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"Mirror, Mirror, on the Wall, Is My Funding Strategy Fairest of All?"

A closer look at wholesale funding may be necessary

Recent IntraFi research revealed that 97% of bankers expect deposit competition to remain the same or intensify while at the same time less than half the bankers expected loan demand to improve over the next 12 months.

Continued stagnant loan growth, higher competition for deposits, shrinking margins and ultimately lower levels of ROA and ROE throughout the banking industry mandate the development of meaningful and cost-effective funding game plans to support growth requirements.

Successful community institutions typically must grow assets 7-10% annually just to cover increased operating costs and maintain minimal acceptable returns on capital, and they are often those that develop a formal wholesale funding strategy to complement their commercial deposit generating activities.

Far too many community institutions and their boards remain reluctant to directly address this important issue, often for all the wrong reasons. It's prime time to look in the mirror and challenge yourself as to the appropriateness of your funding strategy. Now is not necessarily the time to shrink wholesale funding levels but rather to consider how wholesale funding can support earnings challenges in the current rate environment.

It's my hope this article will serve as a catalyst for management and boards to consider the appropriateness of their funding strategies. In doing so, they may find wholesale funding is a necessary, profitable risk management tool especially now when borrowings may be the last thing on their minds.

Why Are Institutions Reluctant To Use Wholesale Funding?

Common themes resonate throughout those community institutions that have a sustained reluctance to use wholesale funding sources for anything other than temporary financing. Reasons for not using wholesale funding usually include one or more of:

- The perception of wholesale funding as costly. Leaders would rather increase deposit rates than pay a higher rate for wholesale money (which may seem logical but is often more costly).
- The philosophy that deposits reflect customer relationships while borrowings do not, thus wholesale funding does little to increase the value of a franchise or attain the mission of a community institution.

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Frank Farone is a Managing Director at Darling Consulting Group and consults nationwide with CEOs and CFOs to increase earnings through the proactive management of capital, liquidity/funding risk and interest rate risk. He is a frequent speaker and author on topics such as industry issues and trends, funding solutions, regulatory issues, interest rate risk management, capital management and derivatives hedging techniques.

Frank was designated a "top-rated" speaker by FMS and is well known for his popular seminar "Turbo-Charging Your ALCO Process." He has helped thousands of bankers across the country.

- A perceived lack of spread especially when financing securities with borrowings thereby resulting in a lower return on assets.
- A perceived negative regulatory attitude, which perpetuates board/management negativity.

Wholesale Funding Is Perceived as Costly

In lieu of borrowing money, many institutions continue to offer above market rate premium CD specials in their local markets at rates significantly higher than wholesale. The true effective cost of any new money raised, as well as funds maintained, needs to be compared to the marginal cost of using the wholesale markets.

One approach would be to lower rates across the board (i.e., to wholesale rates or below) and see what sticks and what rolls out the door. The results could be a real eye-opener, and the impact on bottom-line profits may be greater than one might imagine. Moreover, it may be more profitable than raising rates and cannibalizing existing deposit dollars to raise funds.

Typically, CD rates are 38-50 bps below comparable FHLBank advance rates. However, that spread has narrowed recently, creating opportunities to lower CD rates. Consider the "marginal cost" of lowering a 3.75% six-month CD rate by a quarter point to 3.50%. If 20% of the CDs migrate out of the institution, one can replace the funds at a rate of 4.75% and be indifferent from a cost perspective at $8.325 million. Using FHLB funding at 3.80% to replace the outflow would save a total of $422,000 ($177.6 million CDs at 3.50% plus $44.4 million at 3.80% = $7.9MM total).

Balance (in thousands)		Current Rate
$ 222,000		3.75 %
		Rate decrease
		0.15 %	0.25 %	0.35 %
Runoff protected	10.00 %	5.10 %	6.00 %	6.90 %
	20.00 %	4.35 %	4.75 %	5.15 %
	30.00 %	4.10 %	4.33 %	4.57 %

Marginal Cost of 25 bps reduction in CD rates from 3.75% to 3.50%

Source: Darling Consulting Group, Deposits360°®

Balance (in thousands)		Current Rate
$ 540,000		3.65 %
		Rate decrease
		0.25 %	0.50 %	0.75 %
Runoff protected	10.00 %	5.90 %	8.15 %	10.40 %
	25.00 %	4.40 %	5.15 %	5.90 %
	50.00 %	3.90 %	4.15 %	4.40 %

Marginal Cost of Funds for lowering average MMDA rates by 50 bps

Source: Darling Consulting Group, Deposits360°®

Tiering MMDA accounts may also be a profitable strategy. Many institutions haven't updated tiering since deposit insurance was raised to $250,000 from $100,000, and thus pay all depositors the same rate above $100,000. Consider the impact of adding more tiers to your MMDA accounts and reducing rates on each tier versus paying most accounts the top tier. Consider the impact of lowering the average cost by 50 bps.

Deposits Equal Customers?

