THRIFT INDUSTRY HIGHLIGHTS THIRD QUARTER 2002

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SUMMARY

The thrift industry again reported very strong results in the third quarter 2002. Earnings and profitability were higher from the comparable year ago quarter and only slightly lower than the record highs set in the first quarter this year. The sustained strength in earnings and profitability continued to be attributable to a favorable interest rate environment.

Longer-term interest rates fell slightly over the quarter, resulting in a small decline in the industry's aggregate net interest margin, but the yield curve remained steep. Mortgage originations reached a record volume due to favorable mortgage interest rates and continued strength in the nation's housing markets. A decline in mortgage interest rates over the third quarter to the lowest rates in four decades generated record levels of mortgage refinancing.

The industry's equity capital ratio was higher in the third quarter from one year ago, but down slightly from the record high reached at the end of the second quarter. Asset quality was stable or improved for most loan types in the quarter. Troubled assets (defined as noncurrent loans and repossessed assets), were unchanged from the second quarter, which was the first time in two years that this rate had dropped. Loans past due by 30- to 89-days, after falling for the past three quarters, were higher at the end of the third quarter. Asset quality trends remain favorable, in part, because a large part of loan portfolios are new to the books due to high loan origination volumes over the past two years.

EARNINGS AND PROFITABILITY

Net income in the third quarter reached $2.97 billion, up 14 percent from the year ago third quarter and five percent from the prior quarter. Third quarter net income was the second best on record, falling short of the $3.05 billion record set in the first quarter 2002. Profitability, as measured by return on average assets (ROA), was 1.22 percent, up from 1.08 percent in the third quarter one year ago and from 1.18 percent in the prior quarter.

Return on average equity (ROE) was 13.4 percent, up from 13.1 percent in the third quarter one year ago and from 13.2 percent in the prior quarter.

ANALYSIS OF ROA

The increase in third quarter ROA from the prior quarter resulted chiefly from increased gains on sales of assets due to lower longer-term interest rates. Partially offsetting these positive impacts to net income were a lower aggregate net interest margin, additional writedowns of mortgage servicing portfolios, and higher taxes.

In the third quarter, net interest margin (NIM) for the industry was 302 basis points, down from 311 basis points in the prior quarter, but up from 294 basis points in the comparable quarter a year ago. The decline in NIM over the third quarter resulted from asset repricing and investment at lower yields. Over the quarter, interest income as a percentage of average assets fell 16 basis points while interest expense declined by only seven basis points.

Loss provisions on interest bearing assets decreased in the third quarter to 0.28 percent of average assets from 0.35 percent in the prior quarter and 0.32 percent in the third quarter one year ago. Loss provisions have averaged 0.28 percent of average assets over the past seven quarters, 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, fell to negative 0.03 percent of average assets in the third quarter from 0.37 percent in the prior quarter and 0.59 percent in the third quarter one year ago. Since 2001, total fee income has been 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 third quarter was negative 0.89 percent of average assets, down from negative 0.47 percent in the prior quarter and negative 0.21 percent in the third quarter one year ago.

Other fee income climbed to 0.86 percent of average assets in the third quarter from 0.84 percent in the prior quarter and 0.80 percent in the comparable year ago quarter. Fee income has generally grown 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 (activity fees, origination fees, insurance premiums, and penalty fees), and deposit taking (ATM charges, transaction account fees, and penalty fees

Higher gains from sales of assets increased other noninterest income in the third quarter to 1.52 percent of average assets from 1.07 percent in the prior quarter and 0.81 percent in the third 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 was 2.34 percent of average assets in the third quarter, down four basis points from the prior quarter and one basis point from the third quarter a year ago. The decline in the third quarter was primarily due to one thrift's sale of a subsidiary and to lower marketing expenses. General and administrative expense, the largest component of noninterest expense, fell to 2.29 percent of average assets in the third quarter from 2.32 percent in the prior quarter, but was up from 2.26 percent in the third quarter one year ago.

Taxes were 0.67 percent of average assets, up from 0.63 percent in the prior quarter and from 0.62 percent in the third quarter one year ago. Over the past two years, taxes have averaged 0.59 percent of average assets, or about 36 percent of pretax income. Extraordinary items, which lowered ROA in the prior quarter by one basis point due to losses from the early extinquishment of debt by one large thrift, had no impact on net income in the third quarter.

MORTGAGE ORIGINATIONS

Total mortgage originations (which include multifamily and nonresidential mortgages) for the thrift industry were a record $138.3 billion in the third quarter, up from $109.2 billion in the prior quarter and from $118.7 billion in the third quarter one year ago. Mortgage refinancing volume for the industry set a new record in the third quarter in response to lower longer-term interest rates over the quarter. Home sales and mortgage loan demand remained very strong as mortgage interest rates fell to four decade lows. Third quarter 1-4 family mortgage originations by thrifts totaled a record $122.3 billion, up from $92.8 billion in the prior quarter and from $103.8 billion originated in the third quarter one year ago.

