THRIFT INDUSTRY HIGHLIGHTS

SECOND QUARTER 2002

Office of Thrift Supervision / August 26, 2002

SUMMARY

The thrift industry once again reported very strong results in the second quarter 2002. Earnings and profitability were higher from the comparable year ago quarter and only slightly lower than the prior quarter's record high. The sustained strength in earnings and profitability continued to be attributable to a favorable interest rate environment.

Longer-term interest rates fell slightly over the quarter, resulting in a small decline in the industry's aggregate net interest margin, but the yield curve remained steep. Mortgage originations remained at high levels due to favorable mortgage interest rates and continued strength in the nation's housing markets. Although mortgage interest rates remained at historically attractive levels over the second quarter, they generally were higher than late last year and levels of mortgage refinancing continued to fall.

The industry's equity capital ratio climbed to a record high at the end of the second quarter. Asset quality improved for most loan types in the quarter. The level of troubled assets (defined as noncurrent loans and repossessed assets), fell for the first time in two years. Loans past due by 30- to 89-days fell for the third consecutive quarter and the overall level of credit quality in the thrift industry has remained good.

EARNINGS AND PROFITABILITY

Net income in the second quarter reached $2.86 billion, up 14 percent from the year ago second quarter, but down six percent from the record level of the prior quarter. Profitability, as measured by return on average assets (ROA), was 1.19 percent, up from 1.05 percent in the second quarter one year ago, but down slightly from a record 1.24 percent in the prior quarter.

Return on average equity (ROE) was 13.2 percent, up from 13.0 percent in the second quarter one year ago, but down from 14.7 percent in the prior quarter. The drop in ROE from the prior quarter reflected the industry's lower earnings and growth in equity capital in the second quarter.

ANALYSIS OF ROA

The decline in second quarter ROA from the prior quarter resulted from higher write-downs of mortgage servicing assets, a slightly lower aggregate net interest margin (NIM), higher loan loss provisions, and higher noninterest expenses. These decreases were partially offset by higher fee income, higher noninterest income, and lower taxes. Extraordinary items reduced ROA by one basis point in the second quarter, down from a one basis point gain in the first quarter. The extraordinary items in the first and second quarters resulted primarily from the early extinguishment of debt by two large thrifts.

In the second quarter, NIM for the industry was 311 basis points, down from 318 basis points in the prior quarter, but up from 282 basis points in the comparable quarter a year ago. The decline in NIM over the second quarter resulted from asset repricing and investment at lower yields and an increase in wholesale borrowing costs as thrifts lengthened maturities of wholesale borrowings to take advantage of lower longer-term interest rates during the quarter. Over the quarter, interest income as a percentage of average assets fell 17 basis points while interest expense declined by only 9 basis points.

Loss provisions on interest bearing assets increased in the second quarter to 0.34 percent of average assets from 0.27 percent in the prior quarter and 0.26 percent in the second quarter one year ago. Loss provisions have averaged 0.28 percent of average assets since the beginning of 2001, and are generally higher than in recent years, reflecting the slower economy, higher unemployment, and the need to bolster reserves in the face of increased exposure to commercial and consumer lending.

Total fee income, including mortgage loan servicing fee income and other fee income, fell to 0.37 percent of average assets in the second quarter from 0.86 percent in the prior quarter and 0.76 percent in the second quarter one year ago. Since 2001, total fee income has been depressed by lower mortgage loan servicing fee income as a consequence of write-downs of mortgage servicing portfolios by a number of thrifts. These write-downs resulted from higher mortgage prepayments, which decreased the duration and cash flow of servicing assets. Servicing fee income in the second quarter was negative 0.47 percent of average assets, down from 0.05 percent in the prior quarter and negative 0.04 percent in the second quarter one year ago.

Other fee income climbed to 0.84 percent of average assets in the second quarter from 0.81 percent in the prior quarter and 0.80 percent in the comparable year ago quarter. Fee income has generally grown over the past two years due to increases in fees from retail banking, trust activities, the sale of mutual funds and annuities, and loan servicing income from nonmortgage loans. Retail banking fees are generated from lending (activity fees, origination fees, insurance premiums, and penalty fees), and deposit taking (ATM charges, transaction account fees, and penalty fees).

