

Industry Performance

Thrift Industry Highlights - Q2 2000

THE OTS-REGULATED THRIFT INDUSTRY SECOND QUARTER 2000 HIGHLIGHTS

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SUMMARY

The thrift industry performed well in the second quarter, but its performance was not quite as strong as in the first quarter. Earnings declined slightly from the level of the first quarter, and profitability, as measured by return on assets and return on equity, also declined. Asset quality remained at a high level and capital ratios remained strong and stable. On balance, the condition and performance of the thrift industry in the second quarter were solid.

The specter of rising interest rates, a major concern for thrifts, has somewhat receded. Upward pressure on interest rates eased and speculation that the Federal Reserve Board may be at the end of the rate tightening cycle seems to be the prevailing view of market participants.

Despite the industry's strong condition and performance, there are some negative undercurrents that bear watching. First, the number of thrifts with composite examination ratings of 3 (indicating some weakness) continued to climb. Second, noncurrent commercial loan rates have been rising and there is continuing concern that credit conditions could worsen if the economy slows. Third, the industry continues to increase its dependence on non-deposit funding. Finally, competitive pressures in the thrift industry, mortgage markets, and the entire financial services industry remain intense and unrelenting. Taken together, these factors will continue to present challenges to thrift institutions.

EARNINGS AND PROFITABILITY

Second quarter earnings were \$2.0 billion, down from \$2.2 billion in the first quarter and \$2.1 billion in the second quarter one year ago. This was the seventh time the industry's quarterly earnings have exceeded \$2.0 billion.¹ Earnings were down 9.2 percent from the first quarter and 4.3 percent from the second quarter one year ago.

The industry's return on average assets (ROA) was 0.93 percent in the second quarter, down from 1.04 percent in the prior quarter and 1.01 percent in the second quarter one year ago. Adjusting for a significant one-time tax benefit posted by a large thrift, first quarter ROA was about 0.98 percent. Return on average equity (ROE) was 12.0 percent in the second quarter, but down from 13.5 percent in the prior quarter and 12.4 percent in the second quarter one year ago.

ANALYSIS OF ROA

The decline in ROA from the first quarter and the comparable year ago quarter can be traced to lower net interest margins, higher loss provisions, and rising noninterest expense. Increased taxes also had a negative impact between the first and second quarters of this year. On the positive side, fee income continued to climb relative to total assets, and other noninterest income increased from the prior quarter.

Net interest margins were lower, falling to 265 basis points from 270 basis points in the first quarter and 275 basis points one year ago. The margin compression reflected a lagged response to the inverted yield curve in prior periods and pressure resulting from yields on adjustable rate mortgages (ARMs) that have not yet fully adjusted to current market rates. Margin compression could continue into the third and fourth quarters if the yield curve does not normalize to some degree.

Loss provisions on interest-bearing assets were up significantly to 0.23 percent of average assets in the second quarter, from 0.15 percent in the first quarter and 0.16 percent one year ago. The increase was largely due to higher provisions at several institutions with subprime lending programs. Provisions were in line with levels seen in recent years.

Noninterest expense rose to 2.13 percent of average assets from 2.09 percent in the first quarter and in the second quarter one year ago. The increase was due to higher marketing, loan origination, and acquisition-related expenses.

Among the positive factors affecting ROA, fee income rose to 0.78 percent of assets, up from 0.76 percent in the first quarter, and well above 0.67 percent one year ago. The growth in fee income is primarily attributable to increases in deposit and retail banking fees. Other noninterest income, a relatively volatile component of revenue, jumped to 0.38 percent of average assets, an increase of 9 basis points from the first quarter level. This figure is well below 0.43 percent one year ago when thrift institutions were functioning more in a mortgage banking mode. Other noninterest income was boosted in the second quarter by gains from asset sales and a special dividend paid on stock of the Federal Home Loan Bank of San Francisco.

INTEREST RATE RISK

OTS uses its Net Portfolio Value (NPV) Model to monitor thrifts' interest rate risk. The model estimates changes in a thrift's economic value, or net portfolio value, due to changes in interest rates. The change in a thrift's NPV capital ratio due to an adverse, hypothetical 200 basis points movement in interest rates is used to measure the sensitivity of a thrift's portfolio to rate changes. Based on preliminary data, the NPV Model showed the industry's median sensitivity declined modestly to 234 basis points from 238 in the prior quarter. This represents the first decline in sensitivity in seven quarters, and reflects the downward movement in interest rates in the second quarter.

In the second quarter, the median pre-shock capital ratio declined to 11.1 percent from 11.4 percent at the end of March. The median post-shock NPV ratio was off slightly to 8.9 percent, down from 9.0 percent in March. The post-shock capital ratio is a measure of capital strength after a hypothetical adverse interest rate shock of 200 basis points. Overall, post-shock capital ratios remain strong.

ASSET COMPOSITION

Thrifts remain heavily committed to the residential mortgage market with 48.7 percent of assets invested in 1-4 family mortgage loans at the end of the second quarter, up slightly from 48.2 percent one year ago. Holdings of nonresidential mortgages and construction and land loans increased slightly over the past year, while multifamily mortgages and mortgage pool securities were down as a percentage of assets from year-ago levels. The growth in mortgage loan volume reflects the strength of the economy and strong mortgage demand over the past year.

The commercial and consumer lending portfolios of thrifts have grown somewhat over the last several years. These loans typically have shorter terms and higher yields than home mortgage loans. Commercial loans were 2.8 percent of assets at the end of the second quarter, up from 2.1 percent one year ago. Consumer loans grew to 6.3 percent of assets from 6.2 percent of assets one year ago.

