

## Industry Performance

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Thrift Industry Highlights - Q2 2005

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### ***THRIFT INDUSTRY HIGHLIGHTS***

### ***SECOND QUARTER 2005***

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Office of Thrift Supervision / August 19, 2005

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#### **SUMMARY**

Thrift industry results in the second quarter 2005 continued to be characterized by record levels of earnings and equity capital, and overall strong credit quality. Profitability was strong and loan growth was solid over the quarter.

Despite loan portfolio growth, a further flattening of the interest rate yield curve over the quarter contributed to the decline in the industry's aggregate net interest as interest expense climbed at a faster pace than interest income. Mortgage originations continued at a strong pace over the second quarter, and were up from the prior quarter as lower mortgage interest rates over the quarter increased mortgage origination volumes.

Thrift industry assets increased by 17 percent over the year to \$1.39 trillion. The number of thrifts supervised by OTS stood at 870 at the end of the second quarter and OTS supervised 483 U.S. domiciled holding company enterprises with approximately \$7.0 trillion in consolidated assets. These enterprises owned 453 thrifts with total assets exceeding \$1.1 trillion, or 80 percent of total thrift industry assets.

Asset quality remained strong for all loan types over the second quarter and the overall level of credit quality in the thrift industry has remained good, with most loan types showing improvement in delinquencies from one year ago. Troubled assets (defined as noncurrent loans and repossessed assets) reached a record low rate in the second quarter. Loans past due by 30- to 89-days as a percentage of assets were lower from one year ago, but up from the first quarter. The industry's equity capital reached a new record level at the end of the second quarter and its equity capital ratio was higher from the prior and comparable year ago quarters.

#### **EARNINGS AND PROFITABILITY**

Net income reached a record of \$4.03 billion in the second quarter, up 20 percent from the year ago second quarter and up one percent from the prior quarter. This was the second time that quarterly income topped the \$4 billion mark. The number of thrifts reporting losses in the second quarter was 58, down from 86 thrifts in the second quarter one year ago.

Profitability, as measured by return on average assets (ROA), was 1.18 percent in the second quarter, up from 1.16 percent in the comparable year ago quarter, but down four basis points

from 1.22 percent in the first quarter. The median ROA improved to 0.80 percent in the second quarter from 0.73 percent in the second quarter one year ago, and from 0.72 percent in the prior quarter.

Return on average equity (ROE) was 12.79 percent in the second quarter, up slightly from 12.63 percent in the second quarter one year ago, but down from 13.30 percent in the first quarter.

## **ANALYSIS OF ROA**

Lower net interest margin (NIM) and mortgage loan servicing fee income, and higher loan loss provisions and noninterest expense were the primary reasons for the decline in ROA from the prior quarter. Partially offsetting the decrease in quarterly income were higher other fee income and other noninterest income, and lower taxes.

In the second quarter, NIM was 285 basis points (or 2.85 percent of average assets), down six basis points from the comparable year ago quarter and two basis points from the prior quarter.

Loan loss provisions were 0.20 percent of average assets in the second quarter, down from 0.21 percent in the second quarter one year ago, but up from 0.19 percent in the prior quarter. Loan loss provisions averaged 0.26 percent of average assets between 2001 and 2003, but have averaged 0.21 percent of average assets since the beginning of 2003, reflecting improved economic conditions and credit quality over the past two years.

Total fee income, including mortgage loan servicing fee income and other fee income, decreased to 1.02 percent of average assets in the second quarter from 1.06 in the comparable year ago quarter, and was down from 1.22 percent in the first 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 assets 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 fell to negative 0.03 percent of average assets in the second quarter, down from negative 0.02 percent in the second quarter one year ago, and from 0.23 percent in the prior quarter.

Other fee income was down three basis points from the second quarter a year ago at 1.05 percent of average assets, but up from 0.99 percent in the prior quarter. Fee income has generally grown over the past three years from increases in fee income 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 second quarter climbed to 0.64 percent of average assets from 0.62 percent in the second quarter one year ago, and from 0.47 percent in the prior quarter. The improvement in other noninterest income was due to higher gains from sales of assets over the quarter. Other noninterest income primarily includes gains on sales of assets and income from leasing office space. Other noninterest income is typically volatile since it includes realized gains and losses on assets held for sale and the results of balance sheet restructuring activities.

Noninterest expense increased to 2.47 percent of average assets in the second quarter from 2.46 percent in the prior quarter, but was down from 2.59 percent in the second quarter a year ago. General and administrative expense, the largest component of noninterest expense, fell to 2.43

percent of average assets in the second quarter from 2.56 percent in the comparable year ago quarter.

Taxes were up one basis point from the comparable year ago quarter at 0.65 percent of average assets, but were down from 0.68 percent in the first quarter. Over the past two years, taxes have averaged 0.67 percent of average assets, or about 35 percent of pretax income.

## **MORTGAGE ORIGINATIONS**

Total thrift industry mortgage originations (which include multifamily and nonresidential mortgages) climbed to \$191.8 billion from \$161.0 billion in the prior quarter, but were down from \$196.5 billion in the second quarter one year ago. Second quarter 1-4 family mortgage originations by thrifts were \$169.4 billion, down two percent from \$173.5 billion in the second quarter one year ago, but up 20 percent from \$141.5 billion in the prior quarter.

