Thrift Industry Highlights - Q1 2000

THE OTS-REGULATED THRIFT INDUSTRY FIRST QUARTER 2000 HIGHLIGHTS

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These highlights provide a general overview of performance measures for the OTS-regulated thrift industry in the first quarter 2000.

FIRST QUARTER KEY POINTS

The OTS-regulated thrift industry's strong financial performance of the past several years continued in the first quarter. Net interest margin for the industry remained relatively stable despite an inverted yield curve in the first quarter. As mortgage originations fell further in the first quarter, thrifts continued to control operating expenses. Asset quality measures were generally improved over one year ago.

AREAS OF CONCERN

While most performance measures continued to reflect positive trends in the first quarter, there were several areas of increasing interest to OTS. Sensitivity to interest rate risk has increased for six quarters as interest rates have climbed. In the first quarter, an increasing number of thrifts received lower ratings on their most recent examination report. Some larger thrifts ended the first quarter with slightly lower capital ratios. And growth in investment in higher risk assets continues. In addition, OTS Regional Directors report increasing concern about shaky internal controls, ineffective business plans, and earnings and capital not commensurate with risk.

FIRST QUARTER INDUSTRY EARNINGS CONTINUED STRONG

First quarter 2000 earnings increased to $2.23 billion from $1.97 billion in the fourth quarter 1999 and $2.06 billion in the first quarter one year ago. First quarter earnings set a record[1], slightly surpassing third quarter 1998 earnings by $1.5 million. First quarter 2000 earnings were up 13.4 percent from the fourth quarter 1999 and 8.2 percent from the first quarter one year ago.

[1] Thrift financial data have been collected on a quarterly basis since 1984. Prior to 1984, semi-annual and monthly data were collected.

The industry's return on average assets (ROA) in the first quarter 2000 was 1.04 percent, up from 0.93 percent in the prior quarter and 1.00 percent in the first quarter one year ago. Adjusting for a significant one-time tax benefit posted by a large thrift, first quarter 2000 ROA was approximately 0.98 percent.

STRONG ROA WAS SUPPORTED BY STABLE NET INTEREST MARGIN

Thrifts' ratio of net interest income to average assets, or net interest margin (NIM), remained stable at 270 basis points in the first quarter, down one basis point from the fourth quarter and four basis points from one year ago. Primary factors contributing to the stability in the industry's NIM were additional investments in higher yielding nonresidential mortgage loans, construction and land loans, consumer loans, and commercial loans; upward interest rate adjustments on adjustable rate mortgages (ARMs); and increases in lower interest-costing transaction accounts. Although NIM has remained relatively stable in recent quarters, the lagging impact of recent interest rate increases and a flat to inverted yield curve will likely continue to pressure NIM in the near term.

Non-servicing fee income continued to grow in first quarter to 0.64 percent of average assets, up from 0.59 percent in the fourth quarter and 0.52 percent in the first quarter one year ago. The increase in non-servicing fee income was fueled by growth in trust assets administered by thrifts, in credit card receivables, and in transaction accounts.

Servicing fee income fell slightly in the first quarter to 0.12 percent of average assets from 0.14 percent in fourth quarter, but was up from 0.10 percent in the first quarter one year ago. Two-thirds of the first quarter decrease was due to lower servicing fee income at three large thrifts.

Other noninterest income fell to 0.29 percent of average assets from 0.31 percent in the fourth quarter and 0.52 percent in the first quarter one year ago. The higher level of other noninterest income one year ago reflected strong mortgage banking activity and the resultant gains from the sale of assets held for sale and the sale of available for sale securities.

Noninterest expense fell to 2.09 percent of average assets from 2.15 percent in the fourth quarter and 2.13 percent in the first quarter one year ago. The lower level was primarily due to less lending activity in the first quarter causing thrifts to shift from a mortgage banking mode to a portfolio lending mode. Lower acquisition-related expenses due to less consolidation activity in the thrift industry during the first quarter also favorably impacted this ratio.

