

Case Study: Aligning Prepayment Risk Across the Balance Sheet



May 2026

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Overview

- Prepayment risk on both sides of the balance sheet
- Navigating rate volatility
- Pricing & funding considerations

The Hidden Option on Your Balance Sheet

When customers can react to rates faster than you can, they capture option value which can distort asset mix, funding mix, and NIM.



What Happened to CDs When Rates Moved Higher

Static or weak early withdrawal penalties can leave institutions exposed when customers have a strong incentive to move up rate.



What Happened

Retention pressure

Deposits become harder to hold

Funding cost pressure

Replacement funding costs more

Growth distortion

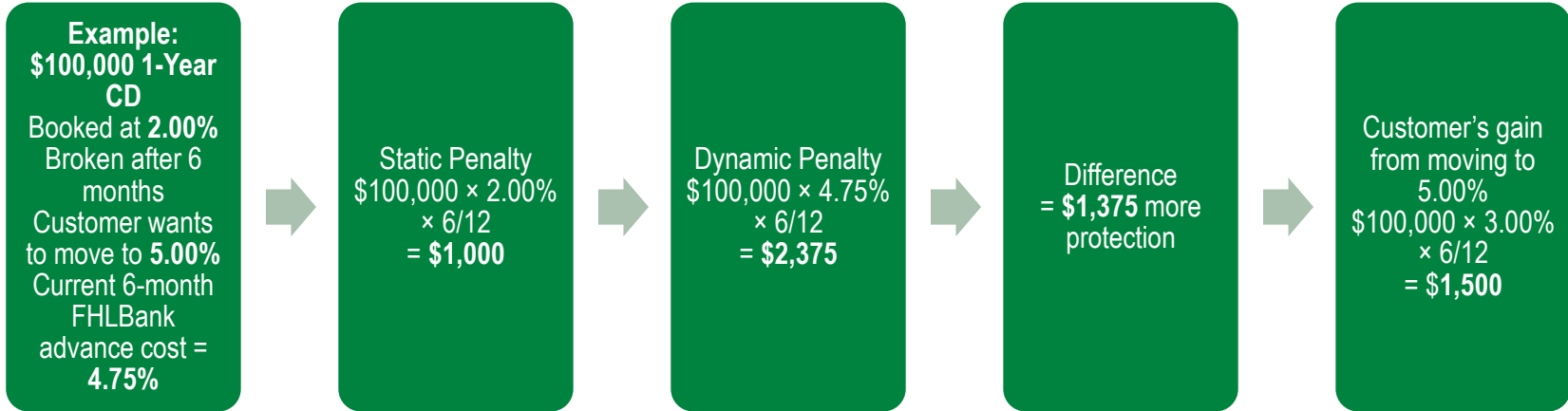
Rates change funding mix, not strategy

Not All Prepayment Penalties Protect You Equally

A simple penalty may be familiar, but a replacement-cost penalty may better reflect an institution's real economics when rates move.

