Thrift Industry Highlights - Q3 2001

THE OTS-REGULATED THRIFT INDUSTRY THIRD QUARTER 2001 HIGHLIGHTS

Office of Thrift Supervision / December 6, 2001

SUMMARY

The thrift industry reported strong results in the third quarter 2001. Broad strength in the housing market fueled by lower mortgage interest rates produced record quarterly earnings and drove the industry's return on average assets (ROA) higher. Net interest margin (NIM) for the industry also expanded in the third quarter due to lower shorter-term interest rates. Meanwhile, the broad-based decline in interest rates also helped to reduce the industry's interest rate risk exposure. Asset and loan growth continued at a moderate pace. Deposit growth was also moderate, with most of the growth in deposits with balances over $100,000. The slowing economy and rising unemployment drove delinquent loan levels slightly higher. Still, credit quality in the thrift industry remains good - reflecting the industry's concentration in residential lending and its limited exposure to commercial lending and nonmortgage consumer lending.

EARNINGS AND PROFITABILITY

Third quarter earnings reached a record $2.61 billion, up four percent from $2.51 billion in the prior quarter. Earnings were up 42 percent from $1.84 billion in the third quarter one year ago. The number of thrifts reporting losses in the third quarter was 116, down from 132 thrifts in the prior quarter and from 134 thrifts in the third quarter one year ago.

The industry's ROA was 1.08 percent in the third quarter, up from 1.05 percent in the prior quarter and 0.82 percent in the third quarter one year ago. ROE rose to 13.11 percent in the third quarter from 12.97 percent in the prior quarter and 10.58 percent in the third quarter one year ago.

ANALYSIS OF ROA

The third quarter improvement in ROA was driven by the expansion in net interest margin and other noninterest income, up 12 and 11 basis points, respectively. These increases more than offset the negatives of higher loan loss provisions, additional impairment reserves for mortgage servicing rights, and higher taxes.

NIM improved to 294 basis points (or 2.94 percent of average assets) in the third quarter from 282 basis points in the prior quarter. NIM expanded because lower shorter-term interest rates reduced the cost of short-term borrowings and deposits. In the third quarter, interest expense as a percentage of average assets fell 43 basis points while interest income declined by 31 basis points. Despite the improved NIM for the industry as a whole, NIM for thrifts under $100 million in assets was unchanged. Portfolios at many of these smaller thrifts are adjusting more slowly to the changes in interest rates.

The slope of the Treasury yield curve grew steeper in the third quarter as the Federal Reserve lowered its target rate for federal funds by another 75 basis points. As in the prior quarter, lower shorter-term interest rates contributed to the net interest margin improvement.
Loss provisions increased in the third quarter to 0.32 percent of average assets from 0.26 percent in the prior quarter and 0.18 percent one year ago. The higher provisions are consistent with the slower economy, rising unemployment, and the need to bolster reserves in the face of increasing noncurrent assets.

Total fee income, including mortgage loan servicing fee income and other fee income, fell to 0.59 percent of average assets in the third quarter from 0.76 percent in the prior quarter and 0.83 percent in the third quarter one year ago. As in each of the prior two quarters, total fee income was depressed by lower mortgage loan servicing fee income resulting from write-downs of mortgage servicing portfolios by a number of thrifts. These write-downs reflected lower servicing asset values resulting from higher mortgage prepayments due to the refinancing boom. Servicing fee income was negative 0.21 percent of average assets in the third quarter, down 17 basis points from the prior quarter and 33 basis points from the third quarter one year ago.

Other fee income was 0.80 percent of average assets in the third quarter, unchanged from the prior quarter and up from 0.71 percent in the third quarter one year ago. The industry reported growth in fees from sales of mutual funds and annuities, but lower retail banking fees due to slower economic activity at the end of the quarter. Retail banking fees are generated from lending (activity fees, origination fees, insurance premiums, and penalty fees), and deposit activity (ATM charges, transaction account fees, and penalty fees).

