

Thrift Industry Highlights - Q1 2001

## THE OTS-REGULATED THRIFT INDUSTRY FIRST QUARTER 2001 HIGHLIGHTS

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### SUMMARY

The thrift industry posted strong results in the first quarter 2001. Industry earnings and key profitability measures - return on average assets (ROA) and return on average equity (ROE) - were up from fourth quarter levels. The aggregate net interest margin (NIM) for the industry also expanded as shorter-term interest rates declined sharply.

Asset growth was strong, reflecting strength in mortgage lending and deposit generation. Not surprisingly, with the slowing economy and rising unemployment, noncurrent asset levels rose slightly. In the first quarter, noncurrent loan rates were higher for all major loan types. Still, overall credit quality in the thrift industry remains at a high level.

### EARNINGS AND PROFITABILITY

First quarter earnings climbed 12 percent to \$2.16 billion from \$1.93 billion in the fourth quarter, but were down three percent from the very strong first quarter one year ago when the industry earned \$2.23 billion. Losses were reported by 132 thrifts, or 12.5 percent of all thrifts, in the first quarter, down from 157 thrifts in the prior quarter, but up from 113 thrifts in the first quarter one year ago.

The industry's return on average assets was 0.92 percent in the first quarter, up from 0.84 percent in the prior quarter, but short of the 1.04 percent posted in the first quarter one year ago. Return on average equity rose to 11.5 percent in the first quarter from 10.61 percent in the prior quarter, but was down from 13.46 percent in the first quarter one year ago.

### ANALYSIS OF ROA

The first quarter improvement in ROA was driven by two factors - growth in NIM and other noninterest income, up 9 and 21 basis points, respectively. These factors more than offset the negative effects of higher loss provisions, lower fee income, rising noninterest expense, and a higher tax burden.

NIM improved in the first quarter to 267 basis points, from the fourth quarter's 258 basis points, as lower interest rates reduced the relative cost of short-term borrowings and deposits. In the first quarter, interest expense as a percentage of average assets fell 27 basis points, outpacing a 17 basis point drop in interest income. However, not all thrifts reported improved NIM. On average, thrifts over \$500 million in assets reported higher NIM in the first quarter while NIM for thrifts under \$500 million reported slightly lower NIM.

Higher loss provisions on interest-bearing assets continued to have a negative impact on ROA. Reflecting slower economic activity and higher noncurrent loan levels, provisions rose to 0.24 percent of average assets from 0.22 percent in the prior quarter and 0.15 percent in the first quarter one year ago.

Fee income was lower in the first quarter at 0.74 percent of average assets, down from 0.83 percent in the prior quarter and 0.76 percent in the first quarter one year ago. The decline was due to a drop in the value of mortgage servicing assets. Increased prepayment speeds resulting from lower mortgage interest rates in the first quarter depressed the market value of mortgage servicing rights as the expected remaining life of mortgage servicing rights shortens with accelerating prepayments.

Growth in other fee income was driven by growth in trust assets, fees from sales of mutual funds and annuities, loan servicing income from nonmortgage loans, and increases in retail banking fees. Retail banking fees are generated from lending (penalty fees, activity fees, origination fees, insurance premiums), and deposit taking (penalty fees, ATM charges, transaction account fees). In the first quarter, other fee income increased to 0.75 percent of average assets, up from 0.72 percent in the prior quarter and 0.64 percent in the first quarter one year ago.

Other noninterest income climbed to 0.58 percent of average assets. Other noninterest income includes the sale of assets held for investment or sale, dividends on FHLB stock, and income from leasing office space. Gains from sales of assets held for sale resulting from increased mortgage banking activity over the quarter helped to bolster other noninterest income. In the fourth quarter, other noninterest income was 0.37 percent of average assets and one year ago it was 0.29 percent. Other noninterest income is typically volatile since it includes gains and losses on assets held for sale and the results of balance sheet restructuring activities.

Noninterest expense increased to 2.28 percent of average assets in the first quarter from 2.25 percent in the prior quarter and 2.09 percent in the first quarter one year ago. General and administrative expense, the largest component of noninterest expense, climbed to 2.20 percent of average assets in the first quarter from 2.17 percent in the fourth quarter. Personnel costs, office occupancy and equipment expense, and marketing expense all rose.

Taxes were higher in the first quarter at 0.54 percent of average assets and were 0.49 percent in the fourth quarter. Since 1996, taxes have averaged 0.51 percent of average assets.

