

Industry Performance

Thrift Industry Highlights - Q1 1997

THE OTS-REGULATED THRIFT INDUSTRY

First Quarter 1997 Highlights

Office of Thrift Supervision
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Earnings Continue to be Solid in the First Quarter

The OTS-regulated thrift industry earned \$1.7 billion in the first quarter of 1997, up from \$1.5 billion last quarter and just slightly below the quarterly earnings of \$1.8 billion posted in the first quarter of 1996. ROA in the first quarter was 91 basis points. This was an increase from the 77 basis points in the prior quarter but a slight decline from the 96 basis points in the first quarter one year ago, as shown in the following chart. First quarter 1996 earnings were bolstered by large one-time restructuring gains posted by several thrifts. Industry earnings in the last quarter of 1996 were hampered by restructuring charges to income incurred by several thrifts. In contrast, first quarter 1997 earnings were largely free of one-time gains or charges.

* Chart 1 *

Thrifts' healthy first quarter earnings were primarily attributable to continued strength in net interest margin, higher fee income, and tight control of overhead expenses. Net interest margin as a percent of average assets was 293 basis points in the first quarter, compared to 285 basis points and 281 basis points in the prior quarter and in the first quarter one year ago, respectively. The increase in net interest margin is primarily due to lower interest expense. Interest expense as a percent of average assets was 4.29 percent in the first quarter -- a decline of 9 basis points from the prior quarter and 11 basis points from one year ago. Interest income as a percent of average assets has remained relatively stable at approximately 7.22 percent over the past year.

The decline in the industry's interest expense reflects the relatively low and stable market rates of interest that have generally prevailed recently. Thrifts' reduced interest expense was attributable principally to a decline in the weighted average cost of older long-term, higher rate certificates of deposits ("CDs"). These older CDs matured and were replaced by CDs paying current, lower, market rates of interest. For example, the weighted average cost of thrifts' long-term CDs (original maturity of more than 3 years) declined to 6.22 percent at the end of the first quarter from 6.36 percent one year ago. Long-term CDs comprised 8.8 percent of thrifts' total deposits at the end of the first quarter, down from 9.9 percent one year ago.

Non-interest paying demand deposits held by the industry have steadily increased as a percent of deposits. Although they still constitute a relatively small proportion of deposits, increases in these low cost funds also contributed to the decline in the industry's interest expense. Thrifts' non-interest demand deposits increased 8 percent over the past year.

The industry's fee income (mortgage loan servicing fees and other fees and charges) has generally increased over the past four years. Fee income as a percent of average assets was 52 basis points in the first quarter, up slightly from 51 basis points last quarter, but up 24 percent from fee income generated one year ago (42 basis points). An increase in fee-generating activities and products, such as loan servicing, mutual fund and annuity sales, and demand deposits, has helped generate this higher fee income.

General and administrative, or overhead, expense for the industry has, as a percent of average assets, remained stable at approximately 2.1 percent over the past four years despite internal growth and expansion of products. For the quarter ended March 31, 1997, thrifts' overhead expense-to- average assets ratio fell slightly to 2.05 percent from the 1996 average ratio of 2.09 percent, excluding the SAIF special assessment expense. The decline in overhead expense is partially attributable to the decline in deposit insurance premiums -- a result of the one-time SAIF special assessment paid in the third quarter of 1996.

ROAs for 1996 and 1997 Are Substantially Higher Than Strong Levels Achieved From 1992 Through 1995

Thrifts' earnings have been strong since 1992. Excluding the third quarter of 1996 when the \$2.1 billion net SAIF special assessment caused the industry to post a loss, more than 90 percent of thrifts were profitable over the past 20 consecutive quarters. Moreover, in each quarter over this timeframe approximately one-third of the industry has posted quarterly ROA over 100 basis points.

Recent industry earnings have strengthened considerably over average earnings achieved between 1992 and 1995. Excluding the net impact of the SAIF special assessment on 1996 earnings, industry ROA for 1996 and for the first quarter of 1997 were almost 50 percent higher than the average ROA in the 1992-1995 time period. Indeed, as the following chart illustrates, the thrift industry hasn't generated annual ROA comparable to 1996/1997 levels since 1962.

*** Chart 2 ***

Two components account for the majority of higher thrift ROA in 1997 relative to 1992: 1) lower provisions for losses; and 2) higher fee income. The following chart highlights the primary components of the industry's strengthened ROA between 1992 and for the first quarter of 1997.

Lower provisions for losses are attributable to thrifts' improved asset quality. Provisions for losses as a percent of average assets declined by almost 60 percent -- reduced to 27 basis points in the first quarter 1997 from 66 basis points in 1992. This is consistent with the reductions in troubled assets and non-current loans over this period as discussed in later sections.

Increased fee income has also helped boost the industry's recent ROA. Fee income as a percent of average assets rose 68 percent to 52 basis points in the first quarter 1997 from 31 basis points in 1992. As previously discussed, increases in fee generating activities and products have resulted in higher fee income.

*** Chart 3 ***

Efficiency Measures Continue to Improve in the First Quarter

The industry's improved profitability is also attributable to continued efficiency gains. Two key efficiency indicators are operating efficiency and earnings efficiency. The chart that follows presents these two measures from 1992 through 1996 and for the first quarter of 1997.

*** Chart 4 ***

Operating efficiency is the ratio of overhead expense to net interest income and fee income -- a lower ratio indicating more efficient operations. In general, operating efficiency measures the percentage of gross "core" earnings consumed by overhead expense. Since 1992, the industry's operating efficiency ratio has improved approximately 7 percent. The industry's operating efficiency ratio improved in the first quarter to 59.5 percent, a 5 percent improvement from the 62.8 percent level in the prior quarter. Part of the improvement in operating efficiency in the first quarter is attributable to the decline in deposit insurance premiums.

