



Orest Gavrylak
Analytical Coordinator
Senior Financial Analyst -
Financial Institutions Group
+1 212 806 3235
ogavrylak@dbrs.com

Alan G. Reid
Managing Director -
Financial Institutions Group
+1 212 806 3232
areid@dbrs.com

Roger Lister
Chief Credit Officer -
Financial Institutions Group
+1 212 806 3231
rlister@dbrs.com

Brenda Lum, CA, CFA
Managing Director -
Canadian Financial
Institutions
+1 416 597 7569
blum@dbrs.com

Larry J. White
Managing Director -
Business Development
+1 212 806 3282
lwhite@dbrs.com

Toronto
DBRS Tower
181 University Avenue
Suite 700
Toronto, ON M5H 3M7
+1 416 593 5577

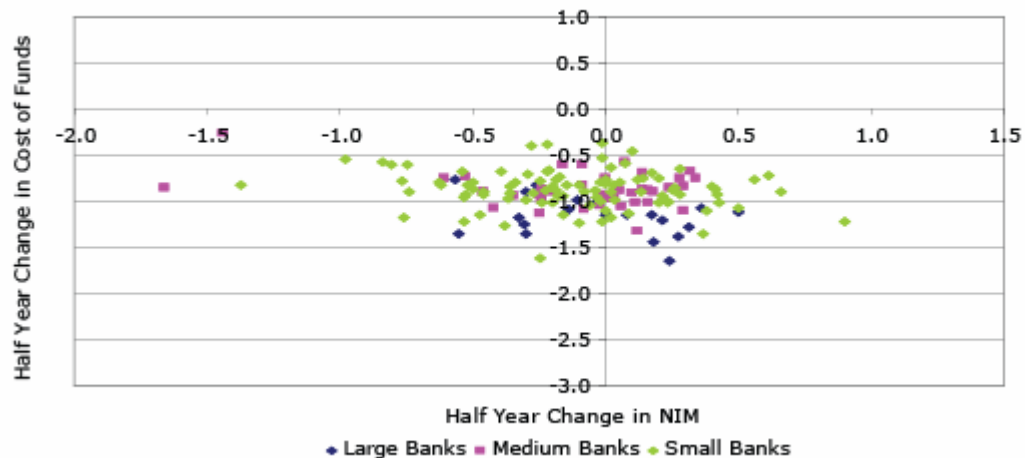
New York
140 Broadway
35th Floor
New York, NY 10005
+1 212 806 3277

Chicago
101 North Wacker Drive
Suite 100
Chicago, IL 60606
+1 312 332 3429

LOST IN TRANSLATION – LOWER FUNDING COSTS OFTEN NOT IMPROVING U.S. BANKS’ NIM

Despite the reductions by the Federal Reserve (the Fed) in the Fed funds target rate by 225 basis points (bps) in 2008 and by 325 bps over the past year, many U.S. banks have not translated the resulting lower cost of funds into a noticeable improvement in their net interest margin (NIM). In fact, many banks have experienced NIM compression. While all the banks* that DBRS analyzed experienced a drop in their cost of funds, the median decline for the group was only 87 bps (Exhibit 1). Moreover, banks with greater reductions in funding costs (y-axis) did not consistently reflect improved NIM (x-axis). One factor contributing to NIM compression has been sharply increased competition for deposits. As we discussed in our [August 20, 2008, newsletter](#), asset yields are also playing a more important role in this cycle; banks that experience less decline in their loan and asset yields are better able to maintain their NIMs.

Exhibit 1. Change from Q4 2007 to Q2 2008 – NIM vs Cost of Funds (%)



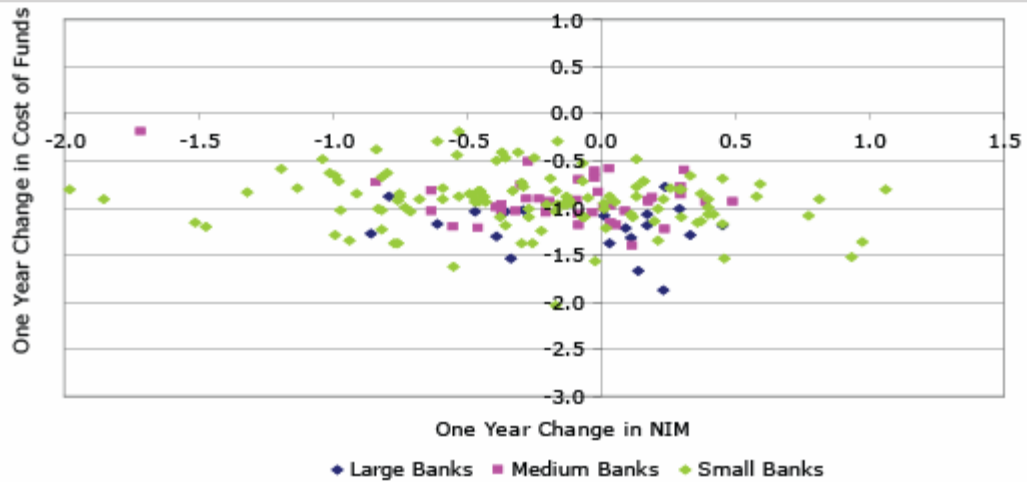
Source: SNL Financial; DBRS.

