# DOWN THE ROAD ON NIM

by Steve Brown

Over the past 10 years, net interest margin for banks under $15B in total assets has been on a steady downward trend. Back in the 90's, NIM was 4.83% for the average independent bank, but it is now down to 4.10% (that is a 15% drop). NIM has steadily declined through various interest rate cycles and curve shapes, so the compression has less to do with the current flatness of the curve and more to do with secular changes in the industry. Over the past 10Ys, loan quality has also improved, which explains a large percentage of the NIM compression. Low probabilities of default have resulted in higher returns, which has created more loan competition and more competitively priced loan transactions. Bankers should understand that NIM compression is a permanent change in the industry. Wall Street conduits, finance firms, insurance companies and hedge funds will not exit these business lines, as too much capital has been invested. In addition, returns have been on the healthy side of 18%. That said, margin compression could receive some small relief if and when the yield curve steepens and/or credit defaults increase (as some investors exit the business). The overall trend however, will continue to be lower. The implication of a sub-3% NIM is huge for banks, as an estimated 25% would not be able to survive. This prognosis begs the question, "What are you doing today to ensure above average shareholder return in the future?" In order of impact, the answer should be: 1) Gain a better understanding of credit Â– Using a loan pricing model, credit scoring, credit stress analysis, migration tracking and developing more of an analytical lending culture are all critical steps. This will ensure the bank continues to make profitable loans on a risk-adjusted return on capital basis. 2) Streamline operations and enhance productivity Â– Banks must be vigilant on expenses and productivity, in order to drive efficiency ratios down below 55%. Exploring outsourcing, centralized credit underwriting, improved marketing, greater use of technology and integrated processes should all be part of the strategic plan. Over the past 10Ys, banks have offset margin compression by picking up increased efficiencies (taking on more credit risk is the other major offsetting factor). This will be harder to do going forward, as most of the "easy" fixes have already been done. Over the next 10Ys, we believe banks will need to target a 45% efficiency ratio without sacrificing risk management or infrastructure to remain top performing. 3) Profitability Â– Banks will be mandated by the market to get a handle on how to manage both relationship and product profitability. Banks that are using such systems already understand the drivers of the business. If more banks had a working profitability system, they would learn that they most likely should not be in the single family mortgage business, indirect auto lending or a host of non-core business lines. The next decade in banking will demand a more systemic approach to bank management. By starting to change the way your bank does business now, the institution will be in an ideal position to outperform down the road.

## BANK NEWS

**M&A**

The HC of Midwest Bank and Trust Company ($2.9B, IL) will acquire the HC of Mount Prospect National Bank ($534mm, IL) for $139.8mm, or about 2.9x book.

**M&A**

The HC of Union Center National Bank ($1.1B, NJ) will acquire Beacon Trust Company for about $10.3mm in cash and stock. Beacon offers trust and investment services and has assets under management of $1.3B.

**Possible M&A**

The WSJ is reporting that Citigroup may jump into the fray and bid for ABN Amro, which is currently in talks with Barclays PLC.

**Brokered CDs**

Over the past 9Y, brokered deposit usage has jumped from $50B to more than $523B, according to the FDIC.

**Loss**

FHLMC reported a $480mm net loss for the 4Q and said it will buy back about $1B in stock. FHLMC guarantees about 20% of the $10.5T mortgage market.

**Competition**

A group of 87 state bankers associations have sent a letter to Congress urging them to close the ILC loophole and restrict commercial company ownership.

**Subprime**

The Conference of State Bank Supervisors is urging Congress not to use taxpayer funds to bail out subprime lenders, to push such borrowers into 30Y fixed rate loans, to require lenders to consider a borrower's ability to repay a loan before making one and to revamp the FHA to allow it to make loans to such borrowers.

**Competition**

Peer-to-peer lender, Zopa (UK), is expanding service into the US to compete with Prosper Market Place (CA). Both companies offer an eBay type lending experience where consumers can borrow from each other, thereby reducing overall costs of the loans. At this point, most loans traded on the platforms are about $50k or smaller.