SAWING THROUGH NIM

by Steve Brown

In yesterday's edition, we discussed the risk of focusing solely on NIM to drive loan pricing decisions. Our commentary equated NIM to a hammer in order to prove a point. While a hammer is certainly a fine tool for many tasks, an expanded tool selection will be needed for different projects at different times. Today we begin by reviewing recent and historical FDIC data. In it, we find that large banks (defined as those with assets above $10B) have a NIM that is roughly 100bp lower (3.35% vs. 4.29%) than independent banks (defined as banks with assets between $100mm and $1B). Yet, these same large banks are able to generate an ROE that is about 100bp higher than the independent bank group (14.14% vs. 13.05%). To fully understand why this is happening requires a closer look at the blueprints. We find that while there are many potential reasons for this striking difference between the groups, some are more obvious than others. [1] The efficiency ratio is much higher (about 11%) at an independent bank than it is at a larger bank (61.9% vs. 55.7%). Evidence suggests that large banks operate more like a manufactured housing builder, while independent banks could be compared to custom builders. The result is that independent banks are also more willing to originate creative and structured loans to service their customers, while large banks are focused on assembly line, but precision based origination. [2] Next, we find that large banks are significantly better than independent banks at leveraging their capital. While independent banks are content to hold an average of 9.72% leverage, large banks run closer to 7.35%. The result in this 33% more aggressive posture from the large bank is that in the end, sheer volume produces greater profitability for this group. In short, independent bank capital is underleveraged when compared to large bank competitors. [3] Independent banks are more willing to allow clients to prepay at any time and in most cases, without penalty. The larger the proportion of floating rate loans, the more rollover and prepayment risk that book of business inherently carries. Higher prepayments translate to higher acquisition costs for the portfolio, resulting in a lower ROE. [4] Independent banks are more willing to originate smaller (and usually more complex) loans on average than larger banks. This results in a higher cost per loan, expanded documentation requirements and reduced overall profitability. While diversification is a good thing, studies suggest there is very little difference in risk between a loan portfolio of 100 credits and one with 30 credits. The mere fact that independent banks originate nearly all loans within a 50-mile radius overwhelms the value received (and reduced risk) from originating smaller credits for diversification reasons. [5] Finally, large banks enjoy just over a 2 to 1 ratio to independent banks of non-interest income to earning assets (3.17% to 1.38%). While many independent banks will feel there is little they can do on this front, a periodic review of deposit account service charges, expanding into insurance and boosting loan servicing activities are all real possibilities. NIM cannot be the only focus, as it is about overall bank profitability. Coupon measurements alone simply do not capture the whole picture. The fact is that the larger and more stable the loan, the more room a bank can saw off the NIM and still boost profitability. There is absolutely no reason to be afraid of a 3.00% NIM if it increases profit, reduces risk and boosts return.

BANK NEWS

Acquisition

Sovereign Bancshares ($353mm, TX) will acquire Jefferson Bank of Texas ($200mm, TX) for an unnamed sum.

Interesting

USAA FSB ($21.1B, TX) announced a new service that will allow its customers to drop off deposits for free next-business day delivery at any of the more than 4,100 UPS Store locations nationwide.

Expansion

M&I Bank will add 6 branches in AZ by the end of the year and hire 60 employees.

Expansion

Fifth Third Bank said they will increase the number of branches in FL to 70 by the end of 2008. The bank currently has 15 locations in the state.

Building Concerns

According to recent estimates by Fortune, nearly 40% of homebuilding is done by undocumented immigrants. A crackdown on immigration laws could result in pressure on an already tight construction labor market. One builder estimated such a move would cause the time required to build a house double or triple and increase costs by 30%.

Marketing

At the end of 2005, some 73mm people were using high-speed internet access, up nearly 15x in the last 5Y. Amazingly, despite the fact that most of our independent bank customers indicate they are in need of deposits, about 90% say they have no internet or email marketing program to attract such business through this expanding channel.

Blazing Speed

JPMorgan Chase continued its rollout of debit cards with blink technology, adding 1.8mm Visa customers in New York, New Jersey and Connecticut. Blink technology allows users to simply wave their credit cards over a specially equipped machine and offer contact-less payment capability.