



## **THRIFT INDUSTRY HIGHLIGHTS SECOND QUARTER 2006**

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### **SUMMARY**

The nation's thrift industry reported strong earnings and profitability, solid loan growth, and healthy asset quality for the second quarter of 2006. Although earnings and profitability were robust, thrift earnings are typically constrained in an interest rate environment characterized by a flat to inverted yield curve. The industry's aggregate net interest margin increased by three basis points from the prior quarter. Total mortgage origination volume for the quarter was down 11 percent from the second quarter one year ago, but up four percent from the prior quarter as lower mortgage interest rates during the quarter led to continued strength in existing and new home sales.

Thrift industry assets increased by 11 percent from the second quarter one year ago to \$1.53 trillion. The number of thrifts supervised by OTS stood at 854 at the end of the second quarter. In addition, OTS supervised 480 holding company enterprises with approximately \$7.5 trillion in U.S. domiciled consolidated assets. These enterprises owned 448 thrifts with total assets of \$1.2 trillion, or 79 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. Despite the sustained strength in industry asset quality, delinquencies of 1-to-4 family and multifamily mortgages, and consumer loans were up from the record low rates of one year ago. In part, delinquencies of 1-to-4 family mortgage loans were higher because changes to accounting and regulatory reporting requirements for banks and thrifts now require loans repurchased, or eligible for repurchase, from Government National Mortgage Association (GNMA) mortgage pools to be included in past due loans<sup>2</sup>. Loans past due by 30- to 89-days as a percentage of assets reached a record low at the end of the first quarter 2005, but have increased in subsequent quarters and were higher from one year ago at the end of the second quarter 2006. The industry's equity capital level reached a record level at the end of the second quarter and, as a percentage of

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<sup>2</sup> GNMA mortgage-backed securities are fully guaranteed by the U.S. Government. Individual loans repurchased from GNMA pools are fully or partially guaranteed or insured by agencies of the U.S. Government.

assets, its equity capital ratio was down slightly from the prior and comparable year ago quarters.

## **EARNINGS AND PROFITABILITY**

Net income was \$4.21 billion in the second quarter, unchanged from the prior quarter, and up four percent from the year ago second quarter. This was the sixth time and sixth consecutive quarter that quarterly income topped the \$4 billion mark. The number of thrifts reporting losses in the second quarter was 80, up from 58 thrifts in the second quarter one year ago.

Profitability, as measured by return on average assets (ROA), was 1.11 percent in the second quarter, down from 1.18 percent in the comparable year ago quarter, and from 1.14 percent in the first quarter. The median ROA declined to 0.64 percent in the second quarter from 0.80 percent in the second quarter one year ago, and was down from 0.66 in the prior quarter.

Return on average equity (ROE) was 11.93 percent in the second quarter, down from 12.79 percent in the second quarter one year ago, and from 12.17 percent in the first quarter.

## **ANALYSIS OF ROA**

The decrease in second quarter ROA from the prior quarter was driven by lower fee income and higher loan loss provisions and noninterest expense. Partially offsetting these negative impacts to quarterly profitability were a higher net interest margin, higher other noninterest income, and lower taxes.

In the second quarter, NIM decreased to 280 basis points (or 2.80 percent of average assets) from 285 basis points in the comparable quarter a year ago, but was up from 277 basis points in the prior quarter.

Loan loss provisions were unchanged from one year ago at 0.20 percent of average assets in the second quarter, but were up from 0.15 percent in the prior quarter. Loan loss provisions averaged 0.26 percent of average assets between 2001 and 2003, but have generally trended lower since the beginning of 2003 reflecting improved economic conditions.

Total fee income, including mortgage loan servicing fee income and other fee income, increased to 1.18 percent of average assets in the second quarter from 1.04 in the second quarter one year ago, but was down from 1.27 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 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 was 0.10 percent of average assets in the second quarter, up from a negative 0.01 percent in the second quarter one year ago, but down from 0.20 percent in the prior quarter.

Other fee income was up three basis points from the second quarter one year ago to 1.08 percent of average assets, and was up from 1.07 percent in the prior quarter. Growth over the year came 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 fell to 0.55 percent of average assets from 0.64 percent in the second quarter one year ago, but was up from 0.44 percent in the first 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 2.63 percent of average assets over the second quarter, up from 2.49 percent in the second quarter one year ago, and from 2.56 percent in the prior quarter. General and administrative expense, the largest component of noninterest expense, increased by 12 basis points to 2.58 percent of average assets in the second quarter from 2.46 percent in the comparable year ago quarter.

Taxes were down five basis points from the second quarter one year ago to 0.60 percent of average assets, and were down from 0.62 percent in the first quarter. Over the past two years, taxes have averaged 0.64 percent of average assets, or about 36 percent of pretax income.

## **MORTGAGE ORIGINATIONS**

Total thrift industry mortgage originations (which include multifamily and nonresidential mortgages) in the second quarter fell to \$171.0 billion from \$191.8 billion in the second quarter one year ago, but were up from \$164.6 billion in the prior quarter. Second quarter 1-4 family mortgage originations by thrifts were \$148.4 billion, down 12 percent from \$169.4 billion in the second quarter one year ago, but up four percent from the \$142.6 billion originated in the first quarter.

