Dillon Wiedemann
Senior Vice President

Bank Trends: Can Margin Improvement Continue in 2025?

Margin Trends in 2024

Community banks saw impressive growth in net interest margin throughout 2024. US banks with less than $10 Billion in assets (around 4,200 institutions) improved NIM from a post-pandemic low of 3.34 at year-end 2023 to 3.52 at year-end 2024. The prolonged period of higher rates allowed community banks to reprice assets at higher yields, with the average institution's yield on earning assets increasing by 35bps through the first three quarters of 2024. During that same period, the rate of increase on cost of funds slowed dramatically from 2023. The average institution saw a smaller increase of only 14bps on their liabilities.

Aided by 100bp of rate cuts from the Fed at the end of 2024, community banks used a slightly different playbook in Q4. The increase in margin in Q4 was driven more by the decrease in liability costs than it was by the increase in asset yields. Interestingly, asset yields peaked in the third quarter and declined slightly in Q4, likely driven by loan yields tied to prime. Reductions in cost of funds were able to outpace that decline, ending in the same result: improved NIM.

Where do we go from here?

Over recent weeks, there has been a lot of change in market sentiment. With reduced government spending, softness in the labor market, and concerns about the overall impact of tariffs, the market is pricing in an increased probability of a recession. In mid-February, the market expected only one rate cut from the Fed with the first cut not being fully priced in until December. The first week of March, the market projected three rate cuts from the Fed with the first cut coming in June.

The possibility of additional rate cuts will likely be welcome news on the liability side of the balance sheet as it should provide cover for community banks to continue reducing their cost of funds. The real question will be by how much? Over the last couple of easing cycles, betas on overall cost of funds for community banks were between 20-29%. Stated more plainly, for every 100bp of rate cuts from the Fed, the average community bank was able to reduce its overall cost of funds by 20-29bp. Depending on liability mix and local competition, your institution may have a different experience. However, there appears to be opportunity for continued margin expansion by reducing liability costs in 2025 (given that we can get the Fed to cooperate).

On the asset side of the balance sheet, loan yields for the industry appear to have peaked as loan rates tied to prime have come down from 2024 highs. There are plenty of institutions still repricing pandemic-era loans higher, but there may be less low-hanging fruit from a repricing standpoint than there has been the last couple of years, as the average loan yield for the industry sits at a healthy 6.53%.

The average bank's investment yield is sitting at 3.02% as of the end of 2024. These assets present the best opportunity on the balance sheet for repricing and to continue margin expansion through 2025. By reinvesting at current market yields, banks can pick up +150bp going back into bonds and potentially much more by reinvesting into loans. The catch is that unrealized losses have taken many of these bonds out of play. There are, however, a couple of strategies banks have been using to reprice these lower yielding bonds to take advantage of high current market yields. These are (1) bond swaps and (2) pre-funding.

1. A bond swap works by selling lower-yielding, currently owned bonds and replacing them with higher yielding bonds. There may be a realized loss on the sell-side bonds, but if the pickup in income is enough, the loss can be recovered in a short period of time.
2. A pre-funding strategy works by borrowing against future

(Continued)

maturities (usually short term) to buy bonds at current yields. Once the currently owned, low-yielding bonds mature, the principal can be used to pay back the borrowings and the higher-yielding bonds remain on the books.

As market volatility has increased in recent weeks, we've seen a steepening of the yield curve from 1yr forward. Bonds with short maturities between 1 and 3yrs may be good candidates to consider for these types of strategies. With the market pricing in higher odds of a recession, there is potential that we end up in a lower rate environment sometime in the future. These bonds with 1-3yr maturities would likely have the most reinvestment risk in that scenario. It's important to note that both scenarios may have a cost to the bank, so if you're considering either of these strategies, the right choice could come down to how the bank prefers to "pay" for it. For a bond swap, selling bonds at a loss can be seen as the equivalent of paying interest up-front, whereas the pre-funding strategy will increase interest expense, which is paid over time.

The benefits may not be immediate for either strategy, but they do allow banks to continue to reprice some of their lowest yielding assets while avoiding reinvestment risk if we end up in a lower rate environment in the future. By identifying repricing opportunities within the bond portfolio, banks may be able to further increase yield on earning assets. Combine this with a little help from the Fed and the industry may be able to continue margin expansion in 2025.

The Baker Group is one of the nation's largest independently owned securities firms specializing in investment portfolio management for community financial institutions.

Since 1979, we've helped our clients improve decision-making, manage interest rate risk, and maximize investment portfolio performance. Our proven approach of total resource integration utilizes software and products developed by Baker's Software Solutions combined with the firm's investment experience and advice. For more information, contact* ***Dillon Wiedemann at The Baker Group: 800.937.2257.***

**The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.*

Dillon Wiedemann
Senior Vice President
The Baker Group LP