if rates start to increase again, the overall balance sheet performs well, and they can pivot their liquidity to funding the loan portfolio.

Our members should consult their ALM provider along with their broker-dealer when considering a pre-funding leverage strategy. As part of this discussion, consider utilizing FHLBank Topeka's interactive funding strategy tool that will help you analyze multiple advance structures to identify what works best for the unique needs of your balance sheet and interest rate risk profile.

Please reach out to your FHLBank Topeka Regional Account Manager (RAM) who can help determine if a pre-funding leverage strategy will benefit your institution.

Contact FHLBank Topeka today to discuss your advance solutions

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