THRIFT INDUSTRY HIGHLIGHTS
THIRD QUARTER 2003

Office of Thrift Supervision / November 19, 2003

SUMMARY

The thrift industry reported very strong results for the third quarter, a transitional quarter for most thrifts given the rise in longer-term interest rates. Although new records were set for mortgage originations and sales volumes, the mortgage refinancing boom has ended for now. Quarterly earnings, return on average assets (ROA), and equity capital were slightly below the record second quarter levels.

Earnings and profitability, while strong, were lower from the prior quarter due to continuing pressure on net interest margins and lower noninterest income. The steep yield curve over the quarter remained favorable to thrifts, but yields on new and repriced assets fell more sharply than funding costs. A decline in mortgage interest rates over the second quarter to the lowest rates in four decades generated record levels of mortgage originations, refinancings, and sales in the current quarter. Over the third quarter, however, longer-term interest rates, including mortgage interest rates, jumped sharply. As a result, applications for mortgages, including refinancing activity, fell to the lowest level of the year. Institutions will need to carefully manage their portfolios and operations as mortgage volumes are forecast to decline in the coming quarters.

The industry's equity capital ratio was slightly lower from one year ago. Asset quality remained strong for all loan types over the quarter and the overall level of credit quality in the thrift industry has remained good. Delinquencies were lower for most loan types in the third quarter. Troubled assets, which include noncurrent loans (loans over 89 days past due or in nonaccrual status) and repossessed assets, as a percentage of total assets were lower at the end of the third quarter, as were loans past due by 30- to 89-days. The strength in thrift portfolios is due, in part, to the industry's concentration in residential lending and its limited exposure to nonmortgage consumer lending and commercial lending.

EARNINGS AND PROFITABILITY

Profitability, as measured by ROA, reached 1.28 percent in the third quarter, up from 1.22 percent in the third quarter a year ago, but down from the record 1.34 percent in the prior quarter. Median ROA was 0.76 percent in the third quarter, down nine basis points over the year and six basis points from the prior quarter. Return on average equity (ROE) was 14.18 percent in the third quarter, up from 13.44 percent in the comparable year ago quarter, but down from 14.71 percent in the prior quarter.

Net income reached $3.44 billion in the third quarter; the fourth time thrift industry net income has topped the $3 billion mark. Third quarter net income was up 16 percent from $2.97 billion in the third quarter one year ago, but down three percent from the record $3.53 billion in the prior quarter. The number of thrifts reporting losses in the third quarter was 87, up from 80 thrifts in the third quarter one year ago. Aggregate losses of $81 million for those thrifts reporting losses in the third quarter were down from $85 million one year ago.

ANALYSIS OF ROA

Improvement in third quarter ROA from the comparable year ago quarter came chiefly from lower loan loss provisions, lower impairment charges on mortgage servicing rights, and higher fee income. Partially offsetting this improvement were a lower net interest margin (NIM), lower other noninterest income, higher noninterest expense, and higher taxes.

In the third quarter, NIM decreased to 284 basis points (or 2.84 percent of average assets) from 302 basis points in the third quarter one year ago, and from 294 basis points in the prior quarter. The decline in NIM from one year ago resulted from the repricing of and investment in assets at lower yields.

Loss provisions on interest-bearing assets were down to 0.20 percent of average assets in the third quarter from 0.28 percent in the third quarter one year ago, and from 0.25 percent in the prior quarter.

Total fee income, including mortgage loan servicing fee income and other fee income, increased to 1.01 percent of average assets in the third quarter from a negative 0.03 percent in the third quarter one year ago, and from 0.55 percent in the prior quarter. Since 2001, total fee income has been depressed by lower mortgage loan servicing fee income as a consequence of impairment charges on mortgage servicing portfolios by a number of thrifts. These impairment charges resulted from higher mortgage prepayments, which decreased the duration and cash flow of servicing assets. Servicing fee income, net of impairment charges, was 0.05 percent of average assets in the third quarter, an improvement of 94 basis points from the third quarter one year ago, and 44 basis points from the prior quarter.

Other fee income was up ten basis points over the year to 0.96 percent of average assets in the third quarter. This growth came from 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).

Other noninterest income in the third quarter decreased to 0.77 percent of average assets from 1.53 percent one year ago, and from 1.30 percent in the prior quarter due to lower gains from sales of assets over the quarter. Other noninterest income primarily includes gains on sales of assets, dividends on FHLB stock, and income from leasing office space. Other noninterest income can be volatile since it includes realized gains and losses on assets and the results of balance sheet restructuring activities.

Noninterest expense increased to 2.44 percent of average assets in the third quarter from 2.34 percent in the third quarter a year ago, but was down from 2.45 percent in the prior quarter. General and administrative expense, the largest component of noninterest expense, increased to 2.40 percent of average assets in the third quarter from 2.29 percent in the comparable year ago quarter.

Taxes were higher in the second quarter at 0.71 percent of average assets, up from 0.68 percent in the comparable year ago quarter. Over the past two years, taxes have averaged 0.68 percent of average assets, or about 35 percent of pretax income.

MORTGAGE ORIGINATIONS

Total mortgage originations (which include multifamily and nonresidential mortgages) topped the $200 billion mark for the second time in the third quarter, reaching a record $250.4 billion. This was up sharply from $138.3 billion in the third quarter a year ago, and from the previous record of $215.1 billion in the prior quarter. Despite record mortgage originations, higher longer-term interest rates in the third quarter reduced mortgage application volumes — particularly demand for mortgage refinancings — to the lowest levels of the year. Refinancing demand fell sharply after the rise in mortgage interest rates. Third quarter 1-4 family mortgage originations by thrifts were a record $229.9 billion, up 88 percent from $122.4 billion in the comparable year ago quarter, and up 17 percent from the previous record of $195.8 billion originated in the prior quarter.

