

Off and running

Community banks set for a robust 2026

By Jim Reber, ICBA Securities

I'm hopeful that those New Year's Resolutions are intact and having their desired effects. In taking one more look back into 2025, it dawns on me the further we got into the year, the better the bankers' comments were about their bank's performance. The industry seems to be hitting on all cylinders (to use a hackneyed expression), but it seems to be true. Between the continued solid credit quality metrics, reasonable loan demand, and an interest rate scenario that looks to favor continued margin expansion, prospects are encouraging for a successful year for community banks.

ICBA successes

Last month ICBA President/CEO Rebeca Romero Rainey and ICBA Chairman Jack Hopkins had a conversation about the state of the industry, and they too talked about the momentum in the industry. Legislation on mortgage "trigger leads," proposals to lower the leverage ratios for community banks, and tax exemptions on 25% of ag and rural lending through the ACRE Act are all going to help profitability.

Also, making the 2018 Tax Cuts and Jobs Act marginal tax rates permanent for both C Corps and S Corps has provided clarity about portions of the balance sheet that have tax-affected assets--namely, municipal bonds. There is no debate that the Act has helped community bank earnings, though the composition of high-performance portfolios has shifted away from tax-frees into taxable instruments.

You can view Rebeca and Jack's conversation at www.icba.org.

Bond portfolios are helping

It was documented here last year that portfolio yields are at a many-year high, thanks to the harsh doses of interest rate therapy in 2022-23, and the slow-to-recede levels of market rates ever since. Community bankers continue to say they're able to roll out of bonds yielding 1% or less that are finally, mercifully maturing, and whatever the proceeds are used for, net interest margins are improved.

Which brings up the second half of this NIM equation. Deposits grew at community banks by about 4% last year, which is near the long-term run rate, and costs of funds have retreated in the past 18 months. Industry-wide, FDIC calculated community bank COF's have fallen by about 30 basis points (0.30%) since mid-2024. The net margin between bond portfolio yields and costs of funds is now over 1% for the first time in about three years.

Yield curve thoughts

Yes Virginia, there is a Santa Claus. The same is true for the other 49 states and the District of Columbia. For community banks, it came in 2025 in the form of a steep(er) interest rate curve. We closed out the year with the "2's to 10's" spread around 67 basis points (0.67%), which is the best we've seen going back four long years. Recall too that the average slope for the full 21st century so far has been right at 100 basis points, and it's entirely possible we'll get there sometime this year.

Steeper yield curves have all sorts of latent and tangible benefits for the banking industry. The most obvious is that managers can more properly price relative risk into the balance sheets. Thirty-year mortgages are *supposed to* be priced higher than 15-year mortgages. A ten-year municipal bond is *supposed to* have a higher yield than a 7-year. And a 36-month CD is *supposed to* pay more than a 24-month. All those notions were set on their heads during the 2-plus year stretch from 2022-24 when yield curves were upside down. Banking fundamentals hopefully will prevail this year, which can only mean more profitability.

Bond swap prospects

Commensurate with the positively sloped yield curve are opportunities for actively managing the

bond portfolio. One strategy is to sell certain securities and simultaneously purchase others in a “bond swap.” Lately, since most positions are still underwater, bonds have been sold at losses, with the improved reinvestment yields making up the ground in less time than the remaining average lives. This strategy is known as “loss-earnback.”

Two pieces of good news: first, early in the year is a popular time to execute these bond swaps, for the simple reason that the bank has a full year to enjoy the higher yields with which to eat away at the realized loss. Secondly, the steeper the yield curve, the less extension risk needed to make the bond math work. So my suggestion is to work with your brokers to model such potential trades, and be sure to document your objectives and rationales. And let me remind the readers that the positive forecast for industry profits might make such loss-earnbacks more tenable.

Lots to like here as we embark on an ambitious 2026. I look forward to seeing many of you at ICBA LIVE, March 6-9, in sunny (and warm) San Diego. For more information, visit www.icba.org/icba-live.

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