Thrifts' enhanced profitability also reflects continued improvements in their balance sheet structure, or earnings efficiency. Measured as a ratio of interest earning assets to interest bearing liabilities, the industry's earnings efficiency has improved approximately 5 percent between 1992 and 1996. Improvement continued in the first quarter as the industry's earnings efficiency ratio increased to 106.5 percent from 105.8 percent in the prior quarter. Earnings efficiency has been augmented by lower levels of non-earning assets, such as repossessed assets, redeployment of funds from cash and non-earning deposits into loans, increases in non-interest deposits, and higher capital levels.

Differences in Regional Profitability Narrow

Although the past five years have been generally very good economically for the U.S., the gains associated with a strong economic environment have been uneven throughout various regions of the U.S. These differences in regional economic performance are reflected in the disparate ROA for thrifts in different OTS regions.

The following chart presents a comparison of aggregate ROA for thrifts located in the OTS supervisory regions with the highest and lowest annual ROAs over the past five years, and in the first quarter of 1997. The top panel presents the difference between these two regions' ROAs and the bottom panel presents these ROAs.

*** Chart 5 ***

As the bottom panel indicates, the difference has recently narrowed due to the continued improvement in the ROA of the "low" region. Since 1994, the "low" region's ROA has increased almost 250 percent, rising from 23 basis points, to 80 basis points in the first quarter 1997. This dramatic improvement in the lowest regional profitability performance has directly contributed to the overall industry's improved profitability. The highest performing region's ROA has been quite strong, averaging 115 basis points over the period presented. This suggests that the improved industry profitability reflects widespread improvements, a further sign of sound underlying economic strength.

Capital Levels Remain Strong

Equity capital for the industry (capital calculated using Generally Accepted Accounting Principles) increased slightly to 7.94 percent in the first quarter from 7.92 percent of assets in the fourth quarter. Equity capital is 14 basis points below the all time high of 8.08 percent in the first quarter of 1996 due to the SAIF special assessment expense in the third quarter of 1996. However, capital remains at very strong levels - approximately double the regulatory "adequately capitalized" requirements set for banks and thrifts.

The industry's tier 1 leverage capital ratio also increased in the first quarter to 7.44 percent of adjusted tangible assets from 7.38 percent in the fourth quarter. Thrifts' risk-based capital ratio, however, declined slightly to 14.48 percent from 14.53 percent in the prior quarter. This decline reflects changes in the composition of assets away from investment securities and into direct lending. Since direct loans generally carry higher risk weights than investment securities, the denominator used in calculating the industry's risk-weighted capital ratio increased, causing the ratio to fall slightly. Despite the slight decline, the industry's risk-based capital ratio remains considerably higher than the 10 percent level needed for "well-capitalized" status.

The percentage of thrifts that met or exceeded well-capitalized standards in the first quarter fell slightly to 96 percent from 97 percent in the fourth quarter. At the end of the first quarter, 3 thrifts were undercapitalized, one of which was critically undercapitalized. (As of May 31, 1997, two undercapitalized thrifts have returned to capital compliance through their own recapitalization efforts. The remaining undercapitalized thrift is currently working on completing its own recapitalization plan.)

The Number and Assets of Problem Thrifts Remain at Low Levels

Problem thrifts, those with CAMELS ratings of "4" or "5" on their most recent safety and soundness examination, increased to 30 (2.3 percent of all thrifts) for the first quarter from the post-FIRREA low of 29 (2.2 percent) at the end of 1996. However, aggregate assets of problem thrifts fell to \$4.6 billion, or 0.6 percent of industry assets, from \$5.4 billion, (0.7 percent) last quarter. One year ago there were 37 problem thrifts (2.6 percent of thrifts) with combined assets of \$11 billion (1.4 percent of industry assets).

Troubled Assets Increase Slightly in the First Quarter

Troubled assets increased slightly in the first quarter to \$8.8 billion or 1.15 percent of total assets, from \$8.7 billion (1.13 percent) in the prior quarter. Last quarter, troubled assets reached the lowest level since 1990 when this measure of asset quality was first used in the thrift industry.¹ One year ago the industry's troubled assets measured \$9.4 billion or 1.24 percent of total assets.

The increase in troubled assets in the first quarter was due to a rise in noncurrent loans which rose to \$6.8 billion from \$6.6 billion in the prior quarter. This increase does not represent a widespread deterioration in asset quality, however. Several thrifts' business strategies involve purchasing already delinquent loans at a discount with the expectation that the loans can be resold at a profit after the thrift performs loan "work outs", i.e. cures the delinquencies. Hence, the majority of these thrifts' assets are, by definition, "troubled". Absent the thrifts that specialize in purchasing discounted noncurrent loans, the industry's total troubled assets would have declined in the first quarter from the prior quarter. Troubled assets would have fallen to \$7.6 billion for the first quarter of 1997 from \$7.8 billion at the end of 1996. The troubled assets ratio would have declined to 1.00 percent in the first quarter from 1.02 percent in the prior quarter.

Thrifts' repossessed assets, net of specific valuation allowances, fell in the first quarter to \$2.0 billion, or 0.27 percent of total assets, from \$2.1 billion (0.28 percent) last quarter, and from \$2.4 billion (0.32 percent) one year ago.

Delinquencies Increase Slightly for Most Loan Types

The following chart presents thrifts' noncurrent loan rates from March 1993 through March 1997 for four major industry loan types: