THRIFT INDUSTRY HIGHLIGHTS FIRST QUARTER 2002

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SUMMARY

The thrift industry reported very strong results in the first quarter 2002, achieving record earnings and profitability. This was the fourth consecutive quarter of record profits and the sixth quarter for earnings growth. The sustained strength in earnings and profitability continued to be in part attributable to a favorable interest rate environment.

The yield curve remained steep over the first quarter and the industry's net interest margins widened. Favorable mortgage interest rates and strength in the nation's housing markets maintained demand for mortgage originations at high levels. However, slightly higher mortgage interest rates over the last half of the first quarter resulted in lower levels of mortgage refinancing.

Asset quality continued to be affected by mixed economic conditions. The level of troubled assets (defined as noncurrent loans and repossessed assets) has increased each quarter since the second quarter of 2000. Despite these increases, the overall level of troubled assets-to-total assets is only slightly above the record low of the second quarter of 2000, and the overall level of credit quality in the thrift industry has remained good.

EARNINGS AND PROFITABILITY

Net income in the first quarter reached a record $3.05 billion, up 41 percent from the year ago first quarter and four percent from the prior quarter. The number of thrifts reporting losses in the first quarter was 102, down sharply from 133 thrifts in both the prior quarter and the first quarter one year ago.

Profitability, as measured by return on average assets (ROA), also reached record levels. The industry's ROA for the first quarter was 1.23 percent, a new quarterly record, and up from 1.22 percent in the prior quarter and 0.92 percent in the first quarter one year ago.

Return on average equity (ROE) was 14.7 percent, down slightly from 14.8 percent in the prior quarter, but up from 11.5 percent in the first quarter one year ago. The drop in ROE from the prior quarter reflected the industry's growth in equity capital in the first quarter.

ANALYSIS OF ROA

Improvement in ROA in the first quarter resulted from a return to positive mortgage loan servicing fee income, lower noninterest expense, and further expansion of net interest margin. These increases more than offset the negatives of lower other noninterest income, increased loan loss provisions, and higher taxes. Extraordinary items added one basis point to ROA in the first quarter, down from ten basis points in the fourth quarter. The extraordinary gains in the first and prior quarters resulted primarily from the early extinquishment of debt by one large thrift.

In the first quarter, NIM averaged 318 basis points, up from 312 basis points in the prior quarter and from 268 basis points in the comparable quarter a year ago. NIM expanded because lower shorter-term interest rates reduced the cost of short-term borrowings and deposits. Over the quarter, interest expense as a percentage of average assets fell 44 basis points while interest income declined by only 37 basis points. For thrifts under $100 million in assets, where portfolios have adjusted more slowly to the changes in interest rates, NIM also expanded in the first quarter.

Loss provisions on interest bearing assets increased in the first quarter to 0.28 percent of average assets from 0.22 percent in the prior quarter and 0.26 percent in the first quarter one year ago. Fourth quarter loss provisions were lower due to one thrift's sale of a large portfolio of assets that resulted in a reversal of previously booked loss provisions. Loss provisions have averaged 0.27 percent of average assets since the beginning of 2001, and are generally higher than in recent years, reflecting the slower economy, higher unemployment, and the need to bolster reserves in the face of increased exposure to commercial and consumer lending.

Total fee income, including mortgage loan servicing fee income and other fee income, increased to 0.86 percent of average assets in the first quarter from 0.46 percent in the prior quarter and 0.73 percent in the first quarter one year ago. The increase resulted from a return of mortgage loan servicing fee income to a positive amount. Throughout 2001, total fee income was depressed by lower mortgage loan servicing fee income as a consequence of write-downs of mortgage servicing portfolios by a number of thrifts. These write-downs resulted from higher mortgage prepayments, which decreased the duration and cash flow of servicing assets. Servicing fee income in the first quarter was 0.05 percent of average assets, up sharply from negative 0.40 percent in the prior quarter and negative 0.01 percent in the first quarter one year ago.

Other fee income fell slightly to 0.81 percent of average assets in the first quarter from 0.86 percent in the prior quarter, but was up from 0.74 percent in the comparable year ago quarter. Fee income has generally been growing over the past two years due to increases in fees from retail banking, trust activities, the sale of mutual funds and annuities, and loan servicing income from nonmortgage loans. 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).

