Thrift Industry Highlights - Q3 2000

THE OTS-REGULATED THRIFT INDUSTRY THIRD QUARTER 2000 HIGHLIGHTS

Office of Thrift Supervision / December 6, 2000

SUMMARY

The thrift industry had a solid, but not a record third quarter. Earnings fell from the level of the second quarter, and profitability, as measured by return on assets and return on equity, also declined. Nevertheless, the thrift industry remains strong, healthy, and profitable, and its performance in the third quarter was reasonably good by historical comparison.

EARNINGS AND PROFITABILITY

Third quarter earnings were $1.9 billion, down from $2.0 billion in the second quarter and $2.1 billion in the third quarter one year ago. Earnings were down 7.9 percent from the second quarter and 11.1 percent from the third quarter one year ago. The new SFAS 133 rule on accounting for gains and losses on derivatives had a modest negative impact on thrift earnings in the third quarter. These adjustments will affect more firms over the next several quarters.

The industry's return on average assets (ROA) was 0.83 percent in the third quarter, down from 0.92 percent in the prior quarter and 0.98 percent in the third quarter one year ago. Return on average equity (ROE) was also lower at 10.7 percent in the third quarter, down from 12.0 percent in the prior quarter and 12.2 percent in the third quarter one year ago. While down from 1998 and 1999 levels, this period's ROA was similar to that of 1997, and was reasonably strong taking into account the fact that this is the first time since 1982 that the industry has operated for an extended period under a sharply inverted yield curve, where 1-year Treasury yields exceed 30-year Treasury yields.

ANALYSIS OF ROA

The decline in ROA from the second quarter and the comparable year ago quarter can be traced to lower net interest margins and other noninterest income, and rising noninterest expense. Also, one-time restructuring charges resulted in net losses at several large thrifts. On the positive side, fee income continued to climb relative to total assets, loss provisions declined from the second quarter (but were up from one year ago), and taxes were slightly lower.

Pressure on thrift net interest margins continued in the third quarter. Net interest margin fell to 259 basis points in the third quarter, from 265 basis points in the second quarter and 271 basis points one year ago. This was the industry's lowest net interest margin since December 1991 when it was 250 basis points. About 75 percent of the industry reported lower net interest margins in the third quarter compared to the prior quarter. The margin compression continued to reflect the impact of an inverted yield curve, rising funding costs, and pressure resulting from lower yielding adjustable rate mortgages (ARMs) that have not yet fully adjusted to current market rates.

Other noninterest income, a relatively volatile component of revenue, fell to 0.30 percent of average assets from 0.35 percent in the second quarter. This figure is well below 0.39 percent one year ago when thrift institutions benefited from a higher level of mortgage banking activity and reported more gains from the sale of assets held for sale. Other noninterest income in the second quarter was boosted by gains from asset sales and a special dividend paid on stock of the Federal Home Loan Bank of San Francisco.

Noninterest expense increased to 2.21 percent of average assets from 2.13 percent in the second quarter and 2.07 percent in the third quarter one year ago. The increase was due to higher marketing, loan origination, and acquisition-related expenses.

Among the positive factors affecting ROA, fee income rose to 0.83 percent of average assets, up from 0.78 percent in the second quarter, and well above 0.65 percent one year ago. Fee income growth has been driven by increases in deposit and retail banking fees, and growth in trust assets administered by thrifts.

Loss provisions on interest-bearing assets fell to 0.18 percent of average assets in the third quarter from 0.20 percent in the second quarter, but were up from 0.14 percent in the third quarter one year ago. The third quarter drop reflected higher second quarter provisions at several institutions. Provisions were consistent with levels seen in recent years.