In general, the outcome was similar for large (> \$20 billion in assets), medium (\$5 - \$20 billion) and small (< \$5 billion) banks. Large banks do appear to be benefiting more from rate cuts in terms of greater declines in their cost of funds, but they are not consistently translating this advantage into NIM expansion any more than small or medium-sized banks can.

The picture is largely the same from a one-year perspective. Again, all banks that were analyzed experienced a drop in their funding cost between Q2 2007 and Q2 2008, but only 36% experienced an increase in their NIM (Exhibit 2). Over the past year to Q2 2008, large banks have been marginally more successful in expanding NIM than small or medium-sized competitors. About 68% of the small and 62% of the medium-sized banks experienced a decrease in NIM, while only 43% of the large banks experienced NIM compression.

* The 192 public commercial banks analyzed represent banks with over \$1 billion in assets, excluding banks with incomplete data sets through Q2 2008.

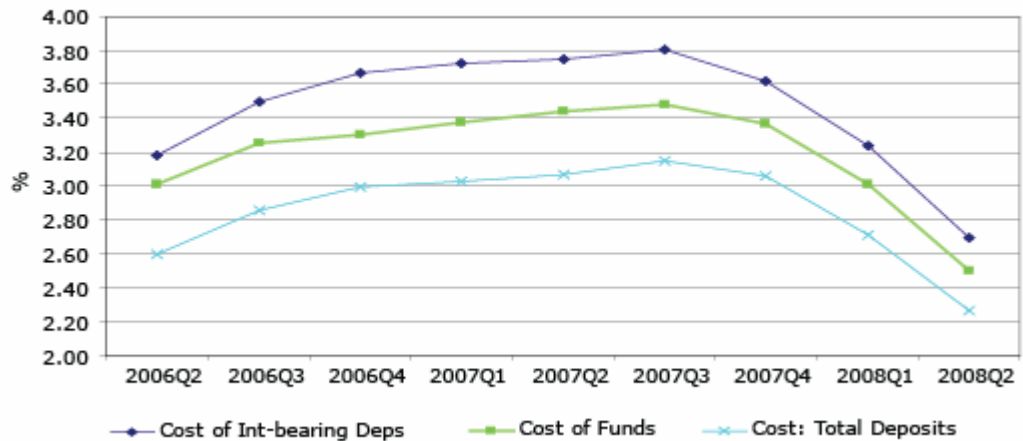
Exhibit 2. Change from Q2 2007 to Q2 2008 – NIM vs Cost of Funds (%)



Source: SNL Financial; DBRS.

Intense competition for deposits appears to be a factor constraining the reduction in deposit costs and funding costs from falling as much as might be expected given the Fed rate cuts. Indeed, the median cost of total deposits and cost of funds fell 80 bps and 94 bps from Q2 2007 to Q2 2008, respectively, versus the Fed rate cut of 325 basis points (Exhibit 3). In competing for deposits, banks have been working to bolster liquidity and funding. As the funding needs of some competitors increased as their access to wholesale markets declined, their aggressive competition for deposits has become a greater factor constraining the decline in deposit rates. Nonetheless, DBRS notes that the utilization of more lower-cost wholesale funding may have been a factor narrowing the gap between the cost of funds and the cost of deposits.

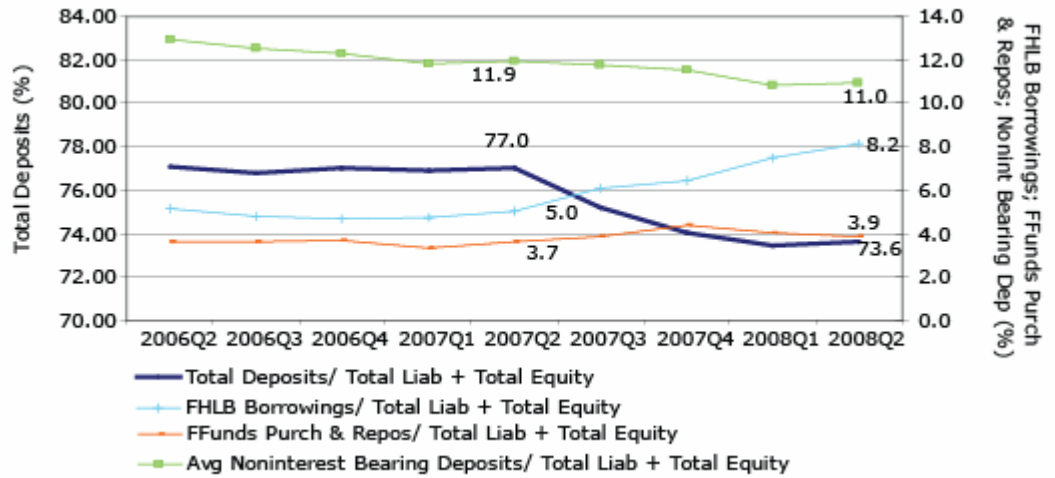
Exhibit 3. U.S. Commercial Banks - \$1 B + (Median)



Source: SNL Financial; DBRS.