Fewer gains from sales of assets caused other noninterest income in the first quarter to fall to 0.44 percent of average assets from 0.84 percent in the prior quarter and 0.59 percent in the first quarter one year ago. Other noninterest income primarily includes gains on sales of assets, dividends on FHLB stock, and income from leasing office space. Other noninterest income is typically volatile since it includes realized gains and losses on assets and the results of balance sheet restructuring activities.

Noninterest expense decreased to 2.30 percent of average assets in the first quarter from 2.47 percent in the prior quarter, but was up from 2.28 percent in the first quarter one year ago. General and administrative expense, the largest component of noninterest expense, fell to 2.26 percent of average assets in the first quarter from 2.38 percent in the prior quarter, but was up from 2.20 percent in the first quarter one year ago. Personnel, office occupancy, legal, marketing, and loan origination and servicing expenses were all lower. Also contributing to the decline in first quarter noninterest expense was the elimination of goodwill amortization by most thrifts, resulting from the adoption of Statement of Financial Accounting Standards No. 142 beginning in 2002. This rule requires that companies not amortize goodwill amounts, but instead test these amounts at least annually for impairment in value.

Taxes were higher at 0.67 percent of average assets, up from 0.62 percent in the prior quarter and 0.54 percent in the first quarter one year ago. Over the past two years, taxes have averaged 0.56 percent of average assets, or about 36 percent of pretax income. Extraordinary items added one basis point to net income in the first quarter, primarily reflecting gains from the early extinquishment of debt by one large thrift.

MORTGAGE ORIGINATIONS

Total mortgage originations (which include multifamily and nonresidential mortgages) for the thrift industry were $111.0 billion in the first quarter, down from a record $124.2 billion in the prior quarter, but up from $87.6 billion in the first quarter one year ago. Home sales and mortgage loan demand remained very strong in the first quarter as mortgage interest rates remained affordably low. First quarter 1-4 family mortgage originations by thrifts totaled $97.4 billion, down from $110.4 billion in the prior quarter, but up from $74.3 billion originated in the first quarter one year ago.

Thrifts' estimated share of all 1-4 family originations[1] climbed to 22.9 percent of total 1-4 family originations in the first quarter from 17.0 percent in the prior quarter and 18.8 percent in the first quarter one year ago. About 40 percent of thrift originations were adjustable rate mortgages (ARMs) in the first quarter, up from 30 percent in the prior quarter and 36 percent in the first quarter one year ago. In contrast, the ARMs share for all lenders was 17 percent in the first quarter, and 11 percent in the prior and comparable year ago quarters.[2] The rising ARMs shares in the first quarter reflected the increase in long-term mortgage interest rates over the quarter.

The volume of mortgage refinancing eased in the first quarter as mortgage interest rates moved higher. Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 38.9 percent of thrift originations in the first quarter, down from 41.0 percent in the prior quarter. In the first quarter a year ago, refinancing accounted for 14.9 percent of thrift originations.

ASSET QUALITY

The thrift industry as a whole continued to maintain good asset quality in the first quarter, but signs of mild deterioration were evident in construction mortgages and commercial nonmortgage loans. Troubled assets, which include noncurrent loans and repossessed assets, climbed to 0.72 percent of assets from 0.70 percent in the prior quarter and 0.62 percent one year ago. Repossessed assets were unchanged from the prior quarter and one year ago at 0.10 percent of assets.

Noncurrent loan rates (loans over 89 days past due or in nonaccrual status) increased over the first quarter to 0.62 percent of assets, and noncurrent rates (as a percentage of total loan type) moved higher for most loan types. Noncurrent loan rates for 1-4 family mortgages, multifamily mortgages, construction and land loans, and commercial loans all were higher from the prior quarter. Mortgages on 1-4 family dwellings and multifamily mortgages 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 strong credit quality. Noncurrent loan rates for 1-4 family loans were 0.87 percent of all 1-4 family loans at the end of the first quarter, up from 0.81 percent at yearend. Noncurrent multifamily loans were 0.17 percent of all multifamily loans, up one basis point from 0.16 percent at yearend.

