

Industry Performance

Thrift Industry Highlights - Q4 2001

THE OTS-REGULATED THRIFT INDUSTRY FOURTH QUARTER 2001 HIGHLIGHTS

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SUMMARY

The thrift industry reported very strong results for the year 2001 and for the fourth quarter. In fact, in terms of earnings and profitability, last year was one of the best in the industry's history. Lower mortgage interest rates and broad strength in the housing market drove net income and return on average assets (ROA) to record levels.

The strength in earnings and profitability was in part attributable to a favorable interest rate environment. As the year progressed, shorter-term interest rates declined, the yield curve steepened, and the industry's net interest margins widened. The low interest rate environment also produced a mortgage refinancing boom, driving mortgage originations and sales volumes to record levels.

Recessionary conditions continued to have an adverse effect on asset quality. 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. The strength in thrift portfolios is due, in part, to the industry's concentration in residential lending and its limited exposure to commercial lending and nonmortgage consumer lending.

EARNINGS AND PROFITABILITY

Net income reached a yearly record of \$10.2 billion in 2001, up 27 percent from \$8.0 billion in the prior year. For the fourth quarter, the industry earned a record \$2.9 billion, up 52 percent from the year ago fourth quarter. This was the third consecutive quarter of record profits. The number of thrifts reporting losses in the fourth quarter was 128, up from 118 thrifts in the prior quarter, but down from 157 in the fourth quarter one year ago.

Profitability, as measured by ROA, also reached record levels. At 1.07 percent for the year, the industry's ROA was the highest in 46 years. Moreover, the return on average assets for the fourth quarter was 1.22 percent, a new quarterly record.

Return on average equity (ROE) climbed to 13.1 percent for the year from 11.6 percent in 2000. In the fourth quarter, ROE was 14.8 percent, up from 13.1 percent in the third quarter and 10.6 percent in the fourth quarter one year ago.

ANALYSIS OF ROA

Improvement in ROA for the year was fueled by expansion of NIM and growth in other noninterest income, up 26 and 41 basis points, respectively. These increases more than offset the negatives of higher loan loss provisions, additional impairment reserves for mortgage servicing rights, higher general and administrative expenses, and higher taxes.

For the fourth quarter, improvement in ROA was driven by expansion of NIM. Chief among negative impacts to fourth quarter ROA were additional impairment reserves for mortgage servicing rights, and higher general and administrative expenses. Extraordinary items added three basis points to ROA for the year and ten basis points for the fourth quarter. These gains resulted primarily from the liquidation of interest rate hedges by one large thrift.

For the year, NIM improved to 289 basis points (or 2.89 percent of average assets) from 263 basis points in 2000. In the fourth quarter, NIM averaged 312 basis points, up from 258 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. For the year, interest expense as a percentage of average assets fell 68 basis points while interest income declined by 42 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 fourth quarter.

Against a backdrop of slower economic activity, rising loan delinquencies, and higher net charge-offs, thrifts increased loss provisions on interest-bearing assets. Provisions rose to 0.26 percent of average assets for the year from 0.19 percent in 2000. Loss provisions were 0.22 percent of average assets in the fourth quarter, unchanged from the fourth quarter one year ago, and down from 0.32 percent in the third quarter. The fourth quarter decline in provisions was due to one thrift's sale of a large portfolio of assets that resulted in a reversal of previously booked loss provisions.

Total fee income, including mortgage loan servicing fee income and other fee income, fell to 0.64 percent of average assets for the year from 0.81 percent in 2000. In the fourth quarter, total fee income was 0.46 percent of average assets, down from 0.59 percent in the prior quarter and 0.83 percent in the fourth quarter one year ago. 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 was a negative 0.16 percent of average assets in 2001, 28 basis points lower than in the prior year. In the fourth quarter, servicing fee income was negative 0.40 percent of average assets, down 19 basis points from the prior quarter and 51 basis points from the fourth quarter one year ago.

On the positive side, other fee income was up 11 basis points for the year to 0.80 percent of average assets. In the fourth quarter, other fee income was 0.86 percent of average assets, up six basis points from the third quarter and 14 basis points from the fourth quarter one year ago. 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 (penalty fees, activity fees, origination fees, insurance premiums), and deposit taking (penalty fees, ATM charges, transaction account fees). Both the level of noninterest-bearing demand deposit accounts and the overall number of deposit accounts increased substantially between December 2000 and December 2001.