INTEREST RATE RISK

OTS uses its Net Portfolio Value (NPV) Model to monitor thrifts' interest rate risk. The model estimates changes in the net economic value of a thrift's portfolio of assets and liabilities due to changes in interest rates. The change in a thrift's NPV capital ratio due to an adverse, hypothetical 200 basis points movement in interest rates is used to measure the sensitivity of a thrift's portfolio to rate changes. Based on preliminary data from 957 reporting institutions, the industry's median sensitivity measure declined to 211 basis points from 234 basis points in the prior quarter. This reduced sensitivity represents the impact of a reduced duration mismatch with asset durations declining while liability durations remained flat.

Median NPV capital ratios remained strong for the quarter, although the pre-shock NPV ratio was down very slightly from 11.2% in the second quarter to 11.1%. The pre-shock NPV ratio remained steady despite an inverted yield curve in light of a declining interest rate environment. The post-shock NPV ratio improved to 9.05% from 8.94% in June. This increase in the post-shock NPV ratio reflects the benefit of the reduced interest rate sensitivity of the industry.

ASSET COMPOSITION

Thrifts continue to be primarily residential mortgage lenders, with 49.1 percent of assets invested in 1-4 family mortgage loans at the end of the third quarter, up slightly from 48.8 percent one year ago. Holdings of nonresidential mortgages and construction and land loans increased slightly over the past year, while multifamily mortgages and mortgage pool securities were down as a percentage of assets from year-ago levels.

The commercial and consumer lending portfolios of thrifts have grown somewhat over the last several years. These loans typically have shorter terms and higher yields than home mortgage loans. Commercial loans were 2.9 percent of assets at the end of the second quarter, up from 2.1 percent one year ago. Consumer loans grew to 6.4 percent of assets from 6.3 percent of assets one year ago.

The number of thrifts with nonresidential mortgage or commercial nonmortgage loan portfolios exceeding 10 percent of total assets fell slightly in the third quarter. Thrifts with construction and land loan portfolios exceeding 10 percent of assets increased somewhat in the third quarter.

MORTGAGE ORIGINATIONS

Home sales and mortgage loan demand remained strong in the third quarter as mortgage interest rates continued to moderate from their five-year highs reached in May. Total mortgage originations (which include multifamily and nonresidential mortgages) fell slightly to $65.8 billion from $66.6 billion in the second quarter and $69.3 billion in the third quarter one year ago. Third quarter 1-4 family mortgage originations by thrifts were $53.2 billion, up 0.5 percent from $52.9 billion in the second quarter, but 4.6 percent lower than the $55.8 billion originated in the third quarter last year.

Thrifts' share of all 1-4 family originations, as estimated from data obtained from the Mortgage Bankers Association of America (MBAA), was 18.6 percent of total 1-4 family originations in the third quarter, up from 18.1 percent one year ago, and down slightly from 19.2 at the end of the second quarter. About 66 percent of thrift originations were ARMs in the third quarter, down from 72 percent in the second quarter. In contrast, the ARM shares for all lenders were 21 percent in the third quarter and 30 percent in the second.[1] The lower ARM shares for the third quarter reflect the decline in long-term mortgage interest rates from their May highs.

Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 9.0 percent of thrift originations in the third quarter, up from 8.7 percent in the second quarter, but down from 11.0 percent one year ago. Refinancing activity has picked up recently due to the decline in longer term interest rates.

ASSET QUALITY

Asset quality measures remained healthy, but show some signs of deterioration. Troubled assets (noncurrent loans and repossessed assets) remained unchanged from the prior quarter at 0.58 percent of assets.

Noncurrent loan rates (loans over 90 days past due or in nonaccrual status) generally remain at low levels and, overall, continue to reflect good asset quality in the thrift industry and the unprecedented strength of the U.S. economy. Noncurrent loan rates for 1-4 family loans were unchanged from the prior quarter at 0.65 percent. Noncurrent loan rates continued to decline for multifamily mortgages and were slightly lower for commercial loans. Noncurrent multifamily mortgages fell to 0.18 percent in the third quarter from 0.20 percent the prior quarter. Noncurrent commercial loans fell slightly to 1.27 percent in the third quarter from 1.28 percent the prior quarter.