OPERATING EFFICIENCY IMPROVED, BUT EARNINGS EFFICIENCY SLIGHTLY DECLINED

Operating efficiency, the ratio of general and administrative expense to net interest income plus fee income, improved (declined) over the quarter. Thrifts' operating efficiency ratio was 58.1 percent in the first quarter, down from 60.2 percent in the fourth quarter and 61.1 percent in the first quarter one year ago. In other words, thrifts spent about 58 cents to generate one dollar of core income in the first quarter, compared to 60 cents in the prior quarter.

The improvement in the first quarter was due to lower operating expense. Operating efficiency has generally improved since 1994. A decline in 1998 operating efficiency was primarily attributable to significant restructuring and merger-related charges that increased overhead expense. As thrifts diversify their portfolios and use less of their revenue to support operations, it is important that they maintain strong internal controls over operations.

Earnings efficiency, the ratio of interest earning assets to interest costing liabilities, was slightly lower over the first quarter due to a decline in equity capital and increased holdings of noninterest earning assets. Federal Home Loan Bank (FHLB) stock, reflecting higher levels of FHLB advances, increased to $11.4 billion at the end of the first quarter, up from $11.0 billion in the prior quarter. Mortgage loan servicing assets increased to $6.2 billion from $6.0 billion in the prior quarter. Lower cash and noninterest earning deposits of $11.9 billion at the end of the first quarter benefited the earnings efficiency ratio as thrifts redeployed excess liquidity maintained for the

Y2K rollover. Cash and noninterest earning deposits were $14.8 billion at the end of the fourth quarter.

FIRST QUARTER 1-4 FAMILY ORIGINATIONS FELL AS INTEREST RATES INCREASED

First quarter mortgage originations fell sharply because of higher interest rates and lower refinancing activity. Originations of 1-4 family mortgages in the first quarter were $39.7 billion, down 17.0 percent from $47.9 billion in the fourth quarter and down 39.9 percent from $66.1 billion originated in the first quarter last year. On the other hand, thrifts' share of all 1-4 family originations, as estimated by the Mortgage Bankers Association of America (MBAA), was 19.9 percent in the first quarter, up from 18.8 percent of total 1-4 family originations one year ago. This is largely due to thrifts' higher proportion of ARM originations. According to data from the Federal Housing Finance Board's monthly Mortgage Interest Rate Survey (MIRS), about 75 percent of thrift originations were ARMs in the first quarter compared to only 32 percent for all lenders. One year ago, 38 percent of thrift originations were ARMs compared to 12 percent for all lenders. Total thrift mortgage originations, which include multifamily and nonresidential mortgages, fell to $51.9 billion in the first quarter, down 15.5 percent from $61.4 billion in the fourth quarter and down 32.9 percent from $77.4 billion in the first quarter one year ago.

Thrift refinancing activity (mortgages refinanced with the same lender) was 10.5 percent of thrift originations in the first quarter, down slightly from 10.8 percent the prior quarter. Thrift refinancing activity was 19.8 percent one year ago. For mortgages refinanced at any lender, the MBAA estimated first quarter refinancing activity to be 21 percent, the same as the prior quarter, but down from 54 percent one year ago.

The 10-year constant maturity Treasury (CMT) interest rate has been, in the past, a common reference rate for longer term contracts, such as 30-year fixed-rate mortgages. The 10-year CMT yield averaged 6.13 percent at the end of the first quarter, down from 6.41 percent at the end of the prior quarter, but up from 5.24 percent one year ago.

Freddie Mac's primary mortgage market survey found that the 30-year fixed-rate commitment rate for conventional mortgage loans, a common benchmark rate for new long-term mortgage loans, averaged 8.23 percent at the end of the first quarter, up from 8.06 percent at the end of the prior quarter and 6.98 percent one year ago. The spread between the 30-year commitment rate and the 10-year CMT widened to 210 basis points at the end of the first quarter from 165 basis points at the end of the prior quarter and 174 basis points one year ago. For the five years prior to 1999, this spread averaged 135 basis points, but since 1998, it has averaged 180 basis points. Because of changes in supply (e.g., budget surplus) and demand (e.g., flight to default-free Treasury securities), the 10-year CMT has become a less reliable barometer for the rates on longer term contracts such as 30-year fixed-rate mortgages.

