HAMMERING NIM

by Steve Brown

A hammer is a great tool for driving nails into wood, however, there are many other tools needed in order to construct a solid building. A bank is no exception. Just as a construction worker wouldn't only rely on a hammer, bankers should not solely rely on Net Interest Margin ("NIM") when building a bank. Over the years, the value of NM has reached epic levels. Many bankers still believe that by focusing on NIM, profitability and performance follows. The belief holds even today that the wider the NIM, the more profitable the institution and the better it is being managed. This is not only misleading, but also incorrect. Psychologists tell us that people tend to stick with what they know and will resist change. Step back 10 years ago when the fax machine ruled the earth. Now, consider what an integral part of everyday business email has become and how the fax machine has become nothing more than a paperweight. While we admit that NIM is an effective tool to use when building and running a bank, we also say one probably wouldn't use a hammer to drive in a screw. While it might get the job done, there are more efficient and effective tools hanging on the pegboard designed for this task. So, to fully understand NIM, it is important to review its subcomponents. In short, NIM is calculated as interest income minus interest expense, divided by average earning assets. NIM is also often confused with net spread. While they can be the same, spread is actually the difference between the average interest rate earned on assets minus the average interest rate paid on liabilities. Therefore, spread equals NIM only if the dollar amount of earning assets equals the dollar amount of interest-bearing liabilities, which rarely happens. As is obvious from the calculation itself, one weakness of NIM is that it is very old fashioned and rudimentary. NIM assumes bank profitability is driven purely on the difference between the coupons it earns on its assets minus the coupons it pays on its liabilities, divided by the asset base that carries a coupon. Another problem with using NIM on the asset side is that as much as 15% of assets could be ignored. Depending on branch growth activity and cost structure (i.e. premises), cash-on-hand, acquisitions (i.e. goodwill), investments in certain subsidiaries, income earned but not collected on loans, net deferred tax assets, loan servicing activity (i.e. servicing value) and other assets, NIM can miss a lot. The most obvious exclusion on the other side of the ledger is non-interest bearing liabilities, which can represent as much as 40% of funding for some banks. While NIM would ignore this component of funding and therefore characterize it as "free," we all know better, as most commercial accounts have an analysis component. This component in effect pays a coupon rate that offsets bank service charges to customers. Sure, the more non-interest bearing liabilities a bank has, the better it generally will perform. But, that doesn't mean this funding has no cost. Since NIM looks only at coupon, this fact is ignored. The danger banks face in solely focusing on "holding NIM above 4%" can significantly increase risk and reduce performance. NIM not only ignores embedded interest rate risk, but as spreads contract and competition increases, these banks take on more risk. The longer this continues, the greater the risk to the structural soundness of the institution. Tomorrow we will scan the pegboard, as we consider the effectiveness of other tools we might want to consider when trying to build a better bank.

BANK NEWS

Acquisition

Shore Bank ($1.78B, IL) will acquire Greater Chicago Bank ($63mm, IL) in a deal valued at nearly $15mm or about 2.26x book.

Acquisition

United Community Banks ($6.1B, GA) will acquire two branches from First Charter ($4.2B, NC) for an undisclosed amount. Total loans from the branches are $9mm, while deposits are $37mm.

Acquisition

Community Banks ($3.3B, PA) will acquire Sentry Trust from Omega Financial ($1.9B, PA) for an undisclosed sum. Sentry will become part of Community Banks Trust & Asset Management division.

Fund Balance

The FDIC reported that the newly created Deposit Insurance Fund had a balance of $49.2B at the end of 1Q 06. The fund is up nearly 1.2% compared to figures before BIF and SAIF were combined.

Gas Prices

Nearly 27% of Americans say that they have changed their vacation plans because of higher gas prices.

Global Impact

According to a new study from BIS economists, global measures play a bigger role than domestic items in determining inflationary pressure in the U.S.

Card Feud

MasterCard is filing a lawsuit to retain rights to World Cup Soccer. The lawsuit comes after Visa paid $200mm to soccer's governing body to become the official financial-services company starting next year.

WA Housing Boom

Washington state's home building sector is continuing to boom, producing an estimated $1B in revenues for state coffers over the next 3Y.