NIM IS OVERRATED

by Steve Brown

Over the next few days, we are going to analyze several metrics our independent bank readers can use to better compete with national banks. We begin with a discussion about net interest margin ("NIM") in an effort to better understand why it has lost value as a performance measure. The calculation for NIM is simply the difference between interest income and interest expenses, divided by average earning assets. The attraction of NIM is that it is painless, easy to calculate and simple to explain. The problems with using NIM as a primary metric are many and include: 1) NIM is first, last and only about interest spread. This was fine as long as banks made most of their money from the difference between interest earnings and interest cost, however those days are gone and as such, its value has waned. Consider that according to FRB research, the top 20% most profitable independent banks generate about 40% of their revenues from fee income, while the remaining 80% of independent banks only derive about 20% that way. It is hard to imagine anyone would run their bank and measure performance by ignoring as much as 40% of the overall operation. That just doesn't make a whole lot of sense. Further, as the graph above shows, large banks have moved away from using NIM as a primary metric. They have instead shifted to earnings and return measures that capture the entire operation. In fact, despite a NIM that is running nearly 100bp below independent banks, larger banks have an ROE that is over 150bp higher. Big banks focus on maximizing their capital dollars and worry less about the net interest stream. 2) NIM doesn't encapsulate risk and may actually encourage bankers to take more risk. The riskier the loan is the higher its coupon and the wider its NIM. Unfortunately, we also know this can hammer profitability when the credit tide turns. Holding the line on NIM is not the same as holding the line on performance Â– not even close. 3) NIM also does not take into account interest rate risk. By simply subtracting current interest expense from current interest income, nothing is captured related to the impact of future or potential interest rate scenarios. Keeping shareholders happy is all about maintaining stable earnings, significantly reducing the value of NIM as a metric. Look, we all know people don't like to change. Perhaps that is why the familiar old NIM blanket remains wrapped around the independent banking sector to this day. Despite the fact that NIM has dropped in 12 of the past 13 years, people continue to hold onto it as some do with GAP. The bottom line is that in this day and age, sometimes simple metrics can be too simple. In coming issues, we'll lay out what we think are a much better set of metrics to use to keep shareholders happy over the long haul.

Related Links:

BIG Loan Pricing Webinar

BANK NEWS

Rough Seas Ahead

The MBA estimates 167k people have their primary residence foreclosed upon every 3 months. Given that about $375B of loans have yet to adjust to higher rates this year and $1T are poised to do so in 2007, many analysts are worried foreclosures could soar much higher. This is worrisome to lenders as well, who expect to take write-downs in some cases of as much as 40%. The cost to a lender of a single family residential home foreclosure (according to FHLMC) is $59,800.

Bank-Owned Real Estate

A House subcommittee will meet to debate the OCC decision to allow national banks to develop CRE projects. Recently, the OCC allowed BofA to develop a luxury hotel, PNC a mixed-use condo project and Union Bank of CA to own 70% of a wind farm.

401(k) Balances

A recent study found the average 401(k) balance for workers rose 50%, hitting $102,014 between 1999 and 2005. Much of the growth is attributed to contributions, asset allocation and high equity returns.

LOAN PRICING

The Banc Investment Group will unveil the latest release of our online loan pricing model today at 1:00pm PT. This is available to all independent banks for a low monthly charge and can be cancelled at any time. This is the only available pricing model we know that takes a risk-adjusted view on loans and is updated with the latest probability of default figures. Loan risk is changing, so loan pricing models have to keep up. In addition to risk, the model also incorporates optionality, structure, acquisition and maintenance costs. For the first time, lenders can better negotiate loan pricing by including all relative information. To see the demo, click below and use "big123" as the password.