Throwing NIM to Gain Performance

by Steve Brown

There was a story about a woman who woke up while being robbed in her home. The hapless burglar did not realize that his victim was a former tomahawk throwing champion. She quickly grabbed a throwing ax (she always keeps one nearby while sleeping!) and chased the intruder from her home. Police found him cowering in the bushes in possession of her belongings. He was taken to jail, which we think is a lucky alternative to having an axe stuck in his cranium.

This is a case where the culprit in a problematic situation is completely obvious, but that is not always so in the banking world where the disappearance of interest income is ongoing but the causes are not always clear. Many banks believe that the primary reason for the ongoing difficult earnings environment is a low net interest margin (NIM).

Bankers were cheerier when it seemed like interest rates were moving higher there for a while this summer. While the implications for interest rate risk on bank balance sheets was concerning, there still had to be some relief that perhaps banks could begin to charge higher rates on loans and hopefully rescue declining NIM. Certainly, banks grapple with NIM but identifying it as the key problem could be another case of mistaken identity of the culprit. Certainly banks should be concerned about compressing margins, but the cause isn't as simple as just looking at NIM. Consider that RAROC is risk adjusted return on capital. While seemingly more complex to measure, RAROC is ultimately the primary measure of success in a bank. To understand better, let's explore the typical RAROC killers without the math, as we use common sense to see why chasing NIM can be a self-defeating process.

It seems counterintuitive not to try for a higher yield on a loan, but in a hyper-competitive market for qualified borrowers, anything that seems too good to be true probably is. A customer that will pay an above-market yield probably carries more risk as well so that has to be incorporated somehow. As we have been reminded the past few years, credit risk poses a greater risk to banks than any other factor. Hopefully your bank has a risk adjusted pricing model in order to calculate what yield (if any) is sufficient to overcome that risk. If not, it could be time to update given the complexity of comparing loan structures these days and the creativity of bankers trying to keep existing or capture new clients.

Among the less obvious of RAROC killers is loan size. Flat fees for loan initiation may be larger on a percentage basis and make up for some of the difference on small loans; but almost universally, small loan size is a major contributor to underperformance. Ongoing due diligence, file maintenance etc. requires the same manpower regardless of loan size, so all things being equal, the bigger the loan the better the performance.

Carrying a loan for a borrower that is not interested in having a deeper relationship with your bank is also a big RAROC killer. This customer is likely to be among the most interest rate sensitive and if your bank wins the business for now, it could mean your pricing is not assessing risk in the same manner as your competitors.

It's difficult not to feel like the low interest rate environment isn't taking a tomahawk to your bank's margins. However, if your bank makes its priority to manage risk effectively as you work with customers who value relationships (and be as efficient as is feasible), your bank will thrive well into the future.

BANK NEWS

M&A

Pacific Premier Bank ($1.6B, CA) will buy restaurant franchisee lender Infinity Franchise Capital (NJ) for $16mm in cash (50%) and stock (50%). Infinity offers equipment, land, building, new store development, partnership restructuring, refinance, remodel and store acquisition loans. Pacific is doing the deal to further diversify the loan portfolio with C&I and owner-occupied CRE loans, as it deploys excess liquidity into higher yielding assets.

M&A

Rockville Bank ($2.2B, CT) will merge with United Bank ($2.5B, MA) in a merger of equals deal. United shareholders will own 51% of the company which will be named United Bank. The banks expect to save about 15% of combined expenses with the deal.

M&A

Essa Bank & Trust ($1.4B, PA) will acquire Franklin Security Bank ($213mm, PA) for $15.7mm in cash.

New Group

Investors Bank ($13.3B, NJ) is launching an asset based lending group focused on middle market companies. The group will provide lines of credit, loans and equipment financing.

Competition

PNC Bank (PA) is installing 480 ATMs in Sheetz convenience stores in MD, NC, OH, PA VA and WV.

Spin Off

GE announced it will offer about 20% of its North American retail finance unit (offers private label credit cards and retailer financing) next year and then spin it off entirely in 2015.

Foreclosures

RealtyTrac reports foreclosure filings increased 2% in Oct. vs. Sep. but remain down 28% YOY.

Downgraded

Credit rating agency Moody's has downgraded ratings one notch on Morgan Stanley, Goldman Sachs, JPMorgan and Bank of New York Mellon, citing reduced assumptions about government support following Dodd Frank. Moody's said they believed bank regulators had made "substantive progress" in establishing a credible framework to wind down a large failing bank.