SNL Blogs

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Banks face increasing NIM pressure

By Jeff K. Davis

The fourth-quarter 2012 bank reporting season is about half over. The primary bombs vis-à-vis Street quantitative and/or qualitative expectations have been Bank of America Corp., Capital One Financial Corp., Citigroup Inc., First Horizon National Corp. and Northern Trust Corp. due to ongoing noise and challenging revenue outlook. Goldman Sachs Group Inc., Morgan Stanley and several super-regionals, notably Fifth Third Bancorp and BB&T Corp., modestly surprised to the upside, though the CEOs' qualitative comments about potential improvement in the economy may have been more important in driving the shares higher. Pinnacle Financial Partners Inc. had a particularly strong quarter and year that was marked by good loan and revenue growth. Upside and downside surprises notwithstanding, profitability for the sector is reasonably good given NIM pressure, while credit costs continue to recede with the help of the Federal Reserve pumping liquidity into the economy and thereby supporting asset values. Also, mortgage banking income is strong, but will eventually fade as refinance activity runs its course.

I think the dominant theme for 2013 and 2014 will be NIM pressure that is going to be much more severe — especially by Q4'13 — than the Street envisions. It may not matter that much for the stocks in terms of downside pressure given that many trade near the group's long-term average of 13x to 14x current earnings. Price-to-tangible book values are modest, but so too are ROTEs vis-à-vis pre-crisis returns. The exceptions are the largest banks that still appear inexpensive, especially if the economy modestly surprises to the upside and the trading businesses do not produce large negative surprise.

As the Street produces its updates for a given company, I think investors should focus on loan yields. NIMs reflect many attributes within a balance sheet that cannot always be reduced to a common denominator such as the yield curve is flattening, though that matters for most banks. Expansion into higher yielding specialty lending, extension of duration in the bond portfolio, and the movement of deposits from CDs to noninterest bearing deposits can mask what is occurring in the core business.

Summary yields and cost of funds

	U.S. Bancorp (USB)			Associated Banc-Corp (ASBC)			Commerce Bancshares (CBSH)			Huntington Bancshares (HBAN)		
Yield/cost of funds (%)	**Q4'12**	**Q4'11**	**Δ (pps)**	**Q4'12**	**Q4'11**	**Δ (pps)**	**Q4'12**	**Q4'11**	**Δ (pps)**	**Q4'12**	**Q4'11**	**Δ (pps)**
Commercial and industrial	3.41	3.82	-0.41	3.92	4.13	-0.21	3.29	3.53	-0.24	3.88	4.01	-0.13
Commercial real estate	4.43	4.57	-0.14	4.11	4.39	-0.28	4.33	4.67	-0.34	4.19	3.99	0.20
1-4 residential mortgage	4.35	4.75	-0.40	4.59	4.71	-0.12	4.15	4.64	-0.49	4.07	4.30	-0.23
Total loans	3.55	3.60	-0.05	3.98	4.27	-0.29	4.64	5.01	-0.37	4.13	4.28	-0.15
Total securities (TE)	2.48	2.91	-0.43	2.79	2.76	0.03	2.59	2.56	0.03	2.43	2.46	-0.03
COF - IB deposits	0.38	0.48	-0.10	0.30	0.53	-0.23	0.28	0.37	-0.09	0.42	0.61	-0.19
Net interest margin (TE)	**3.55**	**3.60**	**-0.05**	**3.32**	**3.21**	**0.11**	**3.35**	**3.44**	**-0.09**	**3.45**	**3.38**	**0.07**

As of Jan 18, 2013
TE = taxable equivalent
During the survey period, 30-Day LIBOR, a benchmark for C&I loans, fell 8 basis points, while the 5-year swap rate, a benchmark for CRE loans, fell 50 basis points.
Sources: Company quarterly reports and the Federal Reserve's H.15 (selected interest rates-daily)

The big picture so far has been a declining cost of funding that has significantly cushioned the reduction in asset yields. That is about to run its course, however, as the COF leverage tapers off as bond and loan yields continue to ease.

Loan yields seem to be somewhat sticky in Q4'12. Has pricing suddenly hardened? I do not believe so. Competition is intense given tepid-to-fair loan demand against a backdrop of a system that is awash in liquidity. CRE yields in particular have not declined much even though banks are increasingly returning to this traditional sector. Why has this occurred? One reason is that as problem loans are being resolved, interest recoveries have increased. Also, pre-payment activity is very high. Unamortized loan fees are recognized in interest income when a pre-payment occurs.

As pre-payment activity runs its course and new loans are booked with fewer floors than was the case in past years, I expect the pace of reduction in loan yields will quicken in 2013 vs. what occurred in 2012. The pressure may be more intense for banks that have a relatively high amount of CRE and residential mortgage loans. As shown in the table, the small sample experienced less reduction in the overall yield in their CRE books vs. the five-year swap rate. Conversely, C&I yields in the sample tightened more so than did 30-day LIBOR, which implies that C&I heavy banks may see better NIM performance over the coming year than CRE and residential mortgage heavy banks.

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