The one-year CMT, a popular index for adjustable rate mortgages, averaged 6.30 percent at the end of the first quarter, up from 5.95 percent at the end of the prior quarter and 4.72 percent one year ago. According to the MIRS, the contract interest rate on ARMs has also followed suit, rising to 7.14 percent at the end of the first quarter from 6.57 percent the prior quarter.

The spread between the Freddie Mac 30-year fixed rate commitment rate (8.23 percent) and the average ARM contract rate (7.14%) was 109 basis points at the end of the first quarter, down from 149 basis points at the end of 1999. The spread between the 10-year CMT and the 1-year CMT fell to -22.4 basis points at the end of the first quarter from 47.3 basis points at the end of the prior quarter. This negative spread reflects the inverted yield curve. This decline of 69.7 basis points is probably the most important factor behind the 40 basis point drop in the spread between 30-year fixed-rate mortgages and 1-year ARMs.

THRIFTS REMAIN HOME LENDERS DESPITE GROWTH IN OTHER LOAN CATEGORIES

The thrift industry's primary emphasis is on home lending. At the end of the first quarter, thrifts held 47.9 percent of their assets in 1-4 family mortgage loans, the same as one year ago. Multifamily mortgages fell to 4.8 percent of assets from 5.2 percent one year ago. Construction loans grew in the first quarter to 2.1 percent of assets, up from 1.8 percent a year ago.

In recent years, thrifts have increased their volume of commercial and consumer lending. These loans typically have shorter terms and higher yields than home mortgage loans. Commercial loans grew to 2.6 percent of thrift assets at the end of the first quarter, up from the 2.0 percent of assets held in commercial loans one year ago. Consumer loans were 6.2 percent of assets at the end of the first quarter, up from 5.9 percent one year ago.

EQUITY CAPITAL RATIO WAS STABLE OR SLIGHTLY INCREASED FOR MOST THRIFTS

The industry's average equity capital ratio continued to decline in the first quarter to 7.69 percent from 7.79 percent in the fourth quarter and 8.14 percent one year ago. Although equity capital recently has fallen from historically high levels, 98 percent of the industry exceeded well-capitalized standards at the end of the first quarter. One, small thrift was less than adequately capitalized at the end of the first quarter.

The amount of equity capital fell to $66.8 billion at the end of the first quarter, down 0.7 percent from $67.3 billion at the end of the fourth quarter and down 1.7 percent from $68.0 billion one year ago. All of this loss was due to institutions exiting OTS regulation.

Unrealized losses on available-for-sale securities have increased since September 1998, as a result of rising interest rates. At the end of the first quarter, unrealized losses on available-for-sale securities were $2.33 billion, an increase of $0.28 billion from $2.05 billion at the end of the fourth quarter. Thrifts reported unrealized gains of $0.74 billion at the end of the first quarter one year ago.

NONCURRENT LOAN RATES WERE STABLE IN THE FIRST QUARTER

Stable noncurrent loan rates (loans over 90 days past due or in nonaccrual status) reflect good asset quality within the industry. Slight increases in noncurrent construction and land loans, nonresidential mortgages, and nonmortgage commercial loans were from the very low noncurrent levels reported over the last year. OTS will continue to closely monitor changes in asset quality data.

The noncurrent rate on thrifts' primary assets, 1-4 family mortgages, fell to 0.73 percent of all 1-4 family loans at the end of the first quarter from 0.77 percent in the prior quarter and 0.84 percent one year ago. The 1-4 family mortgage noncurrent rate has generally fallen for the past four years.

Likewise, there has been a long-term, general decline in the noncurrent rate of multifamily and nonresidential mortgages. Noncurrent multifamily mortgage loans fell to 0.24 percent of all multifamily mortgages from 0.30 percent in the prior quarter and 0.43 percent one year ago.

Noncurrent nonresidential mortgage loans increased to 0.92 percent of all nonresidential mortgages from 0.86 percent in the prior quarter, but were down from 1.19 percent one year ago.

Noncurrent nonmortgage commercial loans rose two basis points to 1.14 percent of all commercial loans from 1.12 percent in the prior quarter and 0.91 percent one year ago. Noncurrent consumer loans fell to 0.73 percent of all consumer loans from 0.77 percent in the fourth quarter and 0.82 percent one year ago.

