Thrift Industry Highlights - Q4 2000

THE OTS-REGULATED THRIFT INDUSTRY FOURTH QUARTER 2000 HIGHLIGHTS

Office of Thrift Supervision / March 7, 2001

SUMMARY

Despite a challenging economic environment, the thrift industry ended the year 2000 with good fourth quarter and year-over-year results. Net interest margins, which had been under considerable pressure in the first nine months of 2000, stabilized in the fourth quarter in response to declining market interest rates. The decline in rates also helped to reduce the industry's sensitivity to interest rate risk and set the stage for a mortgage refinancing boom which should mean higher loan growth and fee income for the thrift industry going forward.

The recent economic downturn, however, has raised some concerns over credit quality. Past due and noncurrent loans increased slightly in the fourth quarter reflecting worsening economic conditions. Nevertheless, the level of credit quality in the thrift industry has remained high - in part due to the industry's concentration in residential lending and its limited exposure to commercial lending and nonmortgage consumer lending.

EARNINGS AND PROFITABILITY

Net income for the year topped $8.0 billion, down 2.7 percent from the record $8.2 billion in 1999. Fourth quarter earnings were $1.91 billion, up 3.8 percent from $1.84 billion in the third quarter, but down 2.7 percent from $1.97 billion in the fourth quarter one year ago.

Return on average assets (ROA), a key measure of profitability, peaked in the first quarter 2000, then trended lower before rebounding in the fourth quarter. ROA was 0.90 percent for the year, down from 0.98 percent in 1999, which was the highest since 1962. In the fourth quarter, ROA was 0.84 percent, up slightly from 0.82 percent in the prior quarter, but off from 0.93 percent in the fourth quarter one year ago.

Return on average equity (ROE) was 11.6 percent for the year, down from 12.2 percent in 1999. In the fourth quarter, ROE was 10.5 percent, essentially unchanged from the prior quarter, and down from 11.8 percent in the fourth quarter one year ago.

ANALYSIS OF ROA

The decline in ROA from the 1999 peak was chiefly the result of pressure on net interest margins (NIM). NIM, the excess of interest income over interest expense as a percentage of average assets, was 263 basis points for the year, down 10 basis points from 1999. In the fourth quarter, NIM was 259 basis points, unchanged from the third quarter. For the industry overall, NIM stabilized in the fourth quarter due to a combination of lower interest rates, a more positively sloped yield curve, and balance sheet portfolio adjustments.

Against a backdrop of weakening economic activity, rising loan delinquencies, and higher net charge-offs, thrifts moved to increase loss provisions on interest-bearing assets. Provisions rose to 0.19 percent of average assets for the year from 0.16 percent in 1999. Loss provisions were higher in the fourth quarter at 0.21 percent, up from 0.18 percent in the third quarter and 0.16 percent in the fourth quarter one year ago. The fourth quarter increase in provisions was due in large part to several large thrifts that returned to normal provisioning after reducing provisions in the third quarter to reflect loss analyses of their loan portfolios.

On the positive side, fee income increased on a year-over-year basis. Fee income growth has been 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). Both the level of noninterest-bearing deposit accounts and the overall number of deposit accounts increased substantially between December 1999 and December 2000. For the year, fee income rose to 0.81 percent of average assets, up from 0.66 percent in the prior year. Fee income for the fourth quarter was unchanged from the prior quarter at 0.83 percent of average assets, and up from 0.73 percent in the fourth quarter a year ago.

Other noninterest income was down nine basis points for the year to 0.32 percent of average assets, due to fewer gains from sales of assets held for sale. In the fourth quarter, other noninterest income rose to 0.36 percent of average assets from 0.30 percent in the third quarter and 0.31 percent in the fourth quarter one year ago. 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. Other noninterest income primarily includes sale of assets held for investment or sale, dividends on FHLB stock, and income from leasing office space.

Noninterest expense increased to 2.17 percent of average assets over the year from 2.11 percent in 1999. In the fourth quarter, noninterest expense rose to 2.25 percent of average assets from 2.15 percent in the fourth quarter one year ago. General and administrative expense, the largest component of noninterest expense, climbed to 2.17 percent of average assets in the fourth quarter from 2.13 percent in the third quarter. Personnel costs, office occupancy and equipment expense, and marketing expense all rose.

Taxes were lower over the year at 0.49 percent of average assets and were 0.48 percent in the fourth quarter. Since 1996, taxes have averaged 0.51 percent of average assets.

For thrifts with a September 30 fiscal yearend, the fourth quarter adoption of Financial Accounting Statement (FAS) 133 on accounting for derivatives and hedging had only a small impact on 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. For firms with a December 31 fiscal yearend - the majority of OTS-supervised institutions - FAS 133 must be adopted no later than January 1, 2001, and first reflected in first quarter financial statements. The first quarter impact of FAS 133 could be significantly greater.

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 968 reporting institutions, the industry's median sensitivity measure declined to 180 basis points from 213 basis points in the prior quarter and 231 one year ago. This reduced sensitivity stems from a reduction in asset duration in the fourth quarter. This occurs because, as interest rates decline, the model's predicted likelihood of mortgage prepayments increases, resulting in a decline in the duration of mortgage assets.

Median NPV ratios remained strong for the quarter, although the median pre-shock NPV ratio was down slightly to 10.9 percent from 11.1 percent in the previous quarter. Median pre-shock NPV was 10.8 percent one year ago. This slight decline for the quarter is primarily attributable to a decrease in the values of mortgage servicing and deposit intangibles in a falling interest rate environment. In contrast, the median post-shock NPV ratio increased from 9.1 percent in the third quarter to 9.2 percent at yearend. Median post-shock NPV was 8.7 percent one year ago. This rise in post-shock NPV reflects the fact that the industry is better able to withstand interest rate shocks given the reduced duration mismatch between assets and liabilities.

ASSET COMPOSITION

Thrifts remain focused on residential mortgage lending, with 48.3 percent of assets invested in 1-4 family mortgage loans at yearend, up slightly from 47.5 percent one year ago. Holdings of construction and land loans increased slightly over the year, while multifamily mortgages, mortgage pool securities, and nonresidential 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 yearend, up from 2.4 percent one year ago. Consumer loans grew to 6.6 percent of assets from 6.2 percent of assets one year ago.

MORTGAGE ORIGINATIONS

Thrift loan portfolios grew 11 percent over the year. Home sales and mortgage loan demand remained strong in the fourth quarter as mortgage interest rates trended lower from their five-year highs reached in May. Total mortgage originations in the fourth quarter (which include multifamily and nonresidential mortgages) increased to $69.0 billion from $65.8 billion from in the third quarter and $61.4 billion in the fourth quarter one year ago. Fourth quarter 1-4 family mortgage originations by thrifts were $55.3 billion, up from $53.2 billion in the third quarter and $47.9 billion originated in the fourth 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 21.1 percent of total 1-4 family originations in the fourth quarter, up from 18.6 percent in the third quarter and 19.6 percent in the fourth quarter one year ago. About 57 percent of thrift originations were ARMs in the fourth quarter, down from 66 percent in the third quarter. In contrast, the ARMs share for all lenders was 16 percent in the fourth quarter and 21 percent in the third.1 The lower ARMs shares in the fourth 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 10.8 percent of thrift originations in the fourth quarter, unchanged from the fourth quarter one year ago, and up from 9.0 percent in the third quarter. Refinancing activity increased due to the decline in longer term interest rates.

ASSET QUALITY

Despite the slowing economy, the thrift industry as a whole has maintained excellent asset quality, but signs of credit deterioration, though mild, are clearly evident in business-related (construction, nonresidential mortgage, and commercial nonmortgage) loans. Consumer-related and housing-related lending have, to date, faired better than business-related loans.