Thrifts' estimated share of all 1-4 family originations[1] was 22 percent of total 1-4 family originations in the third quarter, up from 18 percent in the comparable year ago quarter. An estimated 26 percent of thrift originations were ARMs in the third quarter, down from 46 percent in the third quarter a year ago, but up from 21 percent in the prior quarter. In contrast, the ARMs share for all lenders was 18 percent in the third quarter, 17 percent in the third quarter one year ago, and 14 percent in the prior quarter.[2] The lower ARMs shares over the year reflected the decline in longer-term mortgage interest rates.

In the third quarter, the volume of mortgage refinancing fell sharply from the record volume of the prior quarter as mortgage interest rates increased. Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 42 percent of thrift originations in the third quarter, up from 40 percent in the third quarter one year ago, but down from 54 percent in the prior quarter.

ASSET QUALITY

Asset quality remained strong for all loan types in the third quarter and the overall level of credit quality in the thrift industry has remained good. Troubled assets, which consist of noncurrent loans and repossessed assets, were 0.68 percent of assets at the end of the third quarter, down from 0.70 percent one year ago, and from 0.69 percent in the prior quarter. Repossessed assets were down one basis point over the year, and unchanged from the prior quarter at 0.09 percent of assets.

Noncurrent loan rates were 0.59 percent of assets at the end of the third quarter, improved from 0.60 percent one year ago and in the prior quarter. Noncurrent rates (as a percentage of total loan type) moved higher from a year ago for 1-4 family mortgage loans and consumer loans while noncurrent rates moved lower for other loan types. 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 thrifts' strong credit quality. Noncurrent loan rates on 1-4 family mortgages were up six basis points from one year ago to 0.85 percent of all 1−4 family mortgage loans, and one basis point from 0.84 percent in the prior quarter. Noncurrent multifamily loans were 0.16 percent of all multifamily loans at the end of the third quarter, down from 0.18 percent one year ago.

Noncurrent nonresidential mortgages decreased to 1.03 percent of all nonresidential mortgages from 1.28 percent one year ago. Noncurrent construction and land loans were 1.14 percent of all construction and land loans, down from 1.63 percent one year ago. Noncurrent commercial loans fell to 1.52 percent of all commercial loans at the end of the third quarter from 2.51 percent a year ago. Noncurrent consumer loans were 0.69 percent of all consumer loans at the end of the third quarter, up from 0.60 percent one year ago.

Loans past due by 30 to 89 days were improved for all loan types except multifamily mortgages. Rising levels 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 consumer loans. Total loans past due by 30 to 89 days at the end of the second quarter were $7.2 billion, or 0.66 percent of assets, compared to $7.0 billion, or 0.71 percent of assets, one year ago, and to $7.8 billion, or 0.73 percent of assets, in the prior quarter.

ASSETS, LIABILITIES, AND CAPITAL

Industry assets increased at a 10.8 percent rate over the year to $1.09 trillion from $987 billion in the comparable year ago quarter. Thrifts remain focused on residential mortgage lending, with 48.3 percent of total assets invested in 1-4 family mortgage loans at the end of the third quarter, up from 47.8 percent a year ago. Multifamily mortgages stood at 4.8 percent of total assets at the end of the third quarter, down slightly from 4.9 percent one year ago. Holdings of construction and land loans declined slightly over the year to 2.6 percent of assets, while consumer loans remained unchanged from one year ago at 6.0 percent of assets.

Deposits grew over the year by 9.0 percent to $631.2 billion, up from $579.3 billion one year ago. As a percentage of total assets, deposits fell to 57.7 percent from 58.7 percent in the third quarter a year ago. Federal Home Loan Bank advances declined to 16.1 percent of assets in the third quarter from 18.1 percent a year ago.

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. At the end of the third quarter, over 99 percent of the industry exceeded well-capitalized standards. The industry's equity capital ratio stood at 8.89 percent of assets, down slightly from the third quarter a year ago. The decrease over the year resulted from lower unrealized gains on securities available-for-sale. One small thrift was temporarily less than adequately capitalized at the end of the third quarter. That institution has since been restored to well-capitalized status.

PROBLEM THRIFTS

The thrift industry continued to perform extremely well over the third quarter, and the number of problem thrifts remained at a low level. Problem thrifts – those with composite examination ratings of 4 or 5 – fell by ten over the year to seven, and were down by one over the quarter. Assets of problem thrifts declined to $602 million at the end of the second quarter from $3.6 billion in the third quarter a year ago, and from $720 million in the prior quarter. Both the number and assets of problem thrifts were the lowest since OTS was founded in 1989.

The number of thrifts with composite ratings of 3 decreased to 62 at the end of the third quarter from 75 one year ago and 71 in the prior quarter. 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 are more vulnerable to adverse conditions and require more supervisory attention. Of the 62 thrifts rated 3, 97 percent were well capitalized, providing them with some degree of cushion to work through their problems.

STRUCTURAL CHANGES

The number of institutions supervised by OTS fell to 936 at the end of the third quarter from 947 in the prior quarter and 983 one year ago. During the third quarter, 12 thrifts left OTS supervision. Five exits were due to thrift-to-thrift mergers. There were four charter conversions, two bank acquisitions, and one voluntary dissolution. One *de novo* thrift began operations in the third quarter.

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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*.