



Historical Margins Are History!

*Net interest income is no longer enough –
Bankers must now turn to other profit centers.*

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A significant concern of most bankers over the past year has been the rapid deterioration of their net interest margin and the stagnation of net interest income. Net interest margin (NIM) compression is not a new phenomenon as evidenced by the graph in Exhibit I which shows a continual decline in NIM since 1992. What's different in the current environment is the rapidity with which this decline has accelerated over the past three quarters for many banks.

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Historical Margins - A Thing of the Past?

As shown in Exhibit I, the banking industry is experiencing a secular decline in NIM. This decline is the result of a number of issues, to name a few: commoditization of most bank products; increasing competition for loans and deposits from insurance companies, mutual funds, investment bankers, credit union and, maybe, Wal-Mart; increasing consumer sophistication and instant access to information via the internet; and the current flat/inverted yield curve.

Over the past three quarters, the two main culprits contributing to the rapid decline of NIM have been the flat or inverted yield curve and the narrowing pricing spreads resulting from intense competition for loan assets. The increasing number of organizations chasing too few assets is not expected to change any time soon. As a result, credit spreads will continue to be at the low end of historical levels. At the same time, the globalization of the economy is expected to keep inflation pressures low and contribute to a flatter future yield curve than has been seen historically. Both of these issues will continue to exert pressures on future NIM's.

What can be done?

Any hope for bank profitability to recover in the future will require an improved understanding of the profit dynamics of the balance sheet and the acceptance of the fact that NIM will probably never return to former levels. For future profits, some banks may be able to find ways to increase non-interest income to offset reductions in NIM and net interest income (NII). However, most banks, especially community-oriented banks, will need to consider other approaches to restore profits.

First of all, many banks are moving away from making loans to customers who do not bring deposits with their relationship. These banks are often using pricing models that consider the total relationship value. Loans without deposits are either quickly declined or priced much higher than relationship loans with deposits.

On the liability side of the balance sheet, many banks are reassessing their pricing of customers that demand high rates or customers whose only relationships are high cost CD specials. These banks are comparing these higher cost customers with wholesale funding alternatives and are finding that wholesale funding might not only be less expensive on an “all-in” cost basis, but also a better fit to managing their desired interest rate risk profile.

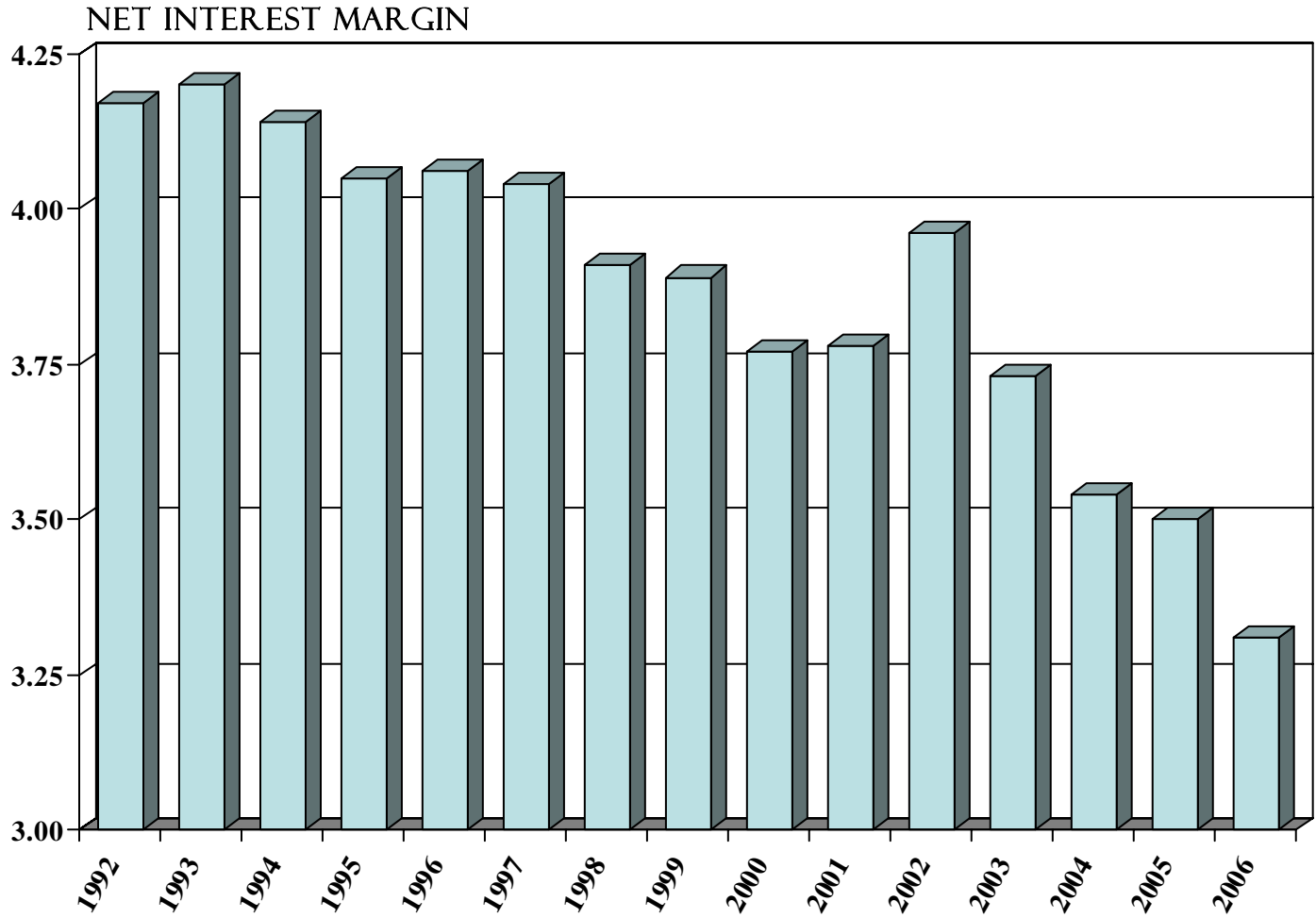
Last, many banks are also taking a very hard look at their operating expenses and product delivery structure. They are looking for ways to use technology to reduce delivery costs and/or improve personnel productivity. They are looking at the role and configuration of their branches to determine if the branches that exist today will be able to meet the evolving role of the branch in the future.

Conclusion

Pressures on net interest margin are not new and are probably here to stay. For banks to thrive in the future, they will need to be more focused on profitable relationships; more non-interest income; improved use of technology; and, improved expense control.

Exhibit I

Bank Net Interest Margin 1992 - 2006



Source for graph data: FDIC Data & Statistics website

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Frank is a managing director of Darling Consulting Group (DCG), working nationwide with CEOs and CFOs of financial institutions to increase earnings through the proactive management of capital, liquidity/funding risk and interest rate risk. He assists clients in understanding and anticipating the effects of changing market conditions on their balance sheets, and develops and implements effective strategies based upon a clear understanding of risk/reward tradeoffs. He is a frequent author and speaker in the banking industry and is on the faculty of numerous educational and banking organizations.

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