Noncurrent construction and land loans were 1.83 percent of all construction and land loans, up from 1.57 percent at yearend. Noncurrent commercial loans jumped to 2.27 percent of all commercial loans from 1.99 percent at yearend. Noncurrent nonresidential mortgages were lower by one basis point over the quarter at 1.45 percent of all nonresidential mortgages. Noncurrent consumer loans fell to 0.55 percent of all consumer loans from 0.60 percent at yearend.

Loans past due by 30 to 89 days in the aggregate were lower at the end of the first quarter. Past due rates moved higher for 1-4 family mortgages, multifamily mortgages, and construction and land loans. Total loans past due by 30 to 89 days declined to $7.1 billion, or 0.71 percent of assets, from $7.6 billion, or 0.77 percent of assets at yearend, but were up from $6.6 billion, or 0.70 percent of assets, one year ago.

INTEREST RATE RISK

The interest rate sensitivity of the thrift industry increased slightly in the first quarter of 2002. OTS uses its Net Portfolio Value (NPV) Model to assess an institution's vulnerability to changes in interest rates. 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 movement in interest rates is used to measure the sensitivity of the portfolio to rate changes. Based on preliminary data from 864 reporting institutions, the industry's median sensitivity measure increased to 201 basis points from 189 basis points in the prior quarter and 190 basis points one year ago. This increased sensitivity reflects the effects of an increase in interest rates during the first quarter.

Median NPV ratios were higher in the first quarter. Median pre-shock NPV was 13.1 percent in the first quarter, up from 12.5 percent in the prior quarter and 12.4 percent one year ago. The increase in pre-shock NPV resulted from a greater decrease in the duration of assets than in the duration of liabilities between the fourth and first quarters. Median post-shock NPV increased to 11.4 percent from 10.8 percent in the fourth quarter and 10.6 percent one year ago. (See the forthcoming *Quarterly Review of Interest Rate Risk* for details).

ASSETS, LIABILITIES, AND CAPITAL

Industry assets climbed at an annualized rate of 8.2 percent during the first quarter to $998 billion from $978 billion at yearend. Industry assets today are the highest since December 1990, when they totaled $1.03 trillion. The number of thrift institutions supervised by OTS, however, fell to 1,007 at the end of the first quarter from 1,019 in the prior quarter and 1,060 one year ago. Thrifts remain focused on residential mortgage lending, with 45.5 percent of assets invested in 1-4 family mortgage loans at the end of the first quarter, down slightly from 47.6 percent at yearend. Construction and land loans declined to 2.9 percent of assets from 3.0 percent at yearend. Holdings of consumer loans fell slightly to 6.6 percent of assets, while multifamily mortgages were unchanged at 4.6 percent of assets. Commercial loans were slightly higher from yearend at 3.1 percent of assets.

Deposits increased to $582 billion from $555 at the end of the prior quarter. As a percentage of total assets, deposits grew to 58.4 percent from 56.8 percent in the prior quarter. Federal Home Loan Bank advances declined to 19.4 percent of assets at the end of the first quarter from 21.2 percent in the prior quarter.

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. Over 98 percent of the industry exceeded well-capitalized standards at the end of the first quarter. Equity capital was 8.7 percent of assets at the end of the first quarter, up from 8.1 percent in the prior quarter. Capital growth over the quarter resulted from growth in retained earnings and new capital brought into the industry. Only two thrifts were less than adequately capitalized at the end of the first quarter.

PROBLEM THRIFTS

The number of problem thrifts remained at a low level in the first quarter. Problem thrifts - those with composite examination CAMELS ratings of 4 or 5 –increased slightly to 19 from 16 at the end of the prior quarter. Assets of problem thrifts increased to $14.7 billion from $3.3 billion in the prior quarter and $5.0 billion in the first quarter one year ago.

Thrifts with composite CAMELS ratings of 3 declined to 71 in the first quarter from 72 in the prior quarter. The number of thrifts rated 3 stood at 90 one year ago. Thrifts with composite ratings of CAMELS 3 exhibit some weaknesses that may range from moderate to severe in one or more of the ratings components. These institutions are more vulnerable to adverse conditions and require more supervisory attention. Of the 71 thrifts rated 3, 90 percent were well capitalized, providing them with some degree of cushion to work through their problems.

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[1] Total 1-4 family mortgage originations estimated by the Mortgage Bankers Association of America.

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