LOSS PROVISIONS AND NET CHARGE-OFFS REMAINED STABLE

Loss provisions fell slightly in the first quarter to 0.16 percent of assets from 0.17 percent of assets in the prior quarter, but were consistent with 1999 loss provisions. Loss provisions have generally declined since 1996.

Thrift net charge-offs have generally declined since 1993 reflecting continued improvements in asset quality. In the first quarter, however, net charge-offs increased due to higher charge-offs for consumer loans and repossessed assets. Though no systemic increase was noted, OTS continues to monitor asset quality closely. Increased charge-offs were concentrated in a few thrifts.

TROUBLED ASSETS REACHED A NEW LOW

Asset quality measures generally continued to show improvement in the first quarter. Troubled assets (noncurrent loans plus repossessed assets) fell slightly to a new record low of $5.3 billion, or 0.61 percent of assets, in the first quarter, from $5.4 billion, or 0.62 percent of assets, in the prior quarter. One year ago, troubled assets were $6.0 billion, or 0.72 percent of assets.

Repossessed assets, net of specific valuation allowances, were 0.12 percent of assets at the end of the first quarter, the same as the prior quarter and down from 0.17 percent of assets one year ago.

Asset quality measures, such as troubled assets and delinquencies, are lagging indicators since these measures cover loans and investments that have already reached a troubled status. Each quarter since mid-1997, OTS has conducted a quarterly Lending Standards Survey of examiners and senior supervisory staff meet regularly to review emerging asset quality issues. Examiners complete the survey upon completion of onsite safety and soundness examinations, and supervisory staff monitor regional economic trends and specific thrift underwriting patterns. Together, these monitoring methods provide OTS with a better gauge of potential asset quality problems.

The most recent survey included results from 200 exams completed in the first quarter of 2000. Survey results for the first quarter found that thrifts engaging in higher risk or nontraditional types of lending are, for the most part, properly managing the increased credit risks. The survey did find a small increase in the number of thrifts engaging in higher risk lending. Higher risk lending is chiefly focused on construction, commercial nonmortgage, nonresidential mortgage, home equity, and consumer loans. Thrifts engaging in higher risk lending or not adequately managing risks receive increased supervisory attention.

NUMBER OF PROBLEM THRIFTS INCREASED IN THE FIRST QUARTER

The number of problem thrifts - those with composite examination ratings of 4 or 5 - increased to

14 in the first quarter from 12 in the fourth quarter. There were three ratings downgrades and one small thrift with assets of $31.5 million failed in the first quarter. Assets of problem thrifts fell slightly to $5.3 billion at the end of the first quarter from $5.5 billion in the fourth quarter. One year ago, there were 14 problem thrifts with $5.0 billion in assets.

A regulatory concern in the first quarter was the rising number of thrifts with composite ratings of 3 on their most recent examinations. Thrifts with composite ratings of 3 exhibit supervisory concerns in one or more of the ratings components and have some weaknesses that may range from moderate to severe. These institutions are more vulnerable to adverse conditions and require more supervisory attention. At the end of the first quarter, 80 thrifts with $32.5 billion in assets were rated 3, up from 68 thrifts with $23.0 billion in assets in the fourth quarter, and 68 thrifts with $27.2 billion in assets one year ago. These ratings downgrades primarily reflected rising sensitivity to interest rate risk and concerns with management of interest rate risk. Other concerns at institutions with ratings downgrades during the first quarter were with capital and earnings where these were not commensurate with risk levels - both credit risk and interest rate risk. Some downgrades also reflected weak underwriting and loan monitoring.

CONCENTRATION IN NONTRADITIONAL LOANS CONTINUED TO INCREASE

Since 1998, the number of thrifts with commercial loan portfolios exceeding 10 percent of total assets grew by 67 percent from 39 to 65. Concentration in commercial loans among those thrifts most heavily engaged in commercial lending (those in the 90th percentile) increased from 8.0 percent of total assets to 9.0 percent since 1998. An increase in concentration at the 90th percentile also occurred for thrifts making nonresidential mortgages and construction and land loans. Thrifts have experience with these loan categories, but these are higher risk loans. Therefore, sound underwriting and monitoring systems are critical.

