REMARKS BY
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CONDITION OF THE THRIFT INDUSTRY
Managing Through a Rising Rate Scenario

I. Introduction

Good afternoon. It is an honor to be invited back to speak before the Exchequer Club. Last May I talked about the vitality of the thrift charter. This is still my favorite subject, and I will update you on the state of the industry today. I will also offer some comments on industry and regulatory preparations for managing through an increasing interest rate environment, an entirely plausible scenario given today's rate environment.

Much of the current economic data points to a moderate growth scenario for this year. Many economists see some potential for rising interest rates, but most seem to agree that inflation remains relatively tame. So what does that mean for interest rates? Only one thing is certain with interest rates – they will change. The change can often come with unforeseen speed or in an unexpected direction.

At OTS, we supervise the thrift industry without a bias for direction or speed of interest rate movements, but rather with a forward looking view to identify potential concerns among a number of possible scenarios. In this regard, the OTS long ago developed a supervisory interest rate risk (IRR) model that supports our examination work and off-site monitoring efforts. In addition, our regulatory framework requires all thrifts to prudently measure, monitor and manage interest rate risk. Our larger and more complex thrifts must maintain an internal model and systems for managing interest rate risk. For our smaller, less complex institutions, the OTS IRR model provides thrift management and boards with a portfolio-wide view of interest rate sensitivity. Thrift institutions also operate under prudential regulatory requirements that govern the use of financial derivatives as a risk management tool.

II. Current Industry Conditions

When I spoke here last year, I noted that the thrift industry reported record earnings for 2002. While the year-end 2003 financial reports are not due until the end of this month, the thrift industry just completed what will very likely be the most profitable year in its history. The thrift industry has reported strong earnings growth over the past several years due to a favorable interest rate environment, good stewardship by thrift managers, record mortgage originations and sales, earnings diversification, and good asset quality. Strong earnings have strengthened thrift capital positions. Nearly all asset quality measures remain strong. Interest rate risk appears manageable. Not surprisingly, the number and assets of problem thrifts are at nominal levels.

Thrift assets continued to grow at a steady pace during the first three quarters of 2003. Industry assets increased at an annualized rate of 11.9 percent, rising to $1.1 trillion by September 2003. Thrift growth was fueled by a favorable rate environment, improving economic conditions and strong loan demand. Funding was derived primarily through deposit growth and, to a lesser extent, borrowings. Though industry consolidation has reduced the overall number of thrift institutions, thrift asset growth is strong. This growth is supported though a network of nearly seven thousand branches. At September 2003, the industry employed over 209,000 people, generating over 14,400 thousand additional jobs since year-end 2002.

The industry earnings performance for 2003 has been quite remarkable. Net income was reported at $10.3 billion through the first nine months of 2003, representing an annualized 1.30 percent return on average assets (ROA). In comparison, net income in 2002 was a record $11.8 billion, or a 1.21 percent ROA. Third quarter 2003 industry net income was $3.4 billion. We expect that the impact of reduced mortgage origination volume will somewhat lower fourth quarter earnings, but full year 2003 earnings could exceed 2002.

Thrift net interest margins (NIM) compressed during 2003 as the continuing low rate environment caused asset yields to drop more rapidly than funding costs. Overall, the industry NIM stood at 2.91 percent through September 2003, as compared to 3.06 percent in 2002. Noninterest income was robust as record mortgage loan volume boosted origination fees and provided gains on loans sold into the secondary market. Industry noninterest income was 1.75 percent of average assets for the first nine months, including a net loss of 19 basis points on mortgage servicing resulting from write-downs of servicing assets. While servicing assets suffered in 2003 from loan portfolio run-off, if mortgage refinance volumes pull back in 2004, as many anticipate, servicing income should rebound and valuation recoveries could provide a partial offset to reduced loan origination and loan sale income.

