

## KEEPING TIME OF BANK PERFORMANCE

by [Steve Brown](#)

Einstein was close. He said time is relative and just a measure of things by using another dimension similar to height or width. Plato was even more correct when he argued that time is a construct, imposed by man, in order to make sense of the world. NIM is a lot like time in the respect that it is an artificial measure usually imposed by management to make sense of performance. Disciples of NIM argue that it is one of the best measures of bank performance. To us, it is just one of many measures and one that can often be misleading. Statistically, NIM is sometimes correlated to performance and sometimes not. In fact, correlating NIM to risk-adjusted ROE, we find that it only tracked performance 51% of the time for independent banks in 2006. That is just a little better than average and tells us that NIM is only loosely tied to long-term earnings performance. To better understand why, consider the construction loan. For the month of April, the average NIM on a construction loan for independent banks came in at just a little under 5%. Most banks would be happy with that type of loan, but compare it to a 10Y loan (on an existing multi-tenant office building) with a 2.50% NIM. All things being equal, the term office building loan has a risk profile that is more than 5x safer than the construction loan. More importantly, the longer maturity allows bankers to net present value cash flows over a longer period of time, thereby resulting in a greater net present value. This is to say nothing about the fact that the construction loan comes with significant overhead expenses. This includes the short-term nature of the loan (which has to then be rolled over again), having to underwrite, administering draws and dealing with the documentation. When all is said and done, the average construction loan originated in April had an expected 15.1% risk-adjusted ROE (down 6bp from March) compared to a 22.8% risk-adjusted ROE for our term office building sample (43+ loans) above. This ROE difference comes despite the fact that the average margin on the office loans are almost half that of the construction loans. Note that we have absolutely nothing against construction loans, but only wish to point out that banks that chase NIM are doing themselves a disservice. A wide NIM can also provide an incentive in a tough market for a bank to take more risk, or inefficiently allocate staff or capital. NIM does not take into account multiple years of cash flows, risk or overhead expenses, like risk-adjusted ROE (our favorite) or risk-adjusted ROA (2nd favorite). Looking at NIM is fine as one measuring stick, but banks should realize that it may not be the best predictor of bank performance. NIM is as they say about the relativity of time – an hour can feel like a day, depending on whose relatives are coming over.

### BANK NEWS

#### **M&A**

National City Corporation will acquire the HC for Mid America Bank, FSB (\$11.1B, IL) for approximately \$1.9B, or 1.7x book. The acquisition boost's National City's IL presence to 126 branches and \$10B in deposits and makes it the 4th largest bank in the market.

#### **Home Sales**

Second homes sales have dropped to 36% of all home sales from 40%, caused mostly by slipping investment home activity (down 29%). Meanwhile, vacation home sales have risen 4.7% over the past 12 months.

#### **Private Clients**

A recent study found that in order to lure wealthy clients, banks will need to offer a broader range of products. Wealthy investors are expressing a desire to go beyond investing in stocks, bonds and real estate.

### **Online Security**

VeriSign and Innovative Card Technologies have teamed up to provide a more secure token for customers conducting online banking transactions. The ICT DisplayCard integrates the security of a one-time password token into a card the size of a standard credit card. Customers push a button on the back of the card and then enter the password that appears in the integrated display (passwords change with every transaction). During an online transaction, the password is entered into a user interface with other information (i.e. a static PIN or login name) for multifactor authentication.

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