Industry Performance

Thrift Industry Highlights - Q4 1999

THE OTS-REGULATED THRIFT INDUSTRY FOURTH QUARTER 1999 HIGHLIGHTS

Office of Thrift Supervision / March 8, 2000

These highlights provide a general overview of performance measures for the fourth quarter and for all of 1999.

1999 KEY POINTS
The industry finished the year with record-breaking earnings. Net interest margin (NIM) remained stable despite rising interest rates and a flattening yield curve. Thrifts generally controlled overhead costs; noninterest expense fell as the industry shifted from a mortgage banking to a portfolio lending mode.

Mortgage originations were lower during the year, but remained near record levels. General measures of asset quality continued to improve over the year, and the number and assets of problem thrifts were down over the year.

Asset growth within the industry surpassed assets lost through exits. As of December 31, 1999, there were 1,103 OTS-regulated thrifts with assets totaling $863 billion.

AREAS OF CONCERN
While most of the performance measures were positive, there are several areas of increasing interest to OTS. Interest rate risk exposure increased as evidenced by an increase in the sensitivity measure and a decline in the post-shock net portfolio value. The equity capital ratio declined slightly due to asset growth and unrealized losses on available-for-sale securities.

1999 INDUSTRY EARNINGS SET NEW RECORD
The thrift industry posted record earnings in 1999 for third consecutive year. Net income totaled $8.2 billion in 1999, up 9 percent from $7.6 billion in 1998. ROA was 0.98 percent in 1999, up from 0.97 percent in 1998. 1999 ROA was the highest since 1962, when ROA was also 0.98 percent. The ROA record was 1.20 percent in 1946.

Fourth quarter earnings fell slightly to $1.98 billion from $2.09 billion in third quarter. Fourth quarter earnings were the sixth highest of any quarter, exceeded only by the first three quarters in 1999 and the second and third quarters in 1998. Fourth quarter ROA was 0.93 percent, down from 0.98 percent in the third quarter, but up from 0.69 percent one year ago. ROA in the fourth quarter 1998 was significantly reduced by one-time restructuring charges posted by several large thrifts. Absent one-time charges, fourth quarter 1998 earnings and ROA were $1.9 billion and 0.94 percent, respectively. The average ROA for 1992-1995 was 0.63 percent, compared to 0.98 percent in 1999.

LOWER OPERATING EXPENSES AND INCREASED FEE INCOME LED 1999 ROA IMPROVEMENT
Net interest margin was 271 basis points in the fourth quarter, the same as for the third quarter and one year ago. Adjusting for one large thrift that left OTS regulation in the fourth quarter, NIM was 277 basis points in the third quarter and 275 basis points one year ago.

Although NIM has remained stable over the last few years, the 6 basis point drop in adjusted NIM from the third to fourth quarter reflects some narrowing in yield spreads. Moreover, the industry's increasing interest rate sensitivity may be a leading indicator for future declines in net interest margin.

Net interest margin has remained stable in recent years primarily due to:

- increases in earnings efficiency through 1998,
- additional investment in higher yielding consumer and commercial lending,
- rollover of higher rate deposits and borrowings into similar liabilities with lower interest rates, and
- increases in lower interest-costing transaction accounts.

Servicing fee income climbed to 0.11 percent of average assets in 1999 from 0.06 percent in 1998. Lower fees in 1998 reflected high prepayment rates due to refinancings. The average balance of loans serviced for others in 1999 was $492 billion, down $6 billion, or 1.2 percent, from the average balance of $498 billion in 1998.

Nonservicing fee income rose in 1999 to 0.55 percent of average assets from 0.51 percent in 1998. Growth in demand deposits and other fee generating activities helped strengthen fee income. Demand deposits rose eight percent, to $66.0 billion at the end of 1999, from $61.0 billion one year ago.

Other noninterest income fell to 0.41 percent of average assets in 1999 from 0.68 percent in 1998. The higher level in 1998 was fueled by restructuring gains-on-sale of assets at several large thrifts and higher gains from the sale of assets held for sale, reflecting stronger mortgage banking activity during 1998.

Noninterest expense fell to 2.11 percent of average assets from 2.32 percent in 1998 as the industry shifted to increased portfolio lending from a mortgage banking mode. The industry has generally controlled overhead costs well. In 1998, noninterest expense was high due to charges related to mergers and acquisitions and expenses related to strong mortgage banking activity.

Fourth quarter noninterest expense increased to 2.14 percent of average assets from 2.07 percent in the prior quarter, but was down from 2.53 percent one year ago. The increase was primarily due to the departure of one large thrift with very low noninterest expenses, charges related to mergers and acquisitions, and higher marketing expense at several thrifts.

OPERATING EFFICIENCY IMPROVED WHILE EARNINGS EFFICIENCY FELL

Operating efficiency - the ratio of general and administrative expense to net interest income plus fee income - improved (declined) during the year. This improvement shows that thrifts continue to use less and less of their revenue to support operations. In 1998, this ratio was higher due to high levels of mortgage banking activity and merger/acquisition related charges.