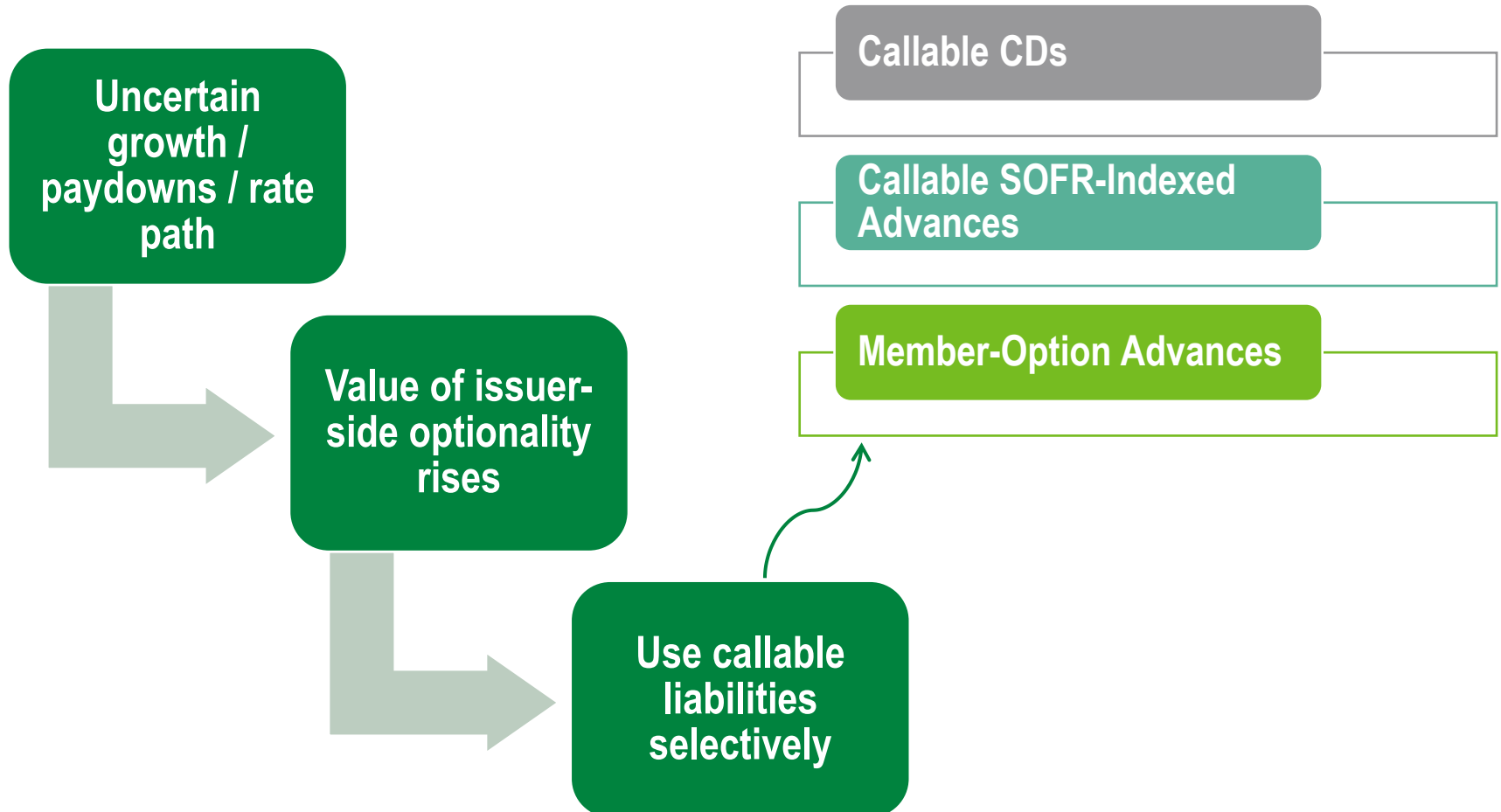
Static Penalty
 6 months interest at contract rate
Easy to explain
May undercharge when rates rise

Dynamic Penalty
 Greater of:
 6 months interest
 or
 replacement cost of same
 remaining term FHLBank advance



Reclaiming Optionality on the Liability Side

Callable funding can give the institution flexibility when growth, paydowns, and the path of rates are uncertain.



Make Funding Behavior More Intentional

Better liability-side design can reduce rate-path distortion and make funding outcomes more reflective of management intent.

Rate-driven liability behavior

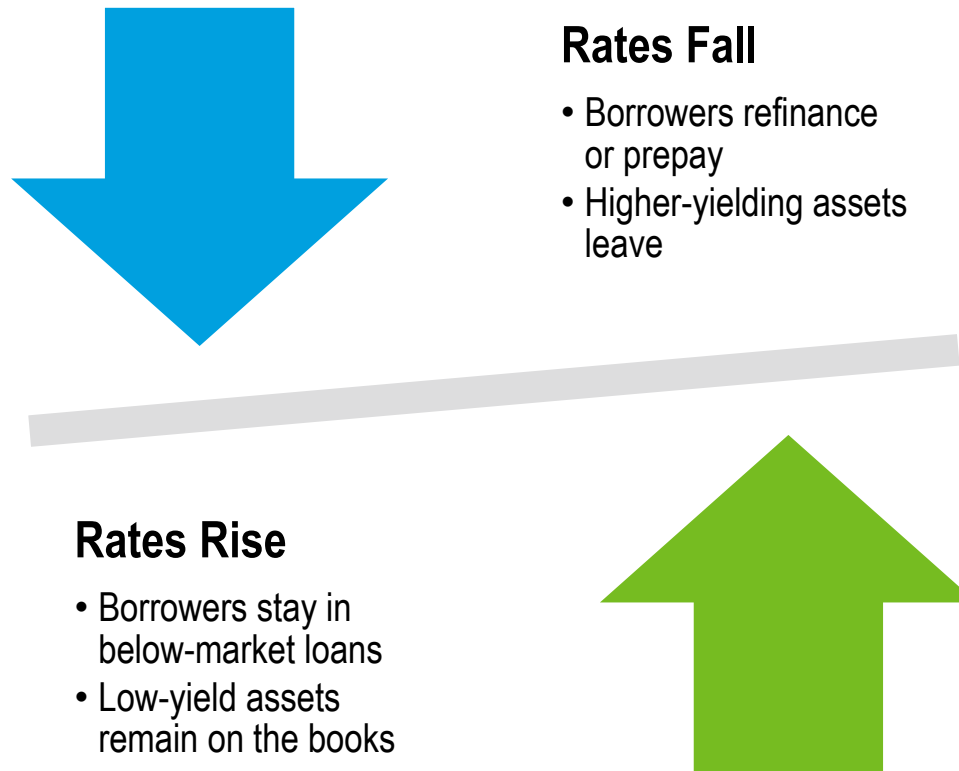
- CDs may leave when better rates appear
- Funding mix can change with rate shocks
- Margin impact may depend on customer timing

Strategy-driven liability management

- Penalties reflect replacement cost
- Callable structures preserve flexibility
- Funding mix better reflects management intent

The Asset Side Has the Same Problem

Fixed-rate commercial and CRE loans can give borrowers valuable timing options when rates move, and weak prepay design can distort earning-asset mix just as weak deposit design can impact funding mix.