However, there are some areas of concern. Noncurrent construction and land loans rose to 0.77 percent from 0.76 percent in the prior quarter and 0.66 percent one year ago. Noncurrent nonresidential mortgages increased to 0.94 percent from 0.90 percent in the second quarter, but were down from 1.07 percent one year ago. Noncurrent consumer loans rose to 0.78 percent from 0.73 percent in the second quarter and 0.76 percent one year ago. Although increases in noncurrent loans are a concern, these increases are from a very low base.

Loans past due by 30 to 89 days were higher for all but commercial loan types. Rising delinquencies of loans 30 to 89 days past due are worrisome because they may be a precursor to higher levels of troubled assets going forward. Total loans past due by 30 to 89 days rose to $5.7

billion, or 0.63 percent of total assets, in the third quarter from $5.0 billion in the prior quarter and $5.1 billion one year ago.

The increase in delinquent consumer loan levels, after several years of decline, suggests the potential start of a trend of weakening in consumer loans. This is an area OTS will continue to monitor closely.

Total loss provisions declined to 0.18 percent of average assets in the third quarter from 0.20 percent in the prior quarter. Net charge-offs were down five basis points from the prior quarter at 0.14 percent of average assets and were consistent with levels over the past two years.

BORROWINGS AND CAPITAL

Deposits held by thrifts increased to $518.1 billion from $508.8 billion in the second quarter and $493.7 billion one year ago. As a percentage of total assets, however, deposits declined to 57.0 percent from 57.3 percent in the prior quarter. Non-deposit borrowings, including Federal Home Loan Bank advances, have continued to be the dominant source of incremental funding for asset growth. At the end of the third quarter, total borrowings were 32.6 percent of assets, unchanged from the second quarter.

Capital measures for the industry are strong, relatively stable, and well in excess of minimum requirements. Although capital ratios have declined from historical peaks, 98 percent of the industry exceeds well-capitalized standards. In the third quarter, equity capital was 7.9 percent of assets, up from 7.7 percent in the second quarter, but down from 8.0 percent a year ago. Only two thrifts were less than adequately capitalized at the end of the third quarter.

PROBLEM THRIFTS

The number of problem thrifts - those with composite examination ratings of 4 or 5 - fell by one to 13. Assets of problem thrifts declined to $7.2 billion at the end of the third quarter from $7.6 billion in the second quarter. One year ago, there were 10 problem thrifts with $3.8 billion in assets

A regulatory concern noted the past two quarters is the rising number of thrifts with composite ratings of 3 on their most recent examinations. 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 may require a higher level of supervisory attention. At the end of the third quarter, 95 thrifts with $34.9 billion in assets were rated 3, up from 86 thrifts with $34.2 billion in assets in the prior quarter. These ratings downgrades have largely been due to higher interest rate risk exposure and credit quality concerns. Of the 95 thrifts rated 3, 93 percent were well capitalized, providing them with some degree of cushion to work through their problems.

STRUCTURAL CHANGES

In the third quarter, 17 thrifts left OTS supervision, compared with 18 thrifts in the prior quarter. Exits were due primarily to merger and acquisition activity. There were 8 new entrants in the third quarter, down from 12 in the prior quarter. Of the new entrants, seven were de novo charters and one was a conversion to a thrift charter.

The number of thrift institutions supervised by OTS fell to 1,082 in the third quarter from 1,091 in the prior quarter and 1,111 one year ago. The decline thus far in 2000 of 21 institutions was the

smallest in 14 years. Industry assets increased at a 9.0 percent annual rate to $908 billion at the end of the third quarter from $888 billion in the prior quarter. Asset growth was 5.3 percent from the third quarter a year ago when industry assets were $863 billion. Industry assets today are the highest since 1991, when they totaled $895 billion.

---

[1] Data are from the Federal Housing Finance Board's monthly Mortgage Interest Rate Survey.