Earnings efficiency - the ratio of interest earning assets to interest costing liabilities - was lower at year-end 1999 primarily due to:

- An increase in non-interest earning assets, possibly as thrifts increased liquidity to meet Y2K cash needs, and
- A decline in the equity capital ratio resulting from asset growth and unrealized losses on available-for-sale securities of $2.1 billion at the end of 1999. This was

$3.3 billion lower than the unrealized gains of $1.2 billion reported at the end of 1998.

A lower earnings efficiency ratio and further interest rate increases may create pressure on net interest margin.

FOURTH QUARTER SINGLE-FAMILY ORIGINATIONS FELL AS INTEREST RATES INCREASED

Higher interest rates and lower refinancing activity continued to reduce mortgage origination volume in the fourth quarter from the recent record-breaking levels. Single-family mortgage originations in the fourth quarter were $47.8 billion, down from $55.8 billion in the prior quarter and down 41 percent from the record $81.5 billion in the fourth quarter one year ago.

The decline in originations was widespread among all mortgage lenders, but the fall off may have been less for thrifts than for other lenders due to thrifts' origination of ARMs, which are generally in greater demand when interest rates rise. In 1999, thrift originations of ARMs averaged 55 percent compared to only 31 percent in 1998. And, among all lenders, ARM originations grew to 22 percent from 12 percent in 1998.

Total mortgage originations fell to $61.4 billion in the fourth quarter from $69.3 billion in the prior quarter and were down 34 percent from $93.7 billion one year ago. Primarily because of a decline in single-family construction loans, originations of construction loans in the fourth quarter fell to $7.1 billion from a record $7.5 billion in the third quarter, but were up from $6.2 billion one year ago.

Interest rates continued to increase in the fourth quarter, further reducing refinancing activity from the very high levels experienced in 1998 and the first half of 1999. Annual (same lender) refinancings as a percent of all **thrift** originations were down to 14.6 percent in 1999 from 16.0 percent the prior year, but up from 10.5 percent in 1997. Annual refinancings as a percent of originations for all lenders were estimated by the Mortgage Bankers Association of America to be 36 percent in 1999, down from 50 percent in the prior year. Refinancing activity (same lender) made up 10.8 percent of **thrift** originations in the fourth quarter, down from 11.0 percent in the prior quarter and 20.6 percent one year ago.

EQUITY CAPITAL RATIO DECLINED FURTHER BUT REMAINS HEALTHY

The amount of equity capital in the industry remained stable at $67.3 billion from the end of 1998 to the end of 1999. However, though remaining substantially above well-capitalized levels, the industry's equity capital-to-assets ratio declined to 7.79 percent. 98 percent of the industry meets well-capitalized standards, and only 0.2 percent is less than adequately capitalized.

NONCURRENT LOAN RATES WERE STABLE IN 1999

Noncurrent loan rates were stable or lower for 1-4 family, multifamily and nonresidential, and consumer loans. The level of noncurrent commercial loans increased to $41 million, of which $40 million was due to an acquisition by one large thrift.

GENERAL DECLINE IN NET CHARGE-OFFS REFLECTED IMPROVED ASSET QUALITY

Loss provisions and net charge-offs declined over the year. However, there was a slight uptick in fourth quarter provisions due to increases at several large thrifts with investments in nontraditional assets.

NUMBER AND ASSETS OF PROBLEM THRIFTS FELL DURING 1999

The number and assets of problem thrifts fell to 12 and $5.45 billion from 15 and $5.92 billion one year ago. These levels were up slightly from the 10 thrifts with $3.8 billion in assets reported in the prior quarter.

TROUBLED ASSETS REACHED A NEW LOW

Asset quality measures generally remained strong or improved slightly from the prior year end. The troubled assets level fell slightly to $5.4 billion, or 0.62 percent of assets, a new record low.

Noncurrent loan levels were stable or declining, and repossessed asset levels declined. Repossessed assets totaled 0.12 percent of total assets at year-end 1999, down from 0.18 percent at year-end 1998.

THRIFTS REMAIN HOME LENDERS DESPITE GROWTH IN OTHER LOAN CATEGORIES

One of the contributing factors to the industry's sound asset quality is the industry's continued emphasis on home lending. 47.3 percent of thrift assets are in the form of 1-4 family mortgage loans, while only 2.4 percent are commercial loans. In comparison, the FDIC reported that, at the end of the third quarter, commercial banks held 12.5 percent of assets in home mortgages and 20.7 percent in commercial loans.

Construction loan balances increased 27.6 percent, or $3.8 billion in 1999, but remain low at 2.0 percent of total assets. 45 percent of the growth was in single-family mortgages, while 27 percent was in multifamily mortgages. Nonmortgage commercial loan balances increased 30.6 percent, or $4.8 billion in 1999, but remain low at 2.4 percent of total assets. Four thrifts accounted for half of this growth. 77 percent of the growth was in secured, nonmortgage commercial loans (e.g. floorplanning, inventory, and receivables).