Other noninterest income climbed 11 basis points in the third quarter to 0.81 percent of average assets, and was up 51 basis points from a year ago. This increase was due to gains from sales of assets held for sale resulting from increased mortgage banking activity over the quarter. Other noninterest income includes the sale of assets held for investment or sale, dividends on FHLB stock, and income from leasing office space. 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 was down two basis points from the prior quarter at 2.35 percent of average assets, but up from 2.21 percent in the third quarter one year ago. The largest component of noninterest expense, general and administrative expense, was down two basis points from the prior quarter. Personnel costs were slightly higher, while office occupancy, equipment and marketing expenses were lower.

Taxes were up one basis point in the third quarter to 0.62 percent of average assets. The increase reflects the higher level of earnings. Over the past two years, taxes have averaged 0.53 percent of average assets, or about 36 percent of pretax income. Extraordinary items added three basis points to net income in the third quarter, primarily reflecting the after-tax gain from the liquidation of interest rate hedges by a large thrift.

MORTGAGE ORIGINATIONS

Mortgage originations eased somewhat in the third quarter as new loan settlements were delayed for a short time after the September 11 terrorist attacks and the pace of existing home sales slowed from the prior quarter. Nevertheless, the volume of mortgage refinancing surged over the quarter as mortgage interest rates eased further. Originations of 1-4 family mortgages totaled $103.8 billion in the third quarter, down five percent from the record $109.6 billion in the second quarter.

Although third quarter mortgage originations in the thrift industry were off the record second quarter pace, in the first nine months of 2001 originations had surpassed the annual record set in 1998. Total mortgage originations, which include multifamily and nonresidential mortgages, were $118.7 billion in the third quarter, down from a record $125.0 billion in the second quarter.

Thrifts' share of all 1-4 family originations, as estimated from data obtained from the Mortgage Bankers Association of America (MBAA), was 23.4 percent of total originations in the third quarter, up from 22.9 percent in the second quarter and 20.7 percent in the third quarter one year ago. About 36 percent of thrift originations were adjustable rate mortgages (ARMs), up from 28 percent in the second quarter. In contrast, the ARMs share for all lenders was 15 percent in the third quarter and 11 percent in the second quarter.[1] Homeowners are less attracted to ARMs when long-term mortgage interest rates trend lower.

Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 28.8 percent of thrift originations in the third quarter, up sharply from 22.2 percent in the second quarter and 9.0 percent in the third quarter a year ago. Refinancing activity increased due to the decline in longer-term interest rates.

ASSET QUALITY

The thrift industry as a whole continued to maintain good asset quality in the third quarter. However, troubled assets, which include noncurrent loans (loans over 90 days past due or in nonaccrual status) and repossessed assets, climbed to 0.68 percent of assets from 0.64 in the second quarter.

Although repossessed assets remained stable at 0.10 percent of assets in the third quarter, noncurrent loan rates increased to 0.58 percent from 0.54 percent in the second quarter. Noncurrent loan rates were higher for most loan types. Noncurrent 1-4 family mortgages increased to 0.77 percent of all 1-4 family mortgages at the end of the third quarter from 0.72 percent in the prior quarter. The noncurrent rate on construction and land loans was 1.69 percent, up from 1.39 percent in the prior quarter.

Noncurrent nonresidential mortgages climbed to 1.43 percent of all nonresidential mortgages from 1.19 percent in the second quarter. Noncurrent consumer loans stood at 0.74 percent of all consumer loans in the third quarter, up from 0.71 percent in the prior quarter. The noncurrent rates for multifamily mortgages and commercial loans were unchanged from the prior quarter at 0.16 percent and 1.62 percent, respectively.

Loans 30 to 89 days past due increased in the third quarter to 0.79 percent of assets, or $7.7 billion, up from 0.69 percent, or $6.7 billion in the second quarter. One year ago past due loans stood at 0.63 percent of assets, or $5.7 billion. Reflecting weaker economic conditions, past due rates were higher for most loan types. Past due loan rates were lower for multifamily mortgages and construction and land loans.

With the recent rise in noncurrent assets, thrifts have been increasing loss provisions to cover actual and expected loan losses. In the third quarter, total loss provisions increased to 0.33

percent of average assets from 0.27 percent in the prior quarter. Net charge-offs were up one basis point to 0.23 percent of average assets from the prior quarter. Total loss allowances increased by two basis points to 0.66 percent of assets in the third quarter as loss provisions exceeded net charge-offs. At the end of the third quarter, thrifts held $1.03 in loss allowances for every $1.00 of noncurrent loans.

INTEREST RATE RISK

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 point movement in interest rates is used to measure the sensitivity of the portfolio to rate changes. Based on preliminary data from 924 reporting institutions, the industry's median sensitivity measure decreased to 177 basis points from 199 basis points in the prior quarter. This decreased sensitivity stems from a fall in interest rates at all maturities between the second and third quarters.

The median pre-shock NPV ratio fell slightly to 12.3 percent in the third quarter from 12.6 percent in the second quarter. The median post-shock NPV ratio fell slightly to 10.6 percent. The level of the median post-shock NPV ratio shows that the industry is well-positioned to withstand interest rate shocks. For more detailed information on interest rate risk in the thrift industry, see the forthcoming Quarterly Review of Interest Rate Risk.

ASSET COMPOSITION

Although assets grew 7.3 percent over the past four quarters, third quarter growth was sharply lower at 3.9 percent on an annualized basis. Thrifts remain focused on residential mortgage lending, with 47.7 percent of assets invested in 1-4 family mortgage loans at the end of the third quarter, down slightly from 48.0 percent in the second quarter and 49.1 percent one year ago. Holdings of commercial loans, mortgage pool securities, and investment securities as a percentage of assets were lower from the prior quarter, while multifamily mortgages, nonresidential mortgages, and consumer loans were higher.

Construction loan growth slowed in the third quarter to a rate that was lower than the growth rate of total assets. This continues a slower growth trend that began in the prior quarter. Commercial and consumer lending portfolios of thrifts have generally grown over the last several years. Commercial loans were 3.1 percent of assets at the end of the third quarter, down from 3.2 percent in the prior quarter. Consumer loans increased to 6.6 percent of assets from 6.2 percent in the second quarter.

BORROWINGS AND CAPITAL

Deposits grew at a faster pace than assets in the third quarter. Deposits held by thrifts increased to $553.5 billion from $544.8 billion in the second quarter and $518.1 billion one year ago. As a percentage of total assets, deposits climbed to 56.8 percent from 56.5 percent in the second quarter, but were down from 57.0 percent one year ago. The strong deposit growth reflects some movement of funds out of the equities markets and the emphasis by some thrifts in the third quarter to increase deposits. Federal Home Loan Bank (FHLB) advances were lower at 21.9 percent of total assets, down from 22.5 percent one year ago. Other borrowings also declined as thrifts gained lower costing deposits.

Capital measures for the industry remained strong, stable, and well in excess of minimum requirements. At the end of the third quarter, 98 percent of the industry exceeded well-capitalized standards and these thrifts hold over 99 percent of industry assets. Equity capital was 8.36 percent of assets, up from 8.14 percent in the prior quarter and 7.87 percent one year ago. Capital growth over the past year resulted from new capital brought into the industry, growth in retained earnings, and unrealized gains on available for sale securities. Three thrifts were less than adequately capitalized at the end of the third quarter. One thrift failed and was placed in conservatorship on July 27.

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 16. Assets of problem thrifts were $3.5 billion at the end of the third quarter, down from $5.8 billion in the second quarter. Problem thrift assets were $7.2 billion one year ago. Thrifts with composite ratings of 3 declined to 73 in the third quarter from 83 in the prior quarter.

The number of thrifts rated 3 stood at 95 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 73 thrifts rated 3, 86 percent were well-capitalized, providing them with some degree of cushion to work through their problems.

STRUCTURAL CHANGES

In the third quarter, 18 thrifts left OTS supervision, compared with 15 thrifts in the prior quarter. Exits were due primarily to bank acquisitions and thrift merger activity. There were six new entrants in the third quarter, up from four in the prior quarter. Of the new entrants, two were de novo charters and four were conversions to an OTS-regulated thrift charter. Two of the conversions immediately merged to form a single thrift.

The number of thrift institutions supervised by OTS fell to 1,037 at the end of the third quarter from 1,049 in the prior quarter and 1,082 one year ago. Industry assets climbed at a 3.9 percent annual rate during the third quarter to $974 billion from $965 billion in the prior quarter.

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