THE FLIGHT PATH OF NET INTEREST MARGIN

by Steve Brown

Last week we wrote about how we appreciate when commercial pilots maintain positive gravity in turbulence. We were corrected by an astute Seattle banker (who also happens to be a pilot) that mentioned that you don't want pilots pulling up, as that puts more stress on the wings - exactly at a time when you don't want the added stress. In fact, what you want to do in turbulence is to reduce speed and hold the plane steady. This advice is important as it is the same for when banks hit rough air.

The days of double digit loan growth and focusing on the net interest margin are long gone. The loan data at banks indicate that many banks were below average underwriters of credit quality. In researching the lessons learned from the 2004 to 2007 experience, one takeaway is that banks got themselves in trouble by going after higher margined loans without paying attention to expected credit risk or profitability. The data shows that not only did CEOs not help themselves by focusing on NIM and yield on loans, but they actually ended up hurting themselves by negatively selecting those credits that contained underpriced credit risk or didn't come with sufficient and profitable cross-sell opportunity.

Consider that every quarter we look at the correlation of NIM to ROA. For 2Q, like all the other quarters, it is very weak at best. What is a strong driver of ROA is the modest addition of quality loan growth. If you take NIM, adjust it for overhead cost and credit risk and then add non-interest income you will find that this equation accounts for more than 50% of ROA performance. In other words, this formula serves as a blue print for banks looking to hold their plane steady through the current turbulence.

The loans that have performed the best over the past 3Ys are the loans that continue to outperform in 2Q of 2010. These loans are above $1mm to businesses or developments more than 5Ys old where the overall relationship contained both transactional deposits and fee income. The important point here is this profile is almost the exact opposite of what banks asked for in 2007, which are namely high priced loans on a transactional basis.

To put this into practice, loan growth should primarily be made up of sub-4% margined loans that contain a low expected loss number, but additional business. If banks have a way to measure profitability on a prospective basis, that is best. The next best is to focus those relationships that can bring in a lower cost of funds. That is to say that if you have to focus on only one of the following: fees, deposit costs or loan yield, then focusing on deposit costs is best as that has a higher correlation to ROA.

If banks can't generate loan growth to profitable customers, they must be content on not growing. Consider that an investment alternative is always purchasing a loan from our national C&I program. These loans are larger in size, have credit risk that is better than most banks have in their loan portfolios (lower probability of default), have very little acquisition/maintenance costs and aid in diversification away from CRE. While these loans currently have a 4.5% average yield, what is important is that on a risk-adjusted basis, the expected return is in excess of 12%. In other words, these C&I credits should function like investments as they present a suitable benchmark to deploy capital. While these purchased C&I credits won't help build franchise value, they will help maintain it, which is a whole lot better than destroying it. As a result, going after higher quality loans that come with profitable other business, augmented by purchased loans maybe your best flight path in turbulent times.

To further aid in your analysis of whether you are on the right flight path, we have put together a free model that ranks every bank according to COF, yield on earning assets, NIM, ROE and ROA. This is a good high level check to see if your rankings on NIM components are correlated to earnings performance. To see your 2Q ranking, click here and look at the bottom right under "2Q NIM Comparison."

BANK NEWS

Foreclosures

The latest RealtyTrac survey showed that foreclosure, default and home repos were up 4% in July from June, but still 10% lower than July of 2009.

Insured Life

The FDIC is looking into if some life insurers misled customers by implying that their death benefits are FDIC insured. Proper disclosures are required that while funds may be invested in Treasuries and FDIC deposits at banks, there is no guarantee of payment by the Treasury or FDIC.

OD Guidance

The FDIC put out its Overdraft Payment Program Guidance which points banks in the right direction to implementing and maintaining the oversight of automated overdraft payment programs. The proposed FDIC guidance builds on the Fed's regulations and provides enhanced clarity, particularly on non-electronic (checks, ACH transfers, etc.) OD charges and procedures. Banks have until Sept 27th to comment.

Wells Fargo OD Settle

To underscore the above point, it should be noted that Wells Fargo was ordered to pay $203mm by the U.S. District Court to compensate customers who the judge said were improperly charged millions in overdraft fees. At particular issue was the procedure that Wells allowed the posting of transactions largest to smallest, which was deemed to generate outsized fees.