Other noninterest income for the year climbed 41 basis points to 0.74 percent of average assets, due to gains from sales of assets held for sale. In the fourth quarter, other noninterest income rose to 0.84 percent of average assets from 0.81 percent in the third quarter and 0.37 percent in the fourth quarter one year ago. Other noninterest income primarily includes gains on sales of assets held for investment or sale, 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 held for sale and the results of balance sheet restructuring activities.

Noninterest expense increased to 2.36 percent of average assets over the year from 2.17 percent in 2000. In the fourth quarter, noninterest expense rose to 2.46 percent of average assets from 2.25 percent in the fourth quarter one year ago. General and administrative expense, the largest component of noninterest expense, climbed to 2.38 percent of average assets in the fourth quarter from 2.26 percent in the third quarter and 2.17 percent in the fourth quarter one year ago. Personnel costs, marketing expenses, and loan origination and servicing expenses were higher.

Taxes were higher over the year at 0.60 percent of average assets and were 0.62 percent in the fourth quarter. Over the past two years, taxes have averaged 0.54 percent of average assets, or about 36 percent of pretax income. Extraordinary items added three basis points to net income over the year and ten basis points in the fourth quarter, primarily reflecting after-tax gains from the liquidation of interest rate hedges by one large thrift.

MORTGAGE ORIGINATIONS

Total mortgage originations for the thrift industry in 2001 were a record \$456 billion, surpassing the previous record of \$ 318 billion in 1998. Home sales and mortgage loan demand remained very strong over the year as mortgage interest rates trended lower. Total mortgage originations (which include multifamily and nonresidential mortgages) were \$124.2 billion in the fourth quarter, up from \$118.7 billion in the third quarter and \$69.0 billion in the fourth quarter one year ago. Fourth quarter 1-4 family mortgage originations by thrifts reached a record \$110.4 billion in the fourth quarter, up six percent from \$103.8 billion in the third quarter, and nearly twice the \$55.3 billion originated in the fourth quarter one year ago.

Thrifts' share of all 1-4 family originations¹ was 17.0 percent of total 1-4 family originations in the fourth quarter, down from 23.4 percent in the third quarter and 23.3 percent in the fourth quarter one year ago. The fourth quarter drop in total share is, in part, attributed to the exit of one large thrift and a large decline in originations of adjustable rate mortgages. Although thrifts are important sources for adjustable rate mortgages, lower interest rates make fixed rate mortgages more attractive to borrowers. About 26 percent of thrift originations were ARMs in the fourth quarter, down from 36 percent in the third quarter and 57 percent in the fourth quarter one year ago. In contrast, the ARMs share for all lenders was 11 percent in the fourth quarter, 15 percent in the third quarter, and 16 percent in the fourth quarter one year ago.² The lower ARMs shares over the year reflected the decline in long-term mortgage interest rates.

The volume of mortgage refinancing climbed sharply in the fourth quarter as mortgage interest rates eased further. Refinancing activity (counting only those mortgages refinanced with the same lender) accounted for 41.0 percent of thrift originations in the fourth quarter, down from 28.8 percent in the prior quarter and 10.8 percent in the fourth quarter one year ago. Refinancing activity increased due to the decline in longer-term interest rates.

ASSET QUALITY

Despite the slowing economy, the thrift industry as a whole has maintained good asset quality over the year, but signs of credit deterioration, though mild, are clearly evident in business-related (construction, nonresidential mortgage, and commercial nonmortgage) loans. Consumer-related and housing-related lending have, to date, fared better than business-related loans.

Troubled assets, which include noncurrent loans and repossessed assets, climbed to 0.70 percent of assets from 0.68 percent in the third quarter and 0.60 percent one year ago.

Repossessed assets were unchanged from one year ago and the prior quarter at 0.10 percent of assets.

Noncurrent loan rates (loans over 89 days past due or in nonaccrual status) increased over the year to 0.60 percent of assets at yearend, 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, nonresidential mortgages, construction and land loans, and commercial loans all were higher from one year ago. Noncurrent loan rates (loans over 89 days past due or in nonaccrual status) increased over the year to 0.60 percent of assets at yearend, 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, nonresidential mortgages, construction and land loans, and commercial loans all were higher from one year ago.

Noncurrent nonresidential mortgages rose to 1.45 percent of all nonresidential mortgages from 0.96 percent one year ago. Noncurrent construction and land loans were 1.56 percent of all construction and land loans, up from 1.13 percent one year ago. Noncurrent commercial loans jumped to 1.94 percent of all commercial loans at yearend from 1.52 percent a year ago. Noncurrent consumer loans were lower at 0.59 percent of all consumer loans at yearend, down from 0.81 percent one year ago.