Responding to greater difficulty in growing deposits at acceptable deposit rates, banks have utilized other funding sources in order to try and keep pace with declining loan yields. As deposit costs for some banks have remained stubbornly high, banks have employed larger amounts of FHLB advances and, to a much lesser degree, Fed funds and repurchase agreements over the past year. For the banks analyzed, total deposits to total liabilities and equity decreased from 77% at June 30, 2007, to 73.6% at June 30, 2008 (Exhibit 4). Offsetting, FHLB borrowings increased from 5.0% of total liabilities and equity to 8.2% and Fed funds and repurchase agreements increased marginally from 3.7% to 3.9% over the same period.

Exhibit 4. U.S. Commercial Banks - \$1 B + (Median)



Source: SNL Financial; DBRS.

Rating Implications

Despite the Fed rate cuts, banks are struggling to maintain, let alone improve, NIM in this challenging cycle. DBRS views positively those banks that are successfully maintaining or improving NIM in this environment. This success is indicative of sound interest rate risk management and resilient franchises. For banks with a sustained decline in NIM, DBRS looks more closely at the sources of the decline to ascertain whether the drivers are indicative of broader deterioration in a bank's franchise or financial position. In future newsletters, we will investigate the extent to which success in the current environment reflects strength in both preserving asset yields and achieving funding cost reductions.

For further information, please contact:

Mark Nolan
 Vice President
 U.S. Financial Institutions
 +1 212 806 3234
mnolan@dbrs.com



PRIOR NEWSLETTER ARTICLES

(Please click on each title to access the article)

2008

Fannie and Freddie Preferred Stock Exposures Not Material at U.S. Banks Rated by DBRS	August 27, 2008
Preserving Loan Yields Helps NIM at U.S. Banks	August 20, 2008
Enhancement of Fed Liquidity Facilities Positive for Financial Institutions	August 13, 2008
Dusting Off The Texas Ratio: What It Does And Doesn't Tell Us	August 8, 2008
Negative Ratings Outlook on U.S. Broker Dealers	August 5, 2008
U.S. Consumer Loan Performance: The Storm Clouds Gather	July 30, 2008
U.S. Banks Q2 Earnings: Problematic Assets, Higher Credit Costs, No Visa Boost	July 23, 2008
So Far, So Good: C&I Loans Weathering Economic and Housing Downturn	July 21, 2008
When and Where Did You Buy?: The Divergent Impact of Housing Stress Across U.S. Metro Areas	July 2, 2008
Residential Mortgages Risk Containment and Trends	June 25, 2008
A Difficult Cycle for U.S. Banks	June 19, 2008
Q2 2008 Canadian Bank Earnings – Domestic Retail Shines in Tough Market Environment	June 12, 2008
Loan Quality Deterioration Led by Real Estate	June 10, 2008
Aiming for Consistency: DBRS U.S. Bank Ratings	May 21, 2008
U.S. Banks – Coping with Challenging Environment	May 15, 2008
Less Access to Home Equity, More Stress for Households	May 7, 2008
Implications for DBRS Ratings of Unrealized Losses in Banks' AFS Securities	May 1, 2008
The Good, the Bad and the Ugly: Q1 2008 Earnings for U.S. Banks	April 23, 2008
Deteriorating Asset Quality for Banks' HELOCs and Junior Liens Likely to Continue for Several Quarters	April 17, 2008
Canadian Banks: Q1 2008 Earnings Divergent	April 2, 2008
Coping with Rising Loan Loss Provisions – Historical Perspective on U.S. Banking	March 26, 2008
Term Auction Facility (TAF) – A Kinder, Gentler Discount Window	March 12, 2008
Home Sales – The Leading Indicator for Housing and Economy	March 5, 2008
Housing Market Stress Also Affecting Consumer Lenders	February 27, 2008
Tighter Underwriting and Weaker Demand: What It Means for Banks' Earnings and Ratings	February 13, 2008
U.S. Job Growth – Signpost Now Points Down	February 6, 2008
Troubles at Financial Guarantors Add to Burden on Banks	February 4, 2008
U.S. Banks Q4 2007 Earnings: Credit Costs and One-Timers Hurt the Bottom Line	January 23, 2008
Deposit Costs Still a Drag on Spreads	January 16, 2008

Please refer to www.dbrs.com for DBRS's [Privacy Policy](#), [Disclaimers](#), [Proprietary Rights](#), [Terms and Conditions of Use](#). To stop receiving these mailings, please send an email to dbrs_nafi-unsubscribe@news.dbrs.info with 'unsubscribe' in the subject line.