INTEREST RATE RISK SENSITIVITY CONTINUED TO INCREASE

The OTS uses its Interest Rate Risk (IRR) Model to monitor thrifts' interest rate risk. The model measures changes in a thrift's economic value, or net portfolio value (NPV), due to changes in interest rates. The decline in a thrift's NPV due to a 200 basis point movement in interest rates is measured by the IRR model to test the sensitivity of the thrift to interest rate changes. The resulting change in NPV - the post-shock NPV - indicates the thrift's ability to absorb or withstand future interest rate changes.

Based on preliminary first quarter data filed in the Schedule of Consolidated Maturity and Rate Data (CMR), the IRR model showed the industry's median first quarter sensitivity to interest rate risk increased to 239 basis points from 231 basis points in the prior quarter and 144 basis points one year ago. Sensitivity has increased for six consecutive quarters after generally improving between March 1997 and September 1998. Median sensitivity was at its highest level since OTS began using the current IRR model in 1993.

In response to rising short-term interest rates, thrifts are managing their portfolios to somewhat offset increasing sensitivity to interest rate risk. Thrifts reduced the proportion of fixed-rate, 1-4 family mortgage loans held in portfolio to 23 percent of assets at the end of the first quarter from 26 percent of assets one year ago. The proportion of 1-4 family ARMs held in portfolio increased to 32 percent of assets at the end of the first quarter from 31 percent of assets one year ago. The proportion of ARMs with introductory teaser rates fell to 2.4 percent of assets at the end of the first quarter from 3.6 percent of assets one year ago. Low-costing demand deposits rose to 8.0 percent of assets at the end of the first quarter from 7.3 percent of assets one year ago. The proportion of shorter term consumer and commercial loans held in portfolio has increased.

Consumer loans increased to 6.2 percent of assets from 5.9 percent one year ago. Commercial loans increased to 2.6 percent of assets from 2.0 percent one year ago.

PRE-SHOCK NET PORTFOLIO VALUES

Based on preliminary first quarter CMR data, the IRR model revealed that pre-shock NPV, or estimated market values, continue to be well above the well-capitalized threshold of 5.0 percent of assets, even for the bottom 10th percentile of thrifts. The industry's median pre-shock NPV was 11.4 percent at the end of the first quarter, up from 10.8 percent at the end of the fourth quarter and 11.3 percent one year ago.

While pre-shock values increased from December's values, they are below values at the end of September 1999. Given the turmoil in the bond market, it is possible that the steep December drop was an aberration.

MEDIAN POST-SHOCK VALUES REFLECT CHANGE IN PRE-SHOCK VALUES

Reflecting the higher pre-shock NPV, the industry's post-shock NPV also was higher. The industry's median first quarter post-shock NPV increased to 9.0 percent from 8.7 percent in the prior quarter, but was lower than the 10.0 percent median post-shock NPV one year ago.

ASSET GROWTH CONTINUED AND INDUSTRY CONSOLIDATION SLOWED

The number of thrift institutions regulated by OTS fell to 1,097 in the first quarter from 1,103 in the prior quarter and 1,129 one year ago. Industry assets increased at a 2.4 percent annual rate to $868.7 billion at the end of the first quarter from $863.6 billion in the prior quarter. Asset growth was 4.0 percent from the first quarter a year ago when industry assets were $835.0 billion. Industry assets today are the highest since 1991, when they totaled $895 billion.

MERGER AND ACQUISITION ACTIVITY SLOWED DURING THE FIRST QUARTER

Over the first quarter, 16 thrifts left OTS supervision (two were thrift-to-thrift mergers), on par with the 17 thrifts that exited in the prior quarter, and down from the 25 thrifts exiting in the first quarter one year ago. Exits have primarily been due to merger and acquisition activity.

There were ten new entrants in the first quarter, on par with the nine new entrants in the prior quarter and the first quarter one year ago. First quarter new entrant activity was split between five de novo charters and five conversions to a thrift charter. Over the last two years, new entrant activity was concentrated in de novo charters.