Thrifts' estimated share of all 1-4 family originations[1] declined slightly to 17.6 percent of total 1-4 family originations in the third quarter from 18.3 percent in the prior quarter An estimated 46 percent of thrift originations were adjustable rate mortgages (ARMs) in the third quarter, down from 50 percent in the prior quarter, but up from 36 percent in the third quarter one year ago. In contrast, the ARMs share for all lenders was 17 percent in the third quarter, 20 percent in the prior quarter, and 15 percent in the comparable year ago quarter.[2] The declining ARMs share in the third quarter reflected lower long-term mortgage interest rates over the quarter.

Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 39.6 percent of thrift originations in the third quarter, up from 30.3 percent in the prior quarter. In the third quarter a year ago, refinancing accounted for 28.8 percent of thrift originations. .

ASSET QUALITY

The thrift industry as a whole continued to maintain good asset quality in the third quarter with most asset quality indicators remaining stable or showing improvement. Troubled assets, which include noncurrent loans and repossessed assets, remained unchanged from the prior quarter at 0.70 percent of assets. One year ago troubled assets stood at 0.68 percent. 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) were unchanged from the prior quarter at 0.60 percent of assets. Due, in part, to portfolio growth for most loan types, noncurrent rates (as a percentage of total loan type) moved lower for all but consumer loans. Noncurrent loan rates for consumer loans increased to 0.60 percent of all consumer loans from 0.50 percent in the prior quarter, but remained lower than the year ago rate.

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 fell for the second consecutive quarter to 0.79 percent of all 1-4 family loans, down from 0.82 percent at the end of the second quarter. Noncurrent multifamily loans were 0.18 percent of all multifamily loans, down three basis points from 0.21 percent in the prior quarter.

Noncurrent construction and land loans fell to 1.63 percent of all construction and land loans from 1.66 percent in the prior quarter. Noncurrent nonresidential mortgages were lower over the quarter at 1.27 percent of all nonresidential mortgages. Noncurrent commercial loans decreased to 2.51 percent of all commercial loans from 2.52 percent at the end of the prior quarter.

Loans past due by 30 to 89 days in the aggregate were higher at the end of third quarter after decreasing in each of the three previous quarters. Past due loans remained lower than one year ago. In the third quarter, past due rates moved higher only for 1-4 family mortgage loans and consumer loans. Total loans past due by 30 to 89 days increased to $7.0 billion, or 0.71 percent of assets, from $6.2 billion, or 0.64 percent of assets at the end of the prior quarter, but were down from $7.7 billion, or 0.79 percent of assets, one year ago.

INTEREST RATE RISK

The interest rate sensitivity of the thrift industry improved in the third 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 831 reporting institutions, the industry's median sensitivity measure fell to 96 basis points from 161 basis points in the prior quarter and 177 basis points one year ago. This decreased sensitivity reflects the effects of lower interest rates during the third quarter

Median NPV ratios were slightly lower in the third quarter. Median pre-shock NPV was 12.4 percent in the third quarter, down from 13.0 percent in the prior quarter, but up from 12.2 percent one year ago. Median post-shock NPV decreased to 11.2 percent from 11.3 percent in the second quarter and was up from 10.6 percent one year ago. (See the forthcoming *Quarterly Review of Interest Rate Risk* for details).

ASSETS, LIABILITIES, AND CAPITAL

Industry assets grew at a 9.4 percent annualized rate during the third quarter to $987 billion from $964 billion at the end of the prior quarter. The number of thrift institutions supervised by OTS, fell to 983 at the end of the third quarter from 995 in the prior quarter and 1,037 one year ago. Thrifts remain focused on residential mortgage lending, with 47.8 percent of assets invested in 1-4 family mortgage loans at the end of the third quarter, up from 46.6 percent in the prior quarter. Construction and land loans were slightly lower at 2.9 percent of assets. Holdings of multifamily mortgages increased to 4.9 percent of assets, while consumer loans fell to 6.0 percent of assets. Commercial loans were slightly higher at 3.0 percent of assets.

Deposits rose over the third quarter to $579 billion from $565 at the end of the prior quarter. As a percentage of total assets, deposits increased slightly to 58.7 percent from 58.5 percent in the prior quarter. Demand deposits were higher in the third quarter from the prior quarter, the first quarterly increase since June 2001 Federal Home Loan Bank advances declined to 18.1 percent of assets at the end of the third quarter from 18.6 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 third quarter. Equity capital fell slightly from a record 9.1 percent of assets at the end of the second quarter to 9.0 percent in the third quarter, and was up from 8.4 percent in the comparable quarter a year ago. The decrease in capital over the quarter resulted from some thrifts and thrift holding companies pursuing stock repurchase programs due to lower share prices in the third quarter.

PROBLEM THRIFTS

The number of problem thrifts remained at a low level in the third quarter. Problem thrifts - those with composite examination CAMELS ratings of 4 or 5 - fell by one to 17 Assets of problem thrifts increased slightly to $3.6 billion from $3.5 billion in the prior quarter and second quarter one year ago. One small thrift with $51.6 million in assets failed in the second quarter.

Thrifts with composite CAMELS ratings of 3 increased to 75 in the third quarter from 74 in the prior quarter. The number of thrifts rated 3 stood at 73 one year ago. Assets of 3-rated thrifts were $62.1 billion in the third quarter, up from $50.3 billion in the prior quarter and from $61.2 billion 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 75 thrifts rated 3, 93 percent were well capitalized, providing them with some degree of cushion to work through their problems.

[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*.