Common Commercial Loan Prepay Structures

For most banks and credit unions, the practical question is usually step-down versus yield-maintenance-style protection.

Step-Down

- Penalty declines over time
- Simple and easy to explain
- More borrower flexibility
- Protection weakens as the loan seasons

Yield Maintenance / Make-Whole

- Penalty tied more closely to reinvestment economics
- Stronger spread protection
- More economically precise
- Can be harder to explain or negotiate

Defeasance

- Loan is replaced with substitute collateral rather than simply prepaid
- Very strong protection
- More operationally complex
- Most structured of the three

Prepay Structure Can Shape the Right Funding Solution

The same five-year balloon loan may call for very different funding depending on how protected the asset is.

Sample Loan
 \$5MM fixed-rate CRE or C&I loan
 5-year balloon
 6.25% coupon

If Step-Down

Expected life may be shorter
Advance fit:
 shorter **Classic**,
Member-Option, or
laddered Classics

If Yield Maintenance

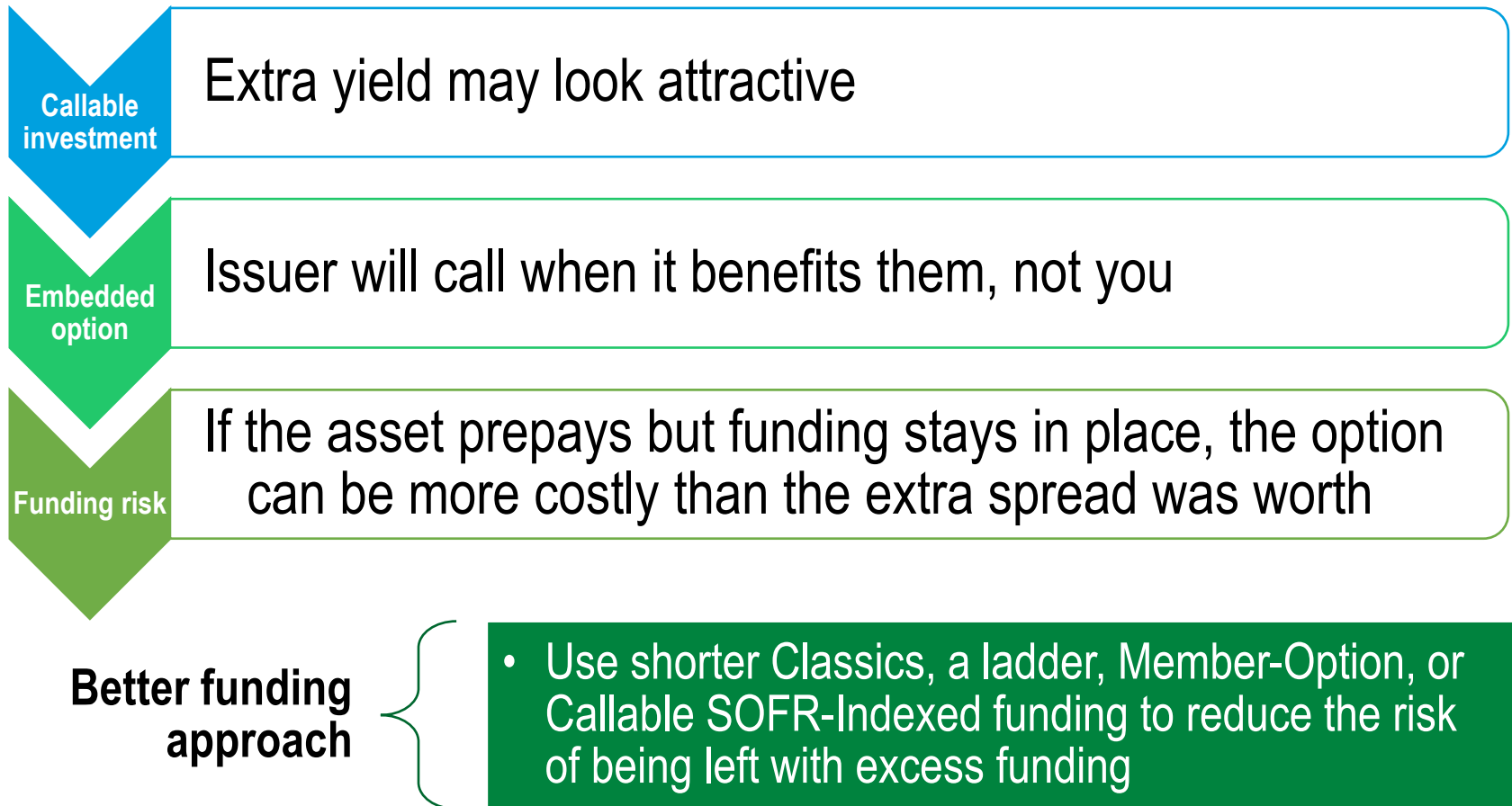
Expected life may be closer to full term
Advance fit: 5-year Classic or
Amortizing Advance