Thrifts with nontraditional loan portfolios (nonresidential mortgages, commercial loans, or construction and land loans) exceeding 10 percent of total assets continued to rise in the second quarter.

MORTGAGE ORIGINATIONS

Although mortgage interest rates hit their highest level in more than five years in May, home sales and mortgage loan demand remained strong. Second quarter 1-4 family mortgage originations by thrifts climbed sharply, and their market share of originations remained high. Originations of 1-4 family mortgages in the second quarter were \$52.9 billion, up 33 percent from \$39.7 billion in the first quarter, but 20 percent lower than the \$66.1 billion originated in the second 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 19.2 percent of total 1-4 family originations in the second quarter, up from 17.4 percent one year ago, and down slightly from 19.8 at the end of the first quarter. This is largely due to higher levels of ARM originations. About 72 percent of thrift originations were ARMs in the second quarter compared to only 30 percent for all lenders.² A year ago, 46 percent of thrift originations were ARMs compared to 17 percent for all lenders.

Total mortgage originations (which include multifamily and nonresidential mortgages) climbed to \$66.6 billion from \$51.9 billion in the first quarter, but were down from \$79.2 billion in the second quarter one year ago. Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 8.7 percent of thrift originations in the second quarter, down from 10.5 percent in the first quarter and 15.7 percent one year ago.

ASSET QUALITY

Asset quality measures showed modest improvement in the second quarter. Troubled assets (noncurrent loans and repossessed assets) declined slightly in volume and as a percent of assets. At the end of the second quarter, troubled assets were \$5.1 billion, or 0.58 percent of assets, reaching a new record low.

Noncurrent loan rates (loans over 90 days past due or in nonaccrual status) remained at low levels, reflecting strong asset quality within the industry. There was an increase in noncurrent commercial loans, however, from very low recent levels.

Noncurrent loan rates fell for 1-4 family, multifamily, and nonresidential mortgages. The noncurrent rate on 1-4 family mortgages fell to 0.65 percent of 1-4 family loans at the end of the second quarter from 0.73 percent in the prior quarter and 0.78 percent one year ago. The rate of noncurrent 1-4 family mortgages has generally fallen for the past four years.

Similarly, there has been a long-term decline in the rate of noncurrent multifamily and nonresidential mortgages. Noncurrent multifamily mortgage loans fell to 0.20 percent of all multifamily mortgages from 0.24 percent in the prior quarter and 0.39 percent one year ago.

Noncurrent nonresidential mortgage loans fell to 0.90 percent of all nonresidential mortgages from 0.91 percent in the prior quarter and 1.07 percent one year ago.

Meanwhile, noncurrent commercial loans rose to 1.28 percent of all commercial loans from 1.13 percent in the prior quarter and 0.90 percent one year ago. Noncurrent consumer loans were stable at 0.73 percent of all consumer loans in the second and prior quarters, and up from 0.70 percent one year ago.

Total loss provisions rose in the second quarter to 0.24 percent of assets from 0.16 in the prior quarter. Most of the increase was due to several institutions that added loss provisions for subprime lending. Net charge-offs were down one basis point to 0.18 percent of assets from the prior quarter.

BORROWINGS AND CAPITAL

Deposits held by thrifts increased slightly to \$508.8 billion from \$505.7 billion in the first quarter and \$492.2 billion one year ago. As a percentage of total assets, however, deposits declined to 57.3 percent from 58.2 percent in the prior quarter. Non-deposit borrowings, including Federal Home Loan Bank (FHLB) advances, have continued to be the dominant source of incremental funding for asset growth. At the end of the second quarter, total borrowings were 32.6 percent of assets, up from 31.7 percent in the first quarter. In the second quarter equity capital was 7.7 percent of assets, unchanged from the first quarter, but down from 8.1 percent a year ago.

Capital measures for the industry are strong, relatively stable, and well in excess of minimum requirements. Although capital ratios have declined from historical peaks, 98 percent of the industry exceeds well-capitalized standards. Only two thrifts were less than adequately capitalized at the end of the second quarter, one of which has since been acquired.

PROBLEM THRIFTS

The number of problem thrifts - those with composite examination ratings of 4 or 5 - remained at 14. Assets of problem thrifts increased to \$7.6 billion at the end of the second quarter from \$5.3 billion in the first quarter. One year ago, there were 10 problem thrifts with \$4.1 billion in assets.

A regulatory concern noted last quarter was 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 may require a higher level of supervisory attention. At the end of the second quarter, 86 thrifts with \$34.2 billion in assets were rated 3, up from 80 thrifts with \$32.5 billion in assets in the prior quarter. These ratings downgrades were largely due to rising interest rate risk exposure and credit quality concerns. Of the 86 thrifts rated 3, 79, or 92 percent, were well capitalized, providing them with some degree of cushion as they work out of their problems.

STRUCTURAL CHANGES

In the second quarter 18 thrifts left OTS supervision, compared with 16 thrifts in the prior quarter. Exits have been due primarily to merger and acquisition activity. There were 12 new entrants in the second quarter, up from the 10 new entrants in the prior quarter. Of the new entrants, ten were de novo charters and two were conversions to a thrift charter.

The number of thrift institutions regulated by OTS fell to 1,091 in the second quarter from 1,097 in the prior quarter and 1,115 one year ago. Industry assets increased at a 9.1 percent annual rate to \$888 billion at the end of the second quarter from \$869 billion in the prior quarter. Asset growth was 4.9 percent from the second quarter a year ago when industry assets were \$847.0 billion. The decline thus far in 2000 of 12 institutions was the smallest in 14 years. Industry assets today are the highest since 1991, when they totaled \$895 billion.