Loans past due by 30 to 89 days were higher over the year. Rising delinquencies 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 the consumer, commercial, and construction and land loan sectors. Total loans past due by 30 to 89 days rose to \$7.6 billion, or 0.77 percent of assets, from \$6.9 billion, or 0.74 percent of assets, one year ago, but were down from \$7.7 billion, or 0.79 percent of assets, in the third quarter.

INTEREST RATE RISK

The interest rate risk exposure and sensitivity of the thrift industry increased slightly in 2001 and in the fourth quarter. 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 200 basis points movement in interest rates is used to measure the sensitivity of the portfolio to rate changes. Based on preliminary data from 892 reporting institutions, the industry's median sensitivity measure increased to 194 basis points from 177 basis points in the prior quarter and 180 basis points one year ago. This increased

sensitivity reflects the effects of an increase in medium- and long-term interest rates during the fourth quarter. (See the forthcoming Quarterly Review of Interest Rate Risk for details).

Median NPV ratios were higher over the year and in the fourth quarter. Median pre-shock NPV was 12.5 percent in the fourth quarter, up from 12.2 percent in the prior quarter and 10.8 percent one year ago. The increase in pre-shock NPV resulted from an increase in the duration of assets and a decrease in the duration of liabilities between the third and fourth quarters. Median post-shock NPV increased to 10.7 percent from 10.6 percent in the third quarter and 9.2 percent one year ago.

ASSET, LIABILITIES, AND CAPITAL

Industry assets increased 5.3 percent during the year to \$978 billion from \$928 billion at yearend 2000. Industry assets today are the highest since March 1991, when they totaled \$981 billion. Thrifts remain focused on residential mortgage lending, with 47.6 percent of assets invested in 1-4 family mortgage loans at yearend, down slightly from 48.3 percent one year ago. Holdings of consumer loans increased slightly over the year to 6.7 percent of assets, while multifamily mortgages were lower at 4.6 percent of assets. Commercial loans were unchanged from one year ago at 3.0 percent of assets.

Deposits grew by 4.9 percent over the year to \$556 billion from \$529 billion at yearend 2000. As a percentage of total assets, however, deposits declined slightly to 56.8 percent from 57.0 percent one year ago. Federal Home Loan Bank advances declined to 21.2 percent of assets at yearend from 23.5 percent one year ago.

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. At yearend, 98 percent of the industry exceeded well-capitalized standards. In the fourth quarter, equity capital was 8.1 percent of assets, up from 8.0 percent a year ago. Capital growth over the year resulted from growth in retained earnings, larger unrealized gains on available for sale securities, and new capital brought into the industry. Only three thrifts were less than adequately capitalized at yearend.

PROBLEM THRIFTS

Despite the slowing economy and concerns about credit quality in the financial services industry, the thrift industry performed well over the past year, and the number of problem thrifts remained at a low level. Problem thrifts - those with composite examination ratings of 4 or 5 - remained unchanged at 16. Assets of problem thrifts declined to \$3.3 billion at the end of the fourth quarter from \$3.5 billion in the prior quarter and \$7.0 billion in the fourth quarter one year ago.

Thrifts with composite ratings of 3 declined to 72 in the fourth quarter from 73 in the prior quarter. The number of thrifts rated 3 stood at 98 one year ago. 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 72 thrifts rated 3, 89 percent were well capitalized, providing them with some degree of cushion to work through their problems.

STRUCTURAL CHANGES

During 2001, 72 thrifts left OTS supervision, down from 76 thrifts in the year 2000. Exits were due primarily to commercial bank acquisitions and charter conversions. Thrift-to-thrift mergers accounted for 16 exits. There were 23 new entrants for the year, down from 41 in the prior year. Of the new entrants, 13 were de novo charters and 10 were charter conversions. One thrift failed in 2001.

In the fourth quarter, 23 thrifts left OTS supervision, compared with 18 thrifts in the third quarter. Exits were due primarily to commercial bank acquisitions and charter conversions. Three of the exits were OTS thrift-to-thrift mergers. There were five new entrants for the quarter, down one from the third quarter. Of the new entrants, three were de novo charters and two were charter conversions.

The number of thrift institutions supervised by OTS fell to 1,019 at yearend from 1,037 in the prior quarter and 1,068 one year ago.

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.