Thrifts accounted for approximately 25 percent of total 1-4 family originations nationwide in the second quarter of 2006,<sup>3</sup> unchanged from the prior quarter, and up from 23 percent in the comparable year ago quarter. An estimated 37 percent of thrift originations were ARMs in the second quarter, down from 44 percent in the prior

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<sup>3</sup> Total 1-4 family mortgage originations estimated by the Mortgage Bankers Association of America.

quarter, and from 42 percent in the comparable year ago quarter. In contrast, the ARM share for all lenders was estimated at 28 percent in the second quarter, 33 percent in the second quarter one year ago, and 25 percent in the first quarter.<sup>4</sup>

The volume of mortgage refinancing was lower from the second quarter one year ago and from the prior quarter. Refinancing activity accounted for 31 percent of thrift originations in the second quarter, up slightly from 30 percent in the second quarter one year ago, but down from 35 percent in the prior quarter.

## ASSET QUALITY

Asset quality within the industry remained strong over the second quarter. OTS is closely monitoring thrift loan performance and asset quality since a significant proportion of thrift loan portfolios are 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 receiving additional supervisory scrutiny since these loans have not been stressed through different economic cycles. Troubled assets, which consist of noncurrent loans and repossessed assets, were down two basis point from the prior quarter at 0.62 percent of assets. Excluding repurchased GNMA loans, troubled assets were unchanged from the prior quarter at 0.47 percent of assets, and up from 0.42 percent at the end of the second quarter one year ago. Repossessed assets were unchanged from the prior quarter at 0.07 percent of assets, and up from 0.05 percent one year ago.

Noncurrent loan rates (loans over 89 days past due or in nonaccrual status), excluding repurchased GNMA loans, were unchanged from the prior quarter at 0.40 percent of assets, but up from 0.37 percent one year ago. Noncurrent loan rates for 1-4 family and multifamily mortgages, and consumer loans were higher from one year ago. 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, excluding repurchased GNMA loans, were up seven basis points from one year ago, but unchanged from the end of the first quarter at 0.51 percent of all 1-4 family loans. Noncurrent multifamily loans increased to 0.16 percent of all multifamily loans from 0.09 percent one year ago. Noncurrent consumer loans increased from 0.61 percent of all consumer loans one year ago to 0.68 percent at the end of the second quarter.

Noncurrent nonresidential mortgages fell to 0.45 percent of all nonresidential mortgages from 0.64 percent one year ago. Noncurrent construction and land loans were 0.46 percent of all construction and land loans, down from 0.49 percent one year ago. Noncurrent commercial loans fell to 1.10 percent of all commercial loans at the end of the second quarter from 1.15 percent a year ago.

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<sup>4</sup> Data are from the Federal Housing Finance Board's monthly *Mortgage Interest Rate Survey*.

Loans past due by 30 to 89 days were higher over the year for 1-4 family mortgages and lower for other major 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, excluding repurchased GNMA loans, were \$8.7 billion, or 0.57 percent of assets compared to \$7.4 billion, or 0.54 percent of assets, one year ago, and \$8.2 billion, or 0.55 percent of assets, in the first quarter.

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

Industry assets increased by 10.5 percent over the year to \$1.53 trillion from \$1.39 trillion. Thrifts remain focused on residential mortgage lending, with 56.4 percent of assets invested in 1-4 family mortgage loans at the end of the second quarter, down slightly from 56.9 percent one year ago. Of these 1-4 family mortgage loans, 10.7 percent are home equity lines of credit, down from 11.0 percent of 1-4 family mortgages in the second quarter one year ago. Holdings of consumer loans increased to 5.9 percent of assets from 5.8 percent a year ago, and multifamily mortgages were down over the year to 4.4 percent of assets from 4.7 percent. Commercial loans fell to 3.0 percent of assets at the end of the second quarter from 3.2 percent one year ago.

Deposits and escrows grew by 10.7 percent over the year to \$863 billion from \$801 billion. As a percentage of total assets, deposits and escrows decreased to 57.6 percent from 57.7 percent one year ago. Federal Home Loan Bank advances were down from one year ago at 17.7 percent of total assets.

Capital measures for the industry continue to be 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 9.25 percent of assets, down slightly from 9.34 percent one year ago. No thrift was less than adequately capitalized at the end of the second quarter.

## **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 – decreased by three over the year to four. Assets of problem thrifts were lower at the end of the second quarter at \$209 million, down from \$2.0 billion at the end of the comparable year ago quarter and from \$1.1 billion at the end of the prior quarter.

Thrifts with composite ratings of 3 remained were up by two over the year to 49 at the end of the second quarter and were up by five from the first 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 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**

Charter choice decisions resulted in six institutions choosing a thrift charter during the second quarter – five were “de novo” institutions and one was an existing state savings bank that converted to a federal thrift charter. One thrift converted to a commercial bank charter over the second quarter. Also during the second quarter, five OTS-regulated thrifts merged with other OTS-regulated thrifts, and non-OTS regulated institutions acquired two thrifts.