Higher gains from sales of assets increased other noninterest income in the second quarter to 1.06 percent of average assets from 0.43 percent in the prior quarter and 0.70 percent in the second quarter one year ago. Other noninterest income primarily includes gains on sales of assets, dividends on FHLB stock, and income from leasing office space. Other noninterest income is typically volatile since it includes realized gains and losses on assets and the results of balance sheet restructuring activities.

Noninterest expense, unchanged at 2.37 percent of average assets from the comparable quarter a year ago, was up from 2.29 percent in the prior quarter. General and administrative expense, the largest component of noninterest expense, rose to 2.31 percent of average assets in the second quarter from 2.25 percent in the prior quarter and 2.28 percent in the second quarter one year ago. Office occupancy, marketing, and loan origination and servicing expenses were all higher.

Taxes were 0.64 percent of average assets, down from 0.68 percent in the prior quarter, but up from and 0.61 percent in the second quarter one year ago. Over the past two years, taxes have averaged 0.56 percent of average assets, or about 36 percent of pretax income. Extraordinary items lowered ROA by one basis point in the second quarter, primarily reflecting losses from the early extinguishment of debt by one large thrift.

MORTGAGE ORIGINATIONS

Total mortgage originations (which include multifamily and nonresidential mortgages) for the thrift industry were $109.2 billion in the second quarter, down from $111.0 billion in the prior quarter and from a record $125.0 billion in the second quarter one year ago. Although the volume of mortgage refinancing was lower in the second quarter, home sales and mortgage loan demand remained very strong as mortgage interest rates remained affordably low. Second quarter 1-4 family mortgage originations by thrifts totaled $92.8 billion, down from $97.4 billion in the prior quarter and $109.6 billion originated in the second quarter one year ago.

Thrifts' estimated share of all 1-4 family originations[1] climbed to 19.4 percent of total 1-4 family originations in the second quarter from 18.0 percent in the prior quarter. About 50 percent of thrift originations were adjustable rate mortgages (ARMs) in the second quarter, up from 40 percent in the prior quarter and 27 percent in the second quarter one year ago. In contrast, the ARMs share for all lenders was 20 percent in the second quarter, 17 percent in the prior quarter, and 11 percent in the comparable year ago quarter.[2] The rising ARMs share in the second quarter reflected higher long-term mortgage interest rates over much of the quarter.

The volume of mortgage refinancing was lower over the second quarter as mortgage interest rates remained higher until late in the quarter. Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 30.3 percent of thrift originations in the second quarter, down from 38.9 percent in the prior quarter. In the second quarter a year ago, refinancing accounted for 22.2 percent of thrift originations.

ASSET QUALITY

The thrift industry as a whole continued to maintain good asset quality in the second quarter. Troubled assets, which include noncurrent loans and repossessed assets, fell to 0.70 percent of assets from 0.72 percent in the prior quarter. One year ago troubled assets stood at 0.64 percent. Repossessed assets were unchanged from the prior quarter and one year ago at 0.10 percent of assets.

Noncurrent loan rates (loans over 89 days past due or in nonaccrual status) fell over the second quarter to 0.60 percent of assets, and noncurrent rates (as a percentage of total loan type) moved lower for most loan types. Noncurrent loan rates for multifamily mortgages and commercial nonmortgage loans were higher from the prior quarter. Noncurrent multifamily loans were 0.20 percent of all multifamily loans, up three basis points from 0.17 percent in the prior quarter. Noncurrent commercial loans jumped to 2.48 percent of all commercial loans from 2.27 percent at the end of the prior quarter.

Mortgages on 1-4 family dwellings and multifamily mortgages are the mainstay of the thrift industry and together make up over half of thrift assets. The industry's concentration in this

---

1 Total 1-4 family mortgage originations estimated by the Mortgage Bankers Association of America.

2 Data are from the Federal Housing Finance Board's monthly *Mortgage Interest Rate Survey*.

sector accounts for its strong credit quality. Noncurrent loan rates for 1-4 family loans were 0.82 percent of all 1-4 family loans at the end of the second quarter, down from 0.87 percent at the end of the first quarter.