Thrifts accounted for an approximately 23 percent of total 1-4 family originations nationwide in the second quarter of 2005, <sup>1</sup> up from 22 percent in the comparable year ago quarter. An estimated 42 percent of thrift originations were adjustable rate mortgages (ARMs) in the second quarter, down from 50 percent in the prior and comparable year ago quarters. In contrast, the ARM share for all lenders was 33 percent in the second quarter, 32 percent in the first quarter, and 36 percent in the second quarter one year ago.<sup>2</sup>

The volume of mortgage refinancing decreased from the prior and comparable year ago quarters even as longer-term interest rates moved lower in the second quarter. Refinancing activity accounted for 30 percent of thrift originations in the second quarter, down from 37 percent in the second quarter one year ago and in the prior quarter. Prior to 2004, Thrift Financial Report refinancing data included only loans where the reporting institution held the original mortgage. Thrifts now report mortgages refinanced from any lender.

## **ASSET QUALITY**

Asset quality improved over the year for most loan types. OTS is closely monitoring thrift loan performance and asset quality since a significant proportion of thrift loan portfolios are now recently originated - or "unseasoned" - loans. Moreover, newer loan types such as interest-only mortgages and the significant rise in home equity lines-of-credit are being given supervisory scrutiny since these loans have not been stressed through different economic cycles. Troubled assets, which consist of noncurrent loans and repossessed assets, reached a record low 0.42 percent of assets at the end of the second quarter, down from 0.50 percent in the comparable year ago quarter. Repossessed assets decreased to 0.05 percent of assets from 0.07 percent of assets one year ago.

Noncurrent loan rates (loans over 89 days past due or in nonaccrual status) fell to a record low rate of 0.37 percent of assets in the second quarter, down from 0.43 percent at the end the second quarter one year ago. Noncurrent loan rates for all loan types improved over the year.

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<sup>1</sup> Total 1-4 family mortgage originations estimated by the Mortgage Bankers Association of America.

<sup>2</sup> Data are from the Federal Housing Finance Board's monthly *Mortgage Interest Rate Survey*.

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 overall strong credit quality. Noncurrent loan rates for 1-4 family loans were 0.44 percent of all 1-4 family loans at the end of the second quarter, down from 0.54 percent one year ago. Noncurrent multifamily loans decreased to 0.08 percent of all multifamily loans from 0.12 percent one year ago.

Noncurrent nonresidential mortgages fell to 0.63 percent of all nonresidential mortgages from 0.77 percent one year ago. Noncurrent construction and land loans were 0.49 percent of all construction and land loans, down from 0.75 percent one year ago. Noncurrent commercial loans fell to 1.17 percent of all commercial loans at the end of the second quarter from 1.33 percent a year ago. Noncurrent consumer loans decreased from 0.69 percent of all consumer loans one year ago to 0.61 percent at the end of the second quarter.

Loans past due by 30 to 89 days were lower over the year for most loan types. Rising delinquencies of loans 30 to 89 days past due can signal that thrifts may experience higher levels of troubled assets in the future. 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 \$7.4 billion, or 0.54 percent of assets compared to \$6.7 billion, or 0.56 percent of assets, one year ago, and \$7.1 billion, or 0.53 percent of assets, in the first quarter.

## **ASSETS, LIABILITIES, AND CAPITAL**

Industry assets increased by 16.8 percent over the year to \$1.39 trillion from \$1.19 trillion a year ago. Thrifts remain focused on residential mortgage lending, with 56.9 percent of assets invested in 1-4 family mortgage loans at the end of the second quarter, up from 53.1 percent one year ago. Of these 1-4 family mortgage loans, six percent are home equity lines of credit, up from five percent of 1-4 family mortgages in the second quarter one year ago. Holdings of consumer loans fell slightly over the year to 5.8 percent of assets from 6.3 percent a year ago, and multifamily mortgages were down over the year to 4.7 percent of assets from 4.8 percent. Commercial loans were stable over the year at 3.2 percent of assets.

Deposits and escrows grew by 15.1 percent over the year to \$801 billion from \$696 billion a year ago. As a percentage of total assets, deposits and escrows decreased to 57.7 percent from 58.5 percent one year ago. Federal Home Loan Bank advances climbed to 19.2 percent of assets at the end of the second quarter from 18.8 percent one year ago.

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. At quarter-end, over 99 percent of the industry exceeded well-capitalized standards. Equity capital at the end of the second quarter was 9.34 percent of assets, up from 9.19 percent in the second quarter one year ago. Capital growth over the year resulted from growth in retained earnings and new capital brought into the industry. Two thrifts were less than adequately capitalized at the end of the second quarter. Subsequent to the end of the second quarter, one of these thrifts was acquired and the other was recapitalized.

## **PROBLEM THRIFTS**

As the thrift industry continued to perform at or near record levels over the past year, the number of problem thrifts has remained at a low level. Problem thrifts - those with composite examination ratings of 4 or 5 - increased by one over the year to seven. Assets of problem thrifts were \$2.0

billion at the end of the second quarter, up from \$493 million a year ago and from \$1.6 billion in the first quarter.

Thrifts with composite ratings of 3 declined to 47 at the end of the second quarter from 52 one year ago, and were down from 53 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. All but one of the 3-rated thrifts at the end of the second quarter were well capitalized, providing them with some degree of cushion to work through their problems.

## **STRUCTURAL CHANGES**

Mergers and acquisitions continued to reduce the number of thrifts. Financial institutions' charter choice decisions resulted in one new institution choosing a thrift charter in the second quarter, three thrifts converting to commercial bank charters, and one thrift converting to a state savings bank. During the quarter, three OTS-regulated thrifts merged with other OTS-regulated thrifts, and non-OTS regulated institutions acquired three thrifts. One thrift left through voluntary dissolution.

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