Thrift Industry Highlights - Q2 2001

THE OTS-REGULATED THRIFT INDUSTRY SECOND QUARTER 2001 HIGHLIGHTS

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SUMMARY

The thrift industry reported strong results in the second quarter 2001. Industry earnings set a new quarterly record. Continued housing market strength and low mortgage interest rates fueled earnings and boosted key profitability measures - return on average assets (ROA) and return on average equity (ROE). The aggregate net interest margin (NIM) for the industry also expanded as shorter-term interest rates declined further.

Asset growth, however, slowed to a more moderate pace from the higher growth rates of recent quarters. 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

Second quarter earnings rose sharply to a record $2.51 billion, up 16 percent from $2.16 billion in the first quarter. Earnings were up 24 percent from the same quarter one year ago when the industry earned $2.02 billion. The number of thrifts reporting losses in the second quarter was 131, down from 133 thrifts in the prior quarter, but up from 106 thrifts in the second quarter one year ago.

The industry's ROA was 1.05 percent in the second quarter, up from 0.92 percent in the prior quarter and in the second quarter one year ago. Second quarter ROA was third best quarterly ROA after 1.13 percent and 1.07 percent in the third and second quarters, 1998, respectively. ROE rose to 12.95 percent in the second quarter from 11.51 percent in the prior quarter and 12.01 percent in the second quarter one year ago.

ANALYSIS OF ROA

The second quarter improvement in ROA was driven by growth in net interest margin and other noninterest income, up 14 and 11 basis points, respectively. These increases more than offset the negatives of rising noninterest expense and higher taxes.

NIM improved to 282 basis points (or 2.82 percent of average assets) in the second quarter from 268 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 second quarter, interest expense as a percentage of average assets fell 37 basis points, nearly three times the 13 basis point drop in interest income. Despite the improved NIM for the industry as a whole, NIM for thrifts under $100 million in assets was lower on average. Portfolios at many of these smaller thrifts are adjusting more slowly to the changes in interest rates.

Over the second quarter, the slope of the Treasury yield curve steepened as the Federal Reserve lowered its target rate for federal funds by another 100 basis points. The lower shorter-term interest rates contributed to the net interest margin improvement in the second quarter. During the first quarter, shorter-term interest rates dropped sharply and the curve became upward sloping, after being inverted for much of 2000.

Loss provisions in the second quarter were unchanged from the first quarter at 0.26 percent of average assets, but were up six basis points from 0.20 percent in the second quarter one year ago. The higher provisions are consistent with the slower economy, rising unemployment levels, and thrifts' changing loan portfolio mix.

Total fee income, including mortgage loan servicing fee income and other fee income, increased to 0.76 percent of average assets in the second quarter from 0.73 percent in the prior quarter. As in the first quarter, second quarter 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. Second quarter servicing fee income was negative 0.04 percent of average assets, down three basis points from negative 0.01 percent in the prior quarter.

Other fee income, however, increased to 0.80 percent of average assets in the second quarter from 0.74 percent in the first quarter and 0.66 percent in the second quarter one year ago. Thrifts reported increases in retail banking fees, growth in trust assets, fees from sales of mutual funds and annuities, and 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).

Other noninterest income climbed further in the second quarter, rising 11 basis points to 0.70 percent of average assets. This increase was due to gains from sales of assets held for sale resulting from increased mortgage banking activity over the quarter. In the second quarter a year ago, other noninterest income was 0.35 percent. 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 increased to 2.37 percent of average assets from 2.28 percent in the first quarter and 2.13 percent one year ago. The largest component of noninterest expense, general and administrative expense, climbed to 2.28 percent of average assets in the second quarter from 2.20 percent in the prior quarter. Personnel costs, office occupancy and equipment expense, and marketing expense were higher.

Taxes were higher in the second quarter at 0.61 percent of average assets, up from 0.54 percent in the first quarter. 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.

MORTGAGE ORIGINATIONS

Mortgage originations set a new record in the second quarter, as mortgage interest rates remained stable at low levels and mortgage refinancing activity increased. Originations of 1-4 family mortgages totaled $109.6 billion in the second quarter, up 48 percent from $74.3 billion in the first quarter.

Total mortgage originations (which include multifamily and nonresidential mortgages) increased to $125.0 billion in the second quarter from $87.6 billion in the first quarter and $66.6 billion in the second quarter one year ago.

Thrifts' share of all 1-4 family originations, as estimated from data obtained from the Mortgage Bankers Association of America (MBAA), was 22.9 percent of total originations in the second quarter, up from 21.2 percent in the first quarter and 19.2 percent in the second quarter one year ago. About 27 percent of thrift originations were adjustable rate mortgages (ARMs), down from 36 percent in the first quarter. In contrast, the ARMs share for all lenders was 10 percent in the second quarter and 11 percent in the first quarter.1 Homeowners remained less attracted to ARMs in the second quarter as stable long-term mortgage interest rates kept fixed rate mortgages attractive to borrowers.

Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 22.2 percent of thrift originations in the second quarter, up sharply from 14.9 percent in the first quarter and 8.7 percent in the second quarter one 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 second quarter. However, troubled assets, which include noncurrent loans (loans over 90 days past due or in nonaccrual status) and repossessed assets, climbed slightly to 0.65 percent of assets from 0.62 in the first quarter.

Although repossessed assets remained stable at 0.10 percent of assets in the second quarter, noncurrent loan rates increased to 0.55 percent from 0.53 percent in the first quarter. Noncurrent loan rates were higher for 1-4 family mortgages and construction and land loans. Noncurrent 1-4 family mortgages increased to 0.74 percent of all 1-4 family mortgages at the end of the second quarter from 0.69 percent in the prior quarter. The noncurrent rate on construction and land loans was 1.39 percent, up from 1.26 percent in the prior quarter.

The noncurrent rate for commercial loans was 1.61 percent of all commercial loans, unchanged from the prior quarter. The noncurrent rates for multifamily mortgages, nonresidential mortgages, and consumer loans edged lower. Noncurrent multifamily mortgages fell to 0.16 percent of all multifamily mortgages from 0.18 percent in the first quarter. Noncurrent nonresidential mortgages fell to 1.20 percent of all nonresidential mortgages from 1.22 percent in the first quarter. Noncurrent consumer loans stood at 0.71 percent of all consumer loans in the second quarter, down from 0.83 percent, although a portion of this decline was due to a reclassification of a portfolio of loans from consumer to mortgage.

Loans 30 to 89 days past due were essentially unchanged in the second quarter - the dollar volume was slightly higher at $6.7 billion while, as a percentage of assets, the proportion was slightly lower. Loans 30 to 89 days past due fell to 0.69 percent of assets at the end of the second quarter from 0.70 percent, or $6.6 billion, in the first quarter. One year ago past due loans stood at 0.56 of assets, or $5.0 billion.

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 952 reporting institutions, the industry's median sensitivity measure increased to 199 basis points from 190 basis points in the prior quarter. This increased sensitivity stems from an increase in medium- and long-term interest rates in the second quarter.

The median pre-shock NPV ratio rose slightly to 12.5 percent in the second quarter from 12.4 percent in the first quarter. The median post-shock NPV ratio fell slightly to 10.5 percent. The relatively stable 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 8.6 percent over the past four quarters, second quarter growth was sharply lower at 4.9 percent on an annualized basis. Thrifts remain focused on residential mortgage lending, with 48.0 percent of assets invested in 1-4 family mortgage loans at the end of the second quarter, down slightly from 48.1 percent in the first quarter and 48.6 percent one year ago. Holdings of mortgage pool securities, multifamily loans, consumer loans, and investment securities as a percentage of assets were lower from the prior quarter, while commercial loans were slightly higher.

Construction loan growth slowed in the second quarter to a rate that was consistent with the growth rate of total assets. This is a change from the more rapid growth experienced in the past year. 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 3.2 percent of assets at the end of the second quarter, up from 3.0 percent in the prior quarter. Consumer loans fell to 6.2 percent of assets from 6.3 percent in the first quarter.

BORROWINGS AND CAPITAL

Deposits grew slightly in the second quarter, at a much slower rate than total assets. Deposits held by thrifts increased to $544.8 billion from $543.3 billion in the first quarter and $508.8 billion one year ago. As a percentage of total assets, however, deposits fell slightly to 56.5 percent from 57.0 percent in the first quarter and 57.3 percent one year ago. A $4.6 billion increase in noninterest-bearing demand deposits more than offset the $2.3 billion drop in broker-originated deposits as a number of thrifts worked to reduce funding costs. Federal Home Loan Bank (FHLB) advances were lower at 22.0 percent of total assets, down from 22.8 percent one year ago.

Escrow accounts were sharply higher, reflecting a mortgage company acquisition by a large thrift and increased mortgage origination activity in the second quarter.

Capital measures for the industry remained strong, stable, and well in excess of minimum requirements. At the end of the second quarter, 97 percent of the industry exceeded well-capitalized standards and these thrifts hold 99 percent of industry assets. Equity capital was 8.14 percent of assets, up from 8.05 percent in the prior quarter and 7.68 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. Only two thrifts were less than adequately capitalized at the end of the first quarter. One of these 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 - increased by three to 17. Assets of problem thrifts were $5.8 billion at the end of the second quarter, up from $5.0 billion in the first quarter. Problem thrift assets were $7.6 billion one year ago.

Thrifts with composite ratings of 3 declined to 83 in the second quarter from 90 in the prior quarter. The number of thrifts rated 3 stood at 86 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 83 thrifts rated 3, 89 percent were well capitalized, providing them with some degree of cushion to work through their problems.

STRUCTURAL CHANGES

In the second quarter, 15 thrifts left OTS supervision, compared with 16 thrifts in the prior quarter. Exits were due primarily to acquisition activity and charter conversions. There were four new entrants in the second quarter, down from eight in the prior quarter. Of the new entrants, three were de novo charters and one was a conversion by a bank.

The number of thrift institutions supervised by OTS fell to 1,049 at the end of the second quarter from 1,060 in the prior quarter and 1,091 one year ago. Industry assets climbed at a 5.0 percent annual rate during the second quarter to $965 billion from $953 billion in the prior quarter. Industry assets are at their highest level since March 1991, when they totaled $981 billion.

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