

One Thing Still Working: Borrow Low, Lend Higher

By VALERIE BAUERLEIN

It's hard to believe, but not all the news in banking is bad. As market fears continue to swirl over whether the government will nationalize some large U.S. institutions, others are starting to see the benefit of a return to old-fashioned, bread-and-butter banking.

Several of the nation's biggest regional banks have reported recent upticks in net interest margin, one of the most fundamental drivers of bank profits, as dirt-cheap funding and choosier loan policies are making it easier for them to borrow money at a low rate, lend it at a higher rate, and pocket the difference.

U.S. Bancorp's net interest margin rose to 3.8% in the fourth quarter from 3.5% a year earlier, driving a 23% annual bump in interest income. Another regional bank, BB&T Corp., said its net interest margin rose to 3.7% in the fourth quarter from 3.5% a year earlier, a significant change when the slightest bump translates to a boost in earnings. Even some community banks, like First Keystone Financial Inc. of the Philadelphia suburb of Media, which has eight branches, highlighted a small jump in net interest margin as the one good thing redeeming an otherwise dismal fourth quarter.

The Federal Deposit Insurance Corp. called margin improvement "one of the few relatively bright spots" in its third quarter banking profile, the most recent published.

"Boring banking is beautiful," says Robert S. Patten, a banking analyst at Morgan Keegan & Co.

Net interest margin is the percentage difference between the interest income produced by a bank's loans and investments and the interest paid on certificates of deposit, savings accounts and other deposits.

It's a far cry from the no-interest loans, packaged securities backed by risky mortgages, and other exotic schemes that banks relied on for rich profits when the housing market and overall economy were booming -- and that have toppled some institutions. Interest-rate cuts and other government interventions in credit markets have made it possible for banks to pay little for funding now. At the same time, loan pricing is improving as banks get choosier about the loans they make and as the secondary market for bundled loans withers.

Deposit pricing is also shrinking as bad-apple banks that charged high rates to lure deposits have gone rotten or disappeared. The average rate on six-month CDs fell to 1.2% this week from 3.6% in August 2007, according to Bankrate.com, showing that banks are borrowing money cheaply from their own customers, as well as the government.

"When all this shakes out, the banks that come through it are going to be in very good shape," says Nancy Bush, analyst at NAB Research LLC in Annandale, N.J. "Net interest income is going to be the driver."

The uptick so far is admittedly tiny and isn't likely to rise much higher until banks clean up souring loans or slough them off to the government. Net interest margins are still hovering at historically low levels. And while the average margin for the top 50 banks rose to 3.3% in the third quarter, it slipped to 3.27% in the fourth quarter, according to SNL Financial of Charlottesville, Va. Banks say the Federal Reserve's rate cut in December caused loan rates to fall and reined in the margin. Souring loans are expected to weigh on banks for several more quarters.

Still, even if margin improvements are small, they offer hope at a time when the industry is otherwise mired in doom and gloom. While bank stocks are beaten down, the margin can be an indicator of the health of a company's strategy and its pricing discipline. U.S. Bancorp, for example, earning \$1.61 a

share last year, putting its price-to-earnings ratio at just over 6, far cheaper than the overall stock market. BB&T earned \$2.49 last year and has a P/E ratio of 6.7.

Banks flourished a decade ago in the heyday for net interest margin, when strong consumer spending and favorable interest rates spurred earnings growth of as much as 20% a year. Ms. Bush says no one should expect a return to that earnings growth, but steady single-digit growth may be realistic.

BB&T, with 1,500 branches concentrated in the Southeast, is particularly bullish about the return of basic banking. "I really believe when we get through this, we're going to see some of the best times in basic commercial banking we've seen in a long time," CEO Kelly King said last month in a conference call with analysts.

Mr. King recalled how securitization transformed the industry over the past quarter-century, with banks losing loan volume and the ability to set the prices they charged for them as those loans were parceled out to investors. Now that the securitization market has dried up, Mr. King said BB&T is already able to charge as much as 1% more on its large loans in the past four months, a reflection of the risk the company is taking on and the tight loan market.

Banks also say they are seeing floors on how low loan rates can go. Meantime, customers are embracing traditional, low-interest investments such as CDs after seeing their mutual-fund investments fall in value.

"Once we get through this cycle of 12 to 18 months, we are in for eight to 10 years of really good operating conditions for good spread lending institutions like us," Mr. King said.

Some bank analysts warn it is too soon to cheer. Friedman, Billings, Ramsey Group Inc. analyst Paul Miller says net interest margin can't make a comeback with President Obama "pushing mortgage rates down to 4%." Most companies are looking at the margin being flat for the year. "It is a bigger hope than reality," he says.

But Mr. Patten, the Morgan Keegan analyst, predicts that net interest margins could expand 0.20 to 0.40 of a percentage point over the next 12 months, largely in the second half of the year.

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