



**Luke Mikles**  
*Senior Vice President, Financial  
Strategies Group*

## Loan Yields, Prepayment Risk, and the Quiet Shift in the Balance Sheet

Over the last few years, community financial institutions have been working through one of the more favorable repricing environments in recent memory. Loans that were put on the books during the low-rate years of the early 2020s sat well below current offering rates, sometimes referred to as reinvestment rates. As these lower yielding loans matured or repriced, they did so into a much higher rate environment. This helped push loan yields up, and with cost of funds moving off of the peak, these higher yielding loans helped support a steady recovery in net interest margin (NIM). If we take a look at year-end call report data, community bank NIM rose every quarter throughout 2025, finishing the year at 3.87%. This is the highest NIM we have seen since 2018. The increase in loan yields as well as higher yields in the investment portfolio have been large contributors to this margin expansion.

However, as we move through 2026, one of the dynamics that drove much of that margin expansion is starting to shift the other way. In September of 2024 the FOMC began their easing cycle and cut rates by 100 basis points over a 3-month span followed by another 75 basis points of cuts from September to December of 2025. After the FOMC cut rates, we started to see current offering rates trend down. The yields within our loan books have now largely caught up to those current offering rates and the prepayment risk that had been mostly dormant for the last few years is now quietly working its way back onto the balance sheet. So, what does this mean for our balance sheets, and how should we be thinking about loan yields and prepayment risk going forward?

First, let's take a look at where we are starting from. After the Fed aggressively raised the federal funds target rate coming out of the pandemic, current offering rates on new loans moved up significantly. A loan that was put on the books in 2020 or 2021 at 3% or 4% was all of a sudden 300-400 basis points below new offering rates on those same types of loans. That large

gap between book yields and new offering rates is what drove prepayment activity to historic lows. It simply did not make any economic sense for a borrower carrying a loan with a 3% or 4% handle to refinance or move into a 7%+ loan. Existing loans stayed on the books longer than originally anticipated, also known as extension risk, but as those loans eventually paid down and matured, they repriced into the higher rate environment. The slower-than-expected roll off of these COVID-era loans, coupled with new loans booked after the rate hikes, drove meaningful improvement in NIM and earnings across financial institutions.

That repricing has largely run its course. Through the first three quarters of 2025, the rise in community bank NIM was driven primarily by an increase in earning asset yields. However, in the fourth quarter, this flipped. Earning asset yields actually decreased by 3 basis points, with loans falling by 4 basis points. NIM continued to expand though, as cost of funds dropped 8 basis points. This represents a significant balance sheet shift as the NIM expansion in Q4 2025 came from the liability side repricing down rather than the asset side repricing up as we had seen in the prior 3 quarters. We now have to think about a world with falling loan rates and accelerating prepayments.

So, what does this mean from an ALM and IRR standpoint? As the spread between loan book yields and current offering rates continues to tighten, prepayment activity will likely pick up, which leads to cash flows coming back faster than expected and a shorter effective duration of the loan portfolio. Over the last two years many financial institutions have been intentionally extending asset duration to protect earnings against falling rates. With the increased prepayment risk to the loan portfolio, this can impact the overall interest rate risk profile of the balance sheet.

The practical starting point when we apply this back to IRR is to review the Constant Prepayment Rate (CPR) assumptions in the IRR model. Overall, we had to make adjustments to those CPRs

*(Continued)*

in 2023 and 2024 to model the prepayment activity that was so far below historical norms that existing assumptions were misleading. It is now time to do that again. If those assumptions have not been updated, the model is likely overstating the duration, or average life, of the loan portfolio and understating the prepayment risk associated with it. Stress testing what happens if prepayment activity moves meaningfully higher is a worthwhile exercise, and one that could give a more accurate picture of where the balance sheet actually stands. As a reminder, we always stress the importance of an annual assumption review as well as periodic stress testing of key assumptions. If the loan book is shortening on its own through faster prepayments, the total asset duration picture may look different than what was planned for. Understanding how prepayment risk could impact the duration of the balance sheet allows us to be more intentional about how we position the asset side as a whole. The investment portfolio is one place where institutions have some flexibility to address this — extending duration on the bond side can help offset what is being lost on the loan side. This is not about making a wholesale bet on interest rates, but rather making sure the balance sheet is positioned in a deliberate and well-understood way across all asset types, not just the loan book in isolation.

It is also worth pointing out that this story does not look the same at every institution. Banks that grew aggressively during 2020 and 2021 still have a meaningful portion of their loan book at very low coupons that will continue to roll and reprice higher for some time. The repricing tailwind is not done for those institutions. On the other hand, banks that grew through the peak of the rate cycle in 2023 and 2024 have a loan book that is already at, or near, current market rates, and the prepayment risk we have been discussing is more pronounced. Two banks with similar margins today can be in very different places on this curve.

To bring this full circle, the loan book repricing story that drove much of the NIM expansion over the last two years is starting to wind down, and a prepayment risk that has been quiet is starting to come back into the picture. To be clear, we are not sounding the red alert alarm bells. Community bank NIM is at its highest level in seven years, and most institutions are entering this

next phase from a strong starting point. But the dynamic that has been working in our favor is shifting. As we have discussed in the past, interest rate risk management is an ever-evolving process. What worked over the last two years may not be what works over the next two and recognizing that shift early is what puts an institution on the best path forward.

*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 **Luke Mikles 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.*

**Luke Mikles**  
**Senior Vice President, Financial Strategies Group**  
**The Baker Group LP**

INTENDED FOR USE BY INSTITUTIONAL INVESTORS ONLY. Any data provided herein is for informational purposes only and is intended solely for the private use of the reader. Although information contained herein is believed to be from reliable sources, The Baker Group LP does not guarantee its completeness or accuracy. Opinions constitute our judgment and are subject to change without notice. The instruments and strategies discussed here may fluctuate in price or value and may not be suitable for all investors; any doubt should be discussed with a Baker representative. Past performance is not indicative of future results. Changes in rates may have an adverse effect on the value of investments. This material is not intended as an offer or solicitation for the purchase or sale of any financial instruments.