Noncurrent construction and land loans fell to 1.65 percent of all construction and land loans from 1.82 percent in the prior quarter. Noncurrent nonresidential mortgages were lower over the quarter at 1.34 percent of all nonresidential mortgages. Noncurrent consumer loans fell to 0.50 percent of all consumer loans from 0.55 percent at the end of the first quarter.

Loans past due by 30 to 89 days in the aggregate were lower for the third consecutive quarter at the end of the second quarter. Past due rates moved higher only for consumer loans. Total loans past due by 30 to 89 days declined to $6.2 billion, or 0.64 percent of assets, from $7.1 billion, or 0.71 percent of assets at the end of the prior quarter, and from $6.7 billion, or 0.69 percent of assets, one year ago.

INTEREST RATE RISK

The interest rate sensitivity of the thrift industry improved slightly in the second quarter of 2002. OTS uses its Net Portfolio Value (NPV) Model to assess an institution's vulnerability to changes in interest rates. The model estimates changes in the net economic value of a portfolio of assets and liabilities due to changes in interest rates. The change in the NPV capital ratio due to an adverse, hypothetical movement in interest rates is used to measure the sensitivity of the portfolio to rate changes. Based on preliminary data from 859 reporting institutions, the industry's median sensitivity measure fell to 162 basis points from 192 basis points in the prior quarter and 199 basis points one year ago. This decreased sensitivity reflects the effects of lower interest rates during the second quarter.

Median NPV ratios were slightly lower in the second quarter. Median pre-shock NPV was 13.0 percent in the second quarter, down from 13.1 percent in the prior quarter, but up from 12.6 percent one year ago. Median post-shock NPV decreased to 11.3 percent from 11.4 percent in the first quarter and was up from 10.7 percent one year ago. (See the forthcoming *Quarterly Review of Interest Rate Risk* for details).

ASSETS, LIABILITIES, AND CAPITAL

Industry assets fell at an annualized rate of 13.4 percent during the second quarter to $964 billion from $998 billion at the end of the prior quarter. The decline was due to a large thrift's charter conversion during the quarter. The number of thrift institutions supervised by OTS, fell to 995 at the end of the second quarter from 1,007 in the prior quarter and 1,049 one year ago. Thrifts remain focused on residential mortgage lending, with 46.6 percent of assets invested in 1-4 family mortgage loans at the end of the second quarter, up slightly from 45.5 percent in the prior quarter. Construction and land loans were unchanged at 2.9 percent of assets. Holdings of multifamily mortgages increased to 4.8 percent of assets, while consumer loans fell slightly to 6.5 percent of assets. Commercial loans were lower from at 2.9 percent of assets.

Deposits decreased to $564 billion from $581 at the end of the prior quarter. As a percentage of total assets, deposits increased slightly to 58.5 percent from 58.2 percent in the prior quarter. Federal Home Loan Bank advances declined to 18.6 percent of assets at the end of the second quarter from 19.4 percent in the prior quarter.

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. Over 98 percent of the industry exceeded well-capitalized standards at the end of the second quarter. Equity capital reached a record 9.1 percent of assets at the end of the second quarter, up from 8.7 percent in the prior quarter. Capital growth over the quarter resulted from growth in retained earnings, new capital brought into the industry, and unrealized gains on assets held for sale.

PROBLEM THRIFTS

The number of problem thrifts remained at a low level in the second quarter. Problem thrifts - those with composite examination CAMELS ratings of 4 or 5 -fell by one to 18. Assets of problem thrifts decreased to $3.5 billion from $14.7 billion in the prior quarter and $5.8 billion in the second quarter one year ago. One small thrift with $51.6 million in assets failed in the second quarter.

Thrifts with composite CAMELS ratings of 3 increased to 74 in the second quarter from 71 in the prior quarter. The number of thrifts rated 3 stood at 83 one year ago. Assets of 3-rated thrifts were $50.3 billion in the second quarter, up from $23.3 billion in the prior quarter, but down from $56.7 billion one year ago. Thrifts with composite ratings of CAMELS 3 exhibit some weaknesses that may range from moderate to severe in one or more of the ratings components. These institutions are more vulnerable to adverse conditions and require more supervisory attention. Of the 74 thrifts rated 3, 92 percent were well capitalized, providing them with some degree of cushion to work through their problems.