For thrifts with a December 31 fiscal yearend - the majority of OTS-supervised institutions - the first quarter adoption of Financial Accounting Statement (FAS) 133 on accounting for derivatives and hedging had only a small impact on industry earnings. FAS 133 applies to firms with derivatives, as defined, including interest rate exchange agreements, such as swaps, caps, and floors. Under FAS 133, all derivatives, including those used for risk management purposes, must be reported on the balance sheet at fair value.

As was the case for much of 2000, the yield curve was inverted at yearend, meaning that yields for shorter-term securities were higher than for many longer-term securities. An inverted yield curve is problematic for the typical thrift because interest expense climbs more rapidly than interest income. By the end of the first quarter, however, the yield curve was more normally

sloped as short-term interest rates dropped sharply. This dramatic improvement in the short end of the yield curve resulted from the Federal Reserve's 150 basis point cut in the target rate for federal funds over the first quarter. And through the end of May, the slope of the yield curve steepened as the Federal Reserve lowered its target rate for federal funds by another 100 basis points. This should mean continued net interest margin improvement for the thrift industry in the second quarter.

## **INTEREST RATE RISK**

The interest rate risk exposure and sensitivity of the thrift industry declined significantly throughout 2000. OTS uses its Net Portfolio Value (NPV) Model to monitor the interest rate risk of thrifts. 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 200 basis points movement in interest rates is used to measure the sensitivity of the portfolio to rate changes. Based on preliminary data from 893 reporting institutions, the industry's median sensitivity measure increased to 190 basis points from 180 basis points in the prior quarter. This increased sensitivity stems from a reduction in the effective duration of liabilities as a result of a methodological change to the NPV Model in the first quarter. (See the forthcoming Quarterly Review of Interest Rate Risk for details.)

The median pre-shock NPV ratio rose to 12.5 percent in the first quarter. This increase for the quarter is attributable to a general fall in interest rates and a methodological change to the NPV Model that results in slightly more favorable deposit intangibles. (See the forthcoming Quarterly Review of Interest Rate Risk for details.) The median post-shock NPV ratio increased to 10.7 percent in the first quarter. This rise in the median post-shock NPV ratio reflects the increase in the median pre-shock NPV ratio, and shows that the industry is better able to withstand interest rate shocks.

## **ASSET COMPOSITION**

Thrifts remain focused on residential mortgage lending, with 48.1 percent of assets invested in 1-4 family mortgage loans at the end of the first quarter, up slightly from 47.9 percent one year ago. Holdings of mortgage pool securities, construction and land loans, and nonresidential mortgages increased slightly over the year, while multifamily mortgages were lower as a percentage of assets than year-ago levels.

Commercial and consumer lending portfolios of thrifts have grown over the last several years. These loans typically have shorter terms and higher yields than home mortgage loans. Commercial loans were 3.0 percent of assets at the end of the first quarter, up from 2.6 percent one year ago. Consumer loans were up slightly to 6.3 percent of assets from 6.2 percent of assets one year ago.

## **MORTGAGE ORIGINATIONS**

Mortgage originations rose sharply in the first quarter as mortgage interest rates declined and the volume of mortgage refinancing increased. Originations of 1-4 family mortgages totaled \$74.3 billion in the first quarter, up 34 percent from \$55.3 billion in the fourth quarter. Mortgage

origination volume in the first quarter was the second highest quarterly volume. The record was set in the fourth quarter of 1998 when 1-4 family mortgage originations totaled \$81.5 billion.

Total mortgage originations in the first quarter (which include multifamily and nonresidential mortgages) increased to \$87.6 billion from \$69.0 billion in the fourth quarter and \$51.9 billion in the first quarter one year ago.

Thriffs' share of all 1-4 family originations, as estimated from data obtained from the Mortgage Bankers Association of America (MBAA), was 21.2 percent of total originations in the first quarter, up from 21.1 percent in the fourth quarter and 19.9 percent in the first quarter one year ago. About 36 percent of thrift originations were adjustable rate mortgages (ARMs), down from 57 percent in the fourth quarter. In contrast, the ARMs share for all lenders was 11 percent in the first quarter and 16 percent in the fourth. Homeowners were less attracted to ARMs in the first quarter as the decline in long-term mortgage interest rates through March increased the attractiveness of fixed rate mortgages.

Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 14.9 percent of thrift originations in the first quarter, up sharply from 10.8 percent in the fourth quarter and 10.5 percent in the first quarter one year ago. Refinancing activity increased due to the decline in longer term interest rates.

## **ASSET QUALITY**

Although the thrift industry as a whole continued to maintain excellent asset quality in the first quarter, troubled assets, which include noncurrent loans and repossessed assets, climbed slightly to 0.62 percent of assets from 0.60 in the fourth quarter.

Noncurrent loan rates (loans over 90 days past due or in nonaccrual status) increased to 0.53 percent of assets in the first quarter from 0.50 percent in the fourth quarter. Noncurrent loan rates were higher for all major loan types. Noncurrent 1-4 family mortgages were 0.69 percent of all 1-4 family mortgages at the end of the first quarter, up from 0.67 percent in the prior quarter. Noncurrent multifamily mortgages rose to 0.18 percent of all multifamily mortgages from 0.15 percent in the fourth quarter. Noncurrent consumer loans stood at 0.83 percent of all consumer loans in the first quarter, up from 0.81 percent. Noncurrent nonresidential mortgages rose to 1.21 percent of all nonresidential mortgages from 0.96 percent in the fourth quarter. Noncurrent construction and land loans were 1.27 percent of all construction and land loans, up from 1.13 percent in the prior quarter. Noncurrent commercial loans climbed to 1.64 percent of all commercial loans in the first quarter from 1.52 percent in the fourth quarter.

In contrast to noncurrent loans, loans past due by 30 to 89 days were lower for most loan types in the first quarter. Total loans past due by 30 to 89 days fell to \$6.6 billion, or 0.70 percent of assets, from \$6.9 billion in the fourth quarter, but was up from \$4.9 billion one year ago.

## **BORROWINGS AND CAPITAL**

Deposits held by thriffs increased to \$543.2 billion from \$529.4 billion in the fourth quarter and

\$505.7 billion one year ago. As a percentage of total assets, however, deposits were unchanged at 57.0 percent in the first quarter, and down from 58.2 percent one year ago. Although Federal Home Loan Bank (FHLB) advances were slightly lower at the end of the first quarter, over the past year advances have been the dominant source of incremental funding for asset growth. At the end of the first quarter, advances were 22.8 percent of total assets, up from 22.2 percent one year ago.

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. At the end of the first quarter, 98 percent of the industry exceeded well-capitalized standards. Equity capital was 8.1 percent of assets, up from 7.7 percent a year ago. Capital growth resulted from new capital brought into the industry, growth in retained earnings, and unrealized gains on available for sale securities. Only four thrifts were less than adequately capitalized at the end of the first quarter.

### **PROBLEM THRIFTS**

Despite the slower economy and some concerns about credit quality, the number of problem thrifts remains at a low level. Problem thrifts - those with composite examination ratings of 4 or 5 - decreased by one to 14. Assets of problem thrifts were \$5.0 billion at the end of the first quarter, down from \$7.2 billion in the fourth quarter. Problem thrift assets were \$5.3 billion one year ago.

Thrifts with composite ratings of 3 declined to 90 in the first quarter from 98 in the prior quarter. The number of thrifts rated 3 stood at 80 one year ago. Thrifts with composite ratings of 3 exhibit some weaknesses that may range from moderate to severe in one or more of the ratings components. These institutions may be more vulnerable to adverse conditions and require a higher level of supervisory attention. Of the 90 thrifts rated 3, 91 percent were well capitalized, providing them with some degree of cushion to work through their problems.

### **STRUCTURAL CHANGES**

In the first quarter, 17 thrifts left OTS supervision, compared with 25 thrifts in the prior quarter. Exits were due primarily to charter conversions and acquisition activity. There were eight new entrants in the first quarter, down from 11 in the prior quarter. Of the new entrants, five were de novo charters and three were conversions to a thrift charter.

The number of thrift institutions supervised by OTS fell to 1,059 at the end of the first quarter from 1,068 in the prior quarter and 1,097 one year ago. Industry assets climbed at a 10.6 percent annual rate during the first quarter to \$953 billion from \$929 billion in the prior quarter. First quarter industry assets were the highest since March 1991, when they totaled \$981 billion.

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<sup>1</sup> Data are from the Federal Housing Finance Board's monthly Mortgage Interest Rate Survey.