THRIFTS WITH CONCENTRATION IN NONTRADITIONAL LOANS AND THE DEGREE OF CONCENTRATION INCREASED

Over the last two years, the number of thrifts with commercial loan portfolios exceeding 10 percent of total assets has doubled from 32 to 63. Concentration in commercial loans among those thrifts most heavily engaged in commercial lending (those in the 90th percentile) has increased from 6.9 percent of total assets to 9.3 percent over the last two years. The increase in concentration at the 90th percentile also occurred for thrifts making nonresidential and construction and land loans.

INTEREST RATE RISK SENSITIVITY INCREASED IN LINE WITH THE 10-YEAR TREASURY CONSTANT MATURITY YIELD

Primarily reflecting the increase in market interest rates, thrifts' sensitivity to interest rate risk increased and post-shock net portfolio value fell. Based on preliminary data, the industry's median fourth quarter sensitivity to interest rate risk increased to 230 basis points from 204 basis points in the prior quarter and 130 basis points one year ago. The sensitivity has increased for five consecutive quarters after generally declining between March 1997 and September 1998. The median sensitivity was at its highest level since OTS began using the current IRR model in 1993.

Rising interest rates generally cause thrift balance sheets to become more sensitive to changes in interest rates as the effective maturity of most mortgages increases when rates rise and prepayments slow. OTS increases monitoring and supervision for thrifts with the highest interest rate risk. An institution's response to an early warning sign (like the sensitivity measure) must be carefully developed and managed. Quick responses that reflect unmanaged shifts to higher risk in other areas (e.g., credit risk) are to be avoided.

Thrifts have engaged in portfolio restructuring to somewhat offset the rise in interest rate risk. For example, they have increased the proportion of ARM originations. The Federal Housing Finance Board's Mortgage Interest Rate Survey of major lenders estimates that 72 percent of fourth quarter thrift mortgage originations were ARMs, up from just 10 percent of originations in the fourth quarter 1998. Thrifts have also added more core deposits to their liabilities mix. Demand deposits rose eight percent to $66.0 billion at the end of 1999 from $61.0 billion one year ago. In addition, thrifts have been modestly increasing the levels of shorter maturity consumer and commercial / small business loans.

MEDIAN POST-SHOCK VALUES REMAIN STRONG DESPITE THE DECLINE

The median fourth quarter post-shock net portfolio value for the industry fell to 8.7 percent from 9.6 percent in the prior quarter and 9.9 percent one year ago. The decline in capital ratios and the rise in sensitivity measures accounted for this decrease. Reflecting higher sensitivity, fourth quarter post-shock NPV dropped to 4.3 percent for those thrifts with the lowest (10th percentile) values from 5.4 percent in the prior quarter and 6.3 percent one year ago. The fourth quarter post-shock NPV for thrifts with the highest values (90th percentile) fell to 16.6 percent from 17.6 percent in the prior quarter and 17.4 percent one year ago.

PRE-SHOCK VALUES REMAIN WELL ABOVE WELL-CAPITALIZED LEVEL

On the positive side, **pre-shock values** - estimated market values, in contrast to GAAP capital values - are well above the well-capitalized standard, even for the bottom 10th percentile. The pre-shock values do **not** consider franchise value. The interest rate risk exposure information is based on preliminary fourth quarter data for 989 thrifts with $842.9 billion in assets.

OTS IS IMPROVING THE NPV MODEL

A month ago, OTS issued a press release announcing a contract award to license an asset/liability management software system developed by Quantitative Risk Management, Inc. (QRM). Our short-term goal is to transfer our existing interest rate risk model - the NPV Model - to the QRM software platform. After transferring the NPV Model to the QRM system, we will consider making selected improvements, or enhancements, to the NPV Model.

A major benefit of utilizing the QRM software is that its architecture will make it easier for OTS to modify our existing model. Possible changes to the NPV model using QRM software include:

- Introduction of non-parallel rate shocks and other stress tests.
- Improved prepayment models.
- Expanded valuation of investment portfolios. We could, for example, collect data on investment security holdings by CUSIP number to improve the precision of the model results.
- Ability to perform net interest income simulations, as appropriate.

In part, improvements to the model's precision may be constrained by reporting burden considerations. In general, the more financial data we collect from the thrift industry, the more precise the model can be. Because of this relationship between data input and model precision, we will be engaging in a dialogue with the industry to determine how best to improve our data collection without imposing an undue burden on the industry. Use of the Optional Supplemental Schedule of Schedule CMR is one way to expand the collection on a voluntary basis.

ASSET GROWTH CONTINUED AND THRIFT INDUSTRY CONSOLIDATION SLOWED

The number of thrift institutions regulated by OTS fell to 1,103 in the fourth quarter from 1,111 in the prior quarter and 1,145 one year ago. Industry assets increased 5.6 percent to $863 billion at end of 1999 - the highest since 1991 when assets totaled $895 billion. Strong asset growth of remaining thrifts more than offset industry exits, but there are several pending departures that will almost certainly cause industry assets to decline in the short term future.

EXITS DECLINED SIGNIFICANTLY IN 1999

Only 80 thrifts left OTS supervision in 1999, compared with 109 in 1998 and 114 in 1997. The number of new entrants in 1999 was similar to 1998. The net reduction of 42 institutions in 1999 was the lowest since a net decline of 27 thrifts in 1986.