Troubled assets, which include noncurrent loans and repossessed assets, climbed to 0.60 percent of assets from the record low of 0.58 percent of assets in the third quarter. Troubled assets were higher one year ago at 0.62 percent.

Noncurrent loan rates (loans over 90 days past due or in nonaccrual status) were unchanged from one year ago at 0.50 percent of assets, but noncurrent rates (as a percentage of total loan type) moved higher for certain loan types. Noncurrent loan rates for construction and land loans, nonresidential mortgages, consumer loans, and commercial loans all were higher from one year ago. Noncurrent construction and land loans were 1.13 percent of all construction and land loans, up from 0.61 percent one year ago. Noncurrent nonresidential mortgages rose to 0.96 percent of all nonresidential mortgages from 0.86 percent one year ago. Noncurrent consumer loans stood at 0.81 percent at yearend, up from 0.77 percent one year ago. Noncurrent commercial loans jumped to 1.52 percent of all commercial loans at yearend from 1.12 percent a year ago.

Meanwhile, noncurrent rates on 1-4 family and multifamily mortgage loans fell on a year over year basis. These mortgage loans are the mainstay of the thrift industry and together make up over half of thrift assets. The industry's concentration in this sector accounts for its excellent credit quality. Noncurrent loan rates for 1-4 family loans were 0.67 percent of all 1-4 family loans at yearend, down from 0.77 percent one year ago. Noncurrent multifamily loans were 0.15 percent of all multifamily loans, down from 0.30 percent one year ago.

Loans past due by 30 to 89 days were higher for all loan types at yearend. Rising delinquencies of loans 30 to 89 days past due are worrisome because they may signal higher levels of troubled assets going forward. The highest past due rates occurred in the consumer, commercial, and construction and land loan sectors. Total loans past due by 30 to 89 days rose to $6.9 billion, or 0.74 percent of assets, from $5.7 billion in the third quarter and $5.2 billion one year ago.

BORROWINGS AND CAPITAL

Deposits held by thrifts increased to $529.4 billion from $518.1 billion in the third quarter and $504.9 billion one year ago. As a percentage of total assets, however, deposits declined to 57.0 percent from 58.5 percent one year ago. Non-deposit borrowings, including Federal Home Loan Bank advances, have continued to be the dominant source of incremental funding for asset growth. At yearend, total borrowings were 32.5 percent of assets, up from 31.3 percent one year ago.

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. At yearend, 97 percent of the industry exceeded well-capitalized standards. In the fourth quarter, equity capital was 8.0 percent of assets, up from 7.8 percent a year ago. Capital growth over the year resulted from new capital brought into the industry, growth in retained earnings, and lower unrealized losses on available for sale securities. Only four thrifts were less than adequately capitalized at yearend.

PROBLEM THRIFTS

Despite the slowing economy and growing concerns about credit quality, the thrift industry is still performing nicely and the number of problem thrifts remains at a low level. Problem thrifts - those with composite examination ratings of 4 or 5 - increased by two to 15. Assets of problem thrifts were $7.0 billion at the end of the fourth quarter, down from $7.2 billion in the third quarter. Problem thrift assets were $5.5 billion one year ago.

A related regulatory concern 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 require a higher level of supervisory attention. At yearend, 98 thrifts with $29.8 billion in assets were rated 3, up from 95 thrifts with $34.9 billion in assets in the prior quarter, and 68 thrifts with $21.6 billion in assets one year ago. These ratings downgrades have largely been due to higher interest rate risk exposure and credit quality concerns. Of the 98 thrifts rated 3, 91 percent were well capitalized, providing them with some degree of cushion to work through their problems.

STRUCTURAL CHANGES

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

The number of thrift institutions supervised by OTS fell to 1,068 at yearend from 1,082 in the prior quarter and 1,103 one year ago. The one-year decline of 35 institutions was the smallest in 15 years. Industry assets increased 7.5 percent during the year to $929 billion at yearend from $864 billion at yearend 1999. Industry assets today are the highest since June 1991, when they totaled $943 billion.

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