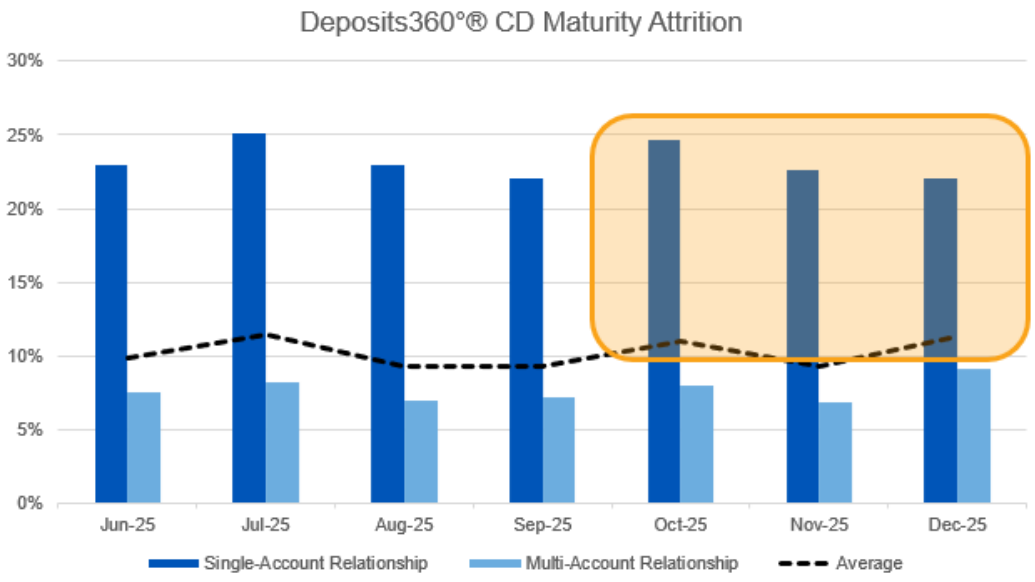
It's true that deposits provide an opportunity to cross-sell other banking products and services to the underlying customer/household and, everything else being equal, should be worthy of a premium. It is also true that newly attracted money may be more reflective of a temporary acquaintance than of a lasting customer relationship. Leaders typically do little to test the cross-selling capacity of these new "customers" (or the institution's ability to sell).

Darling Consulting Group (DCG) sees very high attrition (decay rates) of CD and MMDA specials among customers with no other relationship with the institution. They are fair-weather friends at best, and they may also come with high funding and administrative costs. If you are willing to bend on rate, don't acquiesce to CD-only customers especially when rates are above wholesale levels.

In the table below, the dark blue bars representing single account "CD only" customers have a much higher attrition rate (runoff rate) than the multi-account customers shown in the light blue bars. The dotted line for average attrition rate is rising for both types of depositors, a common trend DCG believes may continue throughout the year. This should not create a panic at pricing committee and rush to raise rates to hold depositors. Now is a perfect opportunity to perform a marginal cost of funds analysis and take a deeper dive into deposit analytics.

For example, in Q4 2025, perhaps seasonality played a part with more money going to pay for gas and heating, a shift to NMDs or FOMO in the stock market and disintermediation, among many other reasons. Rate is not always the driver of behaviors or balances.

The table below shows the retention rate of deposits at 95% despite a reduction of 15 bps in CD rates. 87% rolled back into CDs and 8% migrated to NMDs. Consider the cost of not lowering rates to retain 100% of deposits.



CD Maturity Activity Details from 9/30/2025 to 12/31/2025

Activity	% of Maturity	Balance	From Rate	To Rate
At Maturity Attrition	4.76%	12,372,423	3.91%	-
At Maturity CD Retention	87.09%	226,179,704	3.90%	3.75%
At Maturity Migration to NMD	8.15%	21,158,669	3.89%	1.76%
Total Maturities	**100.00%**	**259,710,796**	**3.90%**	**3.41%**

Source: Darling Consulting Group, Deposits360°®

Lack of Spread
Facing limited local market growth opportunities, many institutions have considered using borrowings such as FHLBank advances to fund the purchase of investment securities only to conclude that the available spreads are insufficient. Senior managers may determine that the resulting after-tax spreads were below their institutions' return on assets (ROA) and, therefore, quickly lose interest (often because incentive compensation is based on ROA targets). They may also be concerned about perceived exposure to potential rising rates from an interest rate risk or "valuation" perspective.

While it is beyond the scope of this article to discuss why ROA is an inappropriate focus for decision-making, in the current rate environment most leverage strategies produce an ROA well above that of many institutions. Seasoned MBSs at discounts yielding 5.55%* funded by 3.75% borrowings now produce a pre-tax return of 1.80%, not to mention the FHLBank dividend impact that adds another 20bps to the spread totaling 200bps spread. Pre-investing cashflows from the historic low rates four to five years ago provides instantaneous earnings and the added benefit of protection against lower rates ahead or slowing loan activity. Another strong and overlooked consideration is the opportunity for gain and a wider spread if the Fed eventually lowers rates or the long end of the curve backs down from today's high. Potential opportunity for gains may just be what's needed to help offset credit-related challenges during the next possible recession.

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Regulatory Concerns and Fears
Regardless of past experiences or grapevine "war stories," the regulatory position was clearly stated 25 years ago: Borrowings and brokered CDs are acceptable funding sources to the extent that they are part of an overall funding plan of the bank.

In a post-SVB world, it's all about collateral management and having access to reliable funding at lightning speed, not 30 days. Leaders who are confident in their use of wholesale funding and can clearly document how these funding sources result in improved earnings, liquidity management and interest rate risk management should be well prepared to tell their story to regulators.

Revisit outdated ALM policies to reflect current market conditions and the new world order of liquidity. Give your institution the flexibility to manage your business with agility and swiftness without self-imposed policies that restrict your ability to manage effectively.

New 30 Year Conventional MBS yielding 5.55%, Price $99-24
Source: Bloomberg

Contact FHLBank Topeka today to discuss your advance options.

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