If Replacement Economics Improve

Runoff may be beneficial
Advance fit:
Member-Option or
Callable SOFR-Indexed Advance

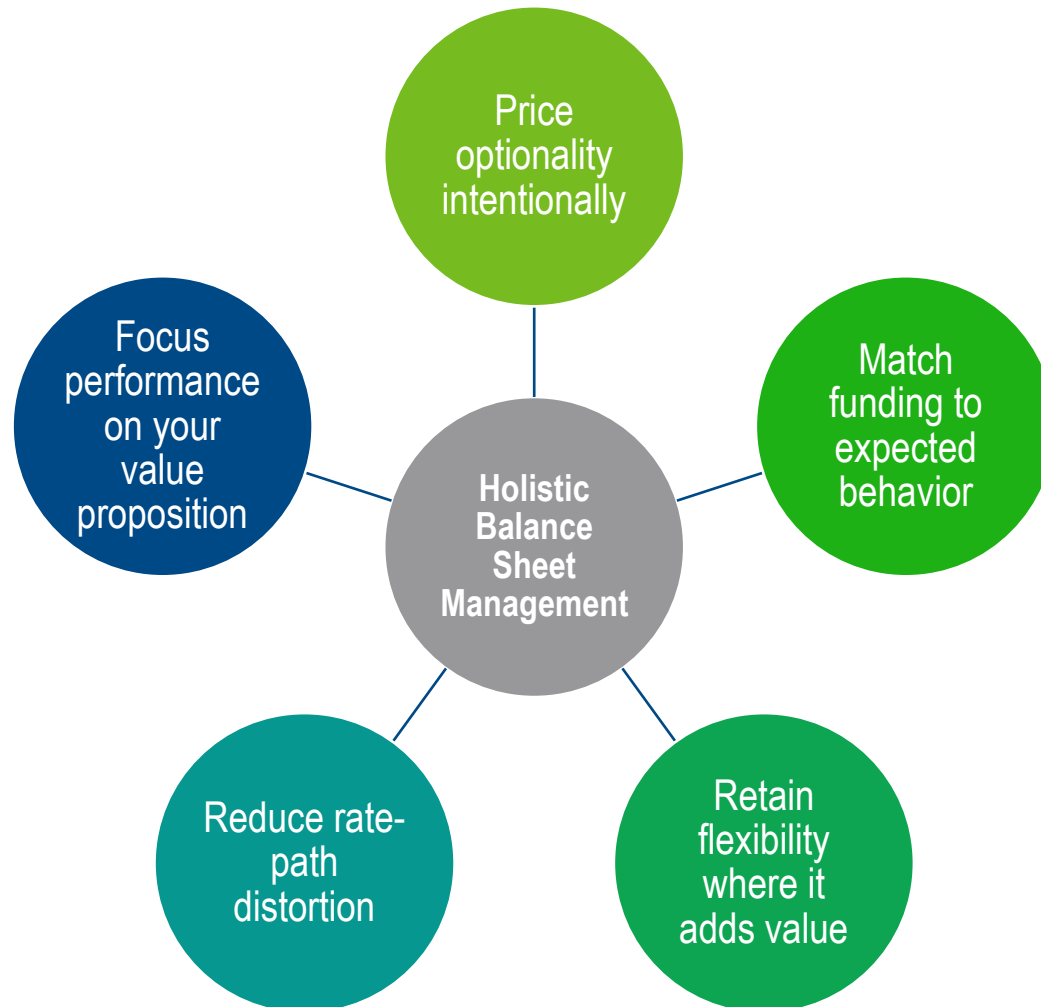
If You Buy Optionality, Fund It Accordingly

Callable investments may offer extra spread, but if you buy them, funding should reflect likely call behavior so the asset can run off without leaving costly funding behind.



Holistic Balance Sheet Management

Ideally, depositories can meet customer prepayment needs, while also maintaining flexibility and performance independent of the path of rates.



Thank You



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