While the historic level of loan originations was a key catalyst in 2003 thrift earnings, the underlying strength and stability of earnings has also been driven by diversification of income sources and continued strong asset quality. The industry's success over the past decade in expanding its line of products and services, such as mutual fund and annuity sales, trust activities, and transaction accounts, has enabled the industry to diversify its income stream and generate more stable earnings. Income from fees and charges measured 0.93 percent of average assets for the first nine months of 2003, up more than 400 percent from 0.17 percent in 1990. Higher proportions of noninterest income have helped stabilize thrift income and should provide better insulation against interest rate fluctuations.

Thrift involvement in trust activities has grown dramatically. We oversee this growth with a regulatory process that requires thrifts to obtain OTS approval prior to commencing trust services and with regular examinations of activities by OTS trust specialists. As of the third quarter of 2003, nearly 10 percent of our thrifts were engaged in some form of trust services, ranging from fiduciary work on managed and nonmanaged accounts, to custodial and safekeeping services. As of September 2003, thrifts administered fiduciary trust accounts with total assets of $187 billion. In addition, thrifts provided custodial and safekeeping services on accounts with an aggregate balance of $328 billion. While not considered a trust activity, many thrifts also offer nondeposit investment products to customers. Demand for these products remains strong even at a time when thrift deposits are growing. Thrifts sold $11.6 billion of nondeposit investment products through the first nine months of 2003, $5.6 billion in annuities and $6.0 billion in mutual funds. These sales generated fee income totaling $332 million.

Thrifts continue to play a significant role in the mortgage market through mortgage loan originations and purchases, loan sales and servicing. OTS-regulated institutions originated $586 billion in 1-4 family mortgage loans through September 2003 and sold $628 billion into the secondary market. Mortgage loan origination volumes in 2003 will significantly surpass the record $472 billion in 1-4 family mortgage loans generated in 2002. In addition to generating and selling a high level of loan products, thrifts provided mortgage servicing on loans with an aggregate principal value of $1.0 trillion at September 2003, up from $948 billion at the close of 2002.

The composition of our industry is quite diverse in terms of size and operating strategy. We regulate a number of large institutions that operate either nationwide or in multiple geographic regions. However, the core of our thrifts remains primarily smaller, community-based organizations. Nearly 90 percent of all thrifts have assets less than $1 billion, and two-thirds of the institutions have assets below $250 million. Given the industry composition, the performance of the larger thrift institutions can somewhat mask the performance of our smaller community thrifts when focusing purely on industry averages. To gain a more complete picture of the industry, we monitor a variety of industry trends using a combination of broad measures, medians and peer analyses among discrete market segments and business strategies.

This past year, we conducted a follow-up review to our 1997 Highly Profitable Thrift study focusing on the performance of community thrifts, which we defined as institutions with assets under $1 billion. Our 2003 review confirmed the 1997 findings that smaller, community based thrifts can indeed generate consistently high earnings. We looked at the level of earnings among community thrifts over the past five years and identified those institutions that were consistently top performers. We studied this group to identify the traits that helped these institutions achieve such strong results.

We found that this group of highly profitable institutions generally consists of active mortgage lenders that also offer a diverse mix of other loan products, retain higher levels of whole loans in portfolio, maintain strong capital levels and have good asset quality. Given these strong operating fundamentals, it was not surprising that these institutions also had consistently higher examination ratings, particularly for the Management component.

Amid all the positive industry trends last year, the second half of 2003 represented a challenging time for many financial institutions as interest rates began to move up from historic lows. Rates moved up quickly during the third quarter and borrowers closed loans at record levels to take advantage of favorable rate locks. Record production may not continue, however, as loan pipelines appeared to be tailing off in the fourth quarter due to higher loan rates.

There were numerous announcements in the mortgage market of impending staff cutbacks to meet the expected drop in loan volume. However, the pace of new home sales and construction starts remains firm providing some support on the origination side. In addition, adjustable-rate mortgage and hybrid mortgage products remain popular and could make up for a portion of the fixed-rate product decline. Adjustable rate loans accounted for 55 percent of all mortgages held in portfolio.

On other industry fronts, asset quality and capital are strong. Thrift loan performance and charge-off data provide little indication of any major credit concerns. Troubled assets represented a modest 0.68 percent of assets as of September 2003, mainly in mortgage loans secured by 1-4 family properties. Loan charge-offs stabilized in 2003 at a manageable rate of 0.26 percent of assets after rising steadily throughout 2002. Industry capital also remains strong at just under 9 percent. Only one thrift failed to meet the Prompt Corrective Action (PCA) capital requirements and that institution returned to a well capitalized position shortly after the close of the third quarter. Moreover, 99.9 percent of the industry met the requirements of the PCA's highest "well capitalized" threshold.

III. Interest Rate Risk Position

In some corners, the looming question is - what will happen to thrifts if interest rates rise rapidly and remain at high levels?

Clearly, every institution has unique characteristics that affect the ultimate impact that upward rate changes have on its operations and financial performance. Some factors are structural or market driven, while others are more qualitative relating to board oversight, managerial capabilities, and the strength of risk management systems. Many thrifts have prudently positioned their balance sheets to moderate the potential negative impact of an increasing rate environment. Other institutions that exhibit higher IRR sensitivity are examined more thoroughly and closely monitored to ensure that the board and management have adequate plans and systems to manage through a period of rising rates. Overall, looking across the industry, we see a relatively moderate IRR sensitivity picture at this stage of the rate cycle. However, there are an increasing number of institutions that exhibit IRR exposure levels that cause supervisory concern.

OTS is unique among U.S. banking regulators in that we developed an internal model for measuring interest rate risk. Nearly all thrifts report detailed maturity and yield/cost data for all significant on-balance sheet components and off-balance sheet commitments and derivatives. We maintain the model for supervisory review purposes, but also to give smaller thrifts a perspective on the potential impact of changing interest rates. The model allows us to take a forward-looking view, from an economic value perspective, to assess interest rate risk exposure. In addition, our regulations require thrift management to monitor and manage interest rate risk on an ongoing basis and maintain exposure risk within prudent risk tolerances. From the vantage point of the OTS model and considering a number of prudent thrift risk management practices, the industry has the opportunity to respond effectively to portfolio sensitivity resulting from shifts in interest rates.

Our supervisory model generates several key measures that benchmark industry and institution interest rate risk positions. One key measure is the base net portfolio value ratio (NPV) of the institution, which represents the net economic value of the organization at a given point in time. A second measure we commonly reference is the post shock NPV ratio or "exposure measure," which is modeled under an assumed instantaneous rate shock of plus or minus 200 basis points. The difference between the base NPV ratio and the post-shock NPV ratio is called the "sensitivity measure." Even with heightened volatility in interest rates, large movements in rates, such as a 200 basis point move, generally occur in a more gradual fashion. Our rate shock measures do not include any benefit of risk mitigation strategies that thrift managers may employ to limit the potential impact of a changing interest rate structure.

The median industry exposure measure and sensitivity measure stood at 10.9 percent and 130 basis points, respectively, at September 2003. A sensitivity measure of less than 200 basis points generally indicates a manageable level of portfolio exposure. The median exposure measure of 10.9 percent points to a strong net portfolio value, which provides an equity buffer against the impact of rising rates. Even though these median IRR measures are generally favorable, the number of institutions that exhibit measures that cause a higher degree of regulatory scrutiny increased sharply in the third quarter due to higher interest rates. Over 95 percent of thrift institutions had IRR measures that would be categorized as having minimal or moderate risk. Nevertheless, continued increases in market rates would certainly result in additional thrifts showing a higher degree of IRR exposure.

The OTS model measures provide just one perspective from which to evaluate IRR exposure. Equally, if not more, important are the qualitative factors relating to risk management that we regularly assess through dialogue with thrift management and at our onsite thrift examinations. Over the past year, we have heightened our supervisory attention on IRR with the realization that rates will not remain at historically low levels indefinitely. We have seen management at a number of thrifts initiate plans to reduce exposure to rising rates, while others are attempting to identify risk reduction alternatives. Those institutions with unusually high levels of IRR sensitivity that do not have a prudent risk management strategy will certainly receive increased scrutiny at onsite examinations in offsite monitoring.

The base net portfolio value of the thrift industry was $101.7 billion or 9.83 percent of assets as of September 30, 2003. This represents a 12 percent premium to the $90.6 billion of book equity capital of the institutions reporting to OTS. These measures do not assume any future business generation or portfolio management changes. As such, they represent more of a snapshot of the portfolio risk characteristics at the end of a quarter, rather than an attempt to estimate the market value that could be realized in the sale of an institution.

Looking at a worst case scenario of an immediate 300 basis point parallel shift in the September 30, 2003, yield curve, OTS's simulated model results indicate that thrift industry NPV would decline by 26 percent or 219 basis points to 7.64 percent of assets. Given that interest rates often move in a more gradual and nonparallel fashion, thrift management should have an opportunity to institute remedial actions to limit the potential impact of a changing rate structure. Thrifts that have planned for or initiated effective risk mitigation strategies will be better equipped to withstand the potential impact that rising rates can have on portfolio value and earnings. Whereas a delayed response to upward rate movements may limit strategic alternatives or make risk reduction options more expensive.

As I noted earlier, thrift net interest margins compressed in 2003. However, the prospect of rising rates, particularly with the present steepness in the yield curve, could have a positive impact on thrift net interest margins in the long term. The industry held a high percentage of adjustable-rate mortgage product, as well as, other shorter-term consumer and commercial credits. A rising rate environment would provide opportunities to reset these loan rates upward. Additionally, thrifts maintained higher levels of liquidity in 2003, forgoing some short-term interest income. This positioning could prove to be fortuitous in a rising rate environment, as thrifts with high liquidity will have funds available to invest in higher yielding loans and investments as rates increase.

Historically, the thrift industry faced intense pressure from rising interest rates. This was most evident in the early 1980s when the net interest margins of many thrifts turned negative. Since that time, improvements in risk management, changes in asset/liability composition, increased product diversification and expanded income diversification have reduced the volatility of thrift portfolio values and net income. We maintain a watchful eye on interest rate risk given the industry's natural concentration in longer-term mortgage loans, which are generally funded with shorter-term deposits and borrowings. Since interest rates typically rise during times of economic expansion, monitoring interest rate risk will be especially important as the economy grows. So, even though thrifts are reporting consecutive years of record earnings, we continue to look ahead to see where challenges may arise.

IV. Thrift Asset/Liability Management and Strategic Planning

As touched on earlier, the asset-liability structure of a typical thrift is inherently sensitive to rising interest rates because long-term assets are funded with shorter-term liabilities. This sensitivity can manifest itself in several ways in a rising rate environment, including a declining market value of long-term assets and a compressed net interest margin. The current interest rate environment and yield curve structure are generally favorable for thrifts' current operations. However, the eventual rise in interest rates that would come with economic recovery or changes in the yield curve could adversely impact thrift earnings.

We have seen a number of thrifts take advantage of the low rate environment to extend liability maturities at favorable terms. The lengthening of liability maturities provides a buffer for thrifts against the impact of rising rates. In addition to strategic funding decisions, mortgage loan demand has shifted thrift loan portfolios increasingly toward holding more fixed-rate loans with shorter-terms (10, 15 and 20 years) than the traditional 30-year product, and higher levels of adjustable-rate loans and hybrid loan types. Shorter-term fixed-rate mortgages provide greater cash flow than traditional 30-year loans, allowing more opportunity to invest as rates rise. Adjustable-rate mortgage rates will reset to higher levels in a rising rate environment. Likewise, hybrid loan products that are fixed for periods of 3, 5, 7 or 10 years and then covert to adjustable rates will reset rates and provide some buffer against rising rates. These asset/liability practices mitigate the adverse impact of rising rates.

Except for a few larger thrifts, most thrifts do not use synthetic derivative instruments to manage interest rate risk. Our regulatory framework restricts thrifts from using derivatives for speculative purposes. We collect data on two types of instruments or contracts that may meet the FAS 133 definition of derivatives, traditional financial derivatives and loan commitments. As of September 2003, the aggregate notional amount of financial derivatives was $95.3 billion. By comparison, the aggregate balance of loan commitments was $272 billion. Within this group, thrifts held commitments to originate or purchase loans or loan-backed securities for a total of $145 billion and commitments to sell loans and loan-backed securities totaling $128 billion.

Much of the financial derivative activities in the thrift industry represent opposite ends of similar transactions. For example, thrifts reported a $28.5 billion notional balance in interest rate swap positions where the thrift pays a fixed rate and receives 3-month LIBOR in return. At the same time, thrifts had $29.5 billion in swap positions where they paid 3-month LIBOR and received payments at a fixed rate. These two contract positions represented 61 percent of all thrift financial derivative positions outstanding as of September 30, 2003. Swaps made up 90 percent of all thrift derivative holdings, while interest rate floor contracts, rate caps and futures rounded out the remaining positions. As you can tell from the relatively low volumes, thrifts' use of financial derivatives is fairly limited.

A traditional way of managing against the potential impact of rising rates is to build liquidity and gradually deploy funds into the rising market. Many thrifts have increased their liquidity base. Some have done so because mortgage prepayments have returned cash to thrift managers faster than they can prudently invest it. Others have chosen a course of "wait and see" before taking significant portfolio positions with the cash build up from loan repayments. In either case, the high levels of liquidity provide an IRR buffer and an investment opportunity when interest rates rise.

Sound strategic planning and prudent risk management are critical for all financial institutions, but particularly for those that have grown more dependent on a particular line of business or are significantly exposed to market events. We encourage thrifts to consider opportunities to prudently diversify, whether in balance sheet holdings, funding composition or income sources. Similarly, betting long on the yield curve to maximize today's earnings while jeopardizing future financial stability is closely scrutinized. OTS expects thrift management to employ sound strategic and contingency planning practices, particularly for institutions that rely heavily on narrow margins or volatile sources of earnings.

Even with the favorable, low rate environment and considering some of the proactive strategies that certain thrifts are employing, OTS remains cautious of the potential impact of significant, sustained increase in market interest rates. OTS will remain vigilant in monitoring for adverse trends and ensuring that thrifts are properly focused on managing the potential impact of changing interest rates.

V. Potential Outcomes

We hold our institutions to high expectations and want them to succeed in their endeavors. Our goal is to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion. The level of our supervisory scrutiny varies based on the overall thrift risk profile. Key considerations include the extent that management and the board is committed to a prudent operating strategy, whether staffing expertise is commensurate with the scope of activities, the effectiveness of internal risk management systems, and the discipline of the internal control environment and thrift ability initiate corrective actions before problems escalate.

There are many pressures that make operating in today's marketplace more difficult than in the past, but there are also more opportunities available to achieve success. As we look forward, there are a number of potential outcomes from further economic recovery and expansion and the likelihood of resulting interest rate increases. Each possibility seemingly comes with two edges, one positive and one negative. I would like to touch on a few potential outcomes:

1. If interest rates rise due to economic expansion, loan performance could suffer due to higher rate resets; however, the impact should be partially offset by improving credit quality of new borrowers. With more job certainty in a growing economy and less joblessness. Credit quality of consumer borrowers should improve along with increasing pay and job tenure.

2. Likewise rising rates may produce a period of narrowing interest margins. Rates on shorter-term deposit liabilities increase at a faster pace than longer-term loans. The impact should be partially offset if the overall loan portfolio quality strengthens. Lower charge-offs could mitigate the impact of the net interest margin pressure.

3. Even with the recent rise in rates, interest rates and mortgage rates are at very low levels historically. Assuming rates rise 100 or 200 basis points on mortgages, the expected decline in demand could be partially offset by a growing number of borrowers who can now afford mortgages because of an improving economy and increasing pay.

4. If economic conditions improve, as many economists expect, small business lending will increase. Small businesses have been a key driver in nearly every economic recovery. Increased SBA loan application volume indicates that small business owners are very optimistic about future business prospects. As small business owners borrow more to fund growth, this line of business could become an increasing portion of thrift loan portfolios.

5. Coming out of the 1991 recession and entering the ensuing economic expansion, thrift industry capital was much weaker than the near record level we have now. Also, thrift portfolios were more narrowly focused on mortgage loans, not other forms of consumer retail credit. Institutions with higher capital and loan diversification should have greater flexibility to withstand the potential consequences of a rising rate environment.

6. If depositors expect that equity investment returns are attractive again, their money may migrate back into stocks and mutual funds and out of deposit accounts. These withdrawals

can either be replaced with other funding, maintaining assets at a stable level, or funded from liquidity causing assets to decline. If assets decline, capital ratios could improve and pressure to maintain capital ratios will decrease. However, deposit outflows invested back into the stock market could also stimulate increased business and consumer loan demand. Expected lending growth in the face of deposit outflows could lead to an increasing reliance on external borrowings.

VI. Supervisory Efforts

Last year, OTS and the other Federal banking regulators issued a mortgage banking advisory to highlight some of the potential dangers related to the mortgage business. The guidance rings particularly true today as rates have risen from record lows and financial institutions are feeling volume pressures. This is the time where earlier strategic planning and prudent risk management practices should allow the best results.

We are closely monitoring how thrifts transition from the current intensive "mortgage-banking" mode to a more typical lending environment. Low mortgage rates have spurred refinancings and record origination volumes, and income from this increased lending has helped boost overall thrift profitability. As the economy continues to recover and interest rates rise from their current low levels, refinancing activity will decline. At the same time, thrift managers could be pressured to maintain current earnings levels despite reduced lending activity. This could manifest itself in reduced overhead costs to help maintain earnings, entering into new activities or reaching for greater fee income. While we expect some staff reductions as lending volumes decline, our examination and supervisory staff will closely evaluate thrifts' responses to ensure that the quality of loan underwriting and internal controls is not compromised. We also will follow-up with thrift management to ensure that institutions are effectively managing new business lines.

My supervisory staff is currently working on an industry release to discuss the current operating environment, highlighting many of the potential concerns that I noted today and providing supervisory guidance on our expectations for thrift management and boards. Our examination teams are well seasoned, and almost all have worked through earlier interest rate cycles. Many even witnessed the unique rate environment from the late 1970s-early 1980s and its implications. This experience and improved techniques, such as improved internal models and OTS's supervisory model, provide us with the necessary tools to evaluate and respond to industry issues. Even so, the most important element is thrift management. With the right people and the appropriate approach, thrifts can navigate through a rising rate environment. We will continue to focus on and closely evaluate the qualitative factors relating to board strategic planning and risk management practices.

VII. Concluding Remarks

Thrift performance has been excellent in earnings growth, capital formation and asset quality. Industry interest rate risk exposure remains at a moderate level. The number and assets of problem institutions are nominal. Thrifts have grown and diversified over the past several years while reporting strong financial results. Our industry continues to play a vital role in providing mortgage funding and other retail products and services to individuals across all reaches of the nation.

We will continue to closely evaluate the risks faced by the industry, with a focus on credit and interest rate risk. We closely watch for changes in thrift activities and assess their response to changing market conditions. When appropriate, we will put the industry on notice of potential issues and suggest best practices. My comments today reflect some of our observations on the industry position relative to potential changes in the external environment. We are confident that the industry will continue to fulfill its primary focus of serving retail customers with mortgage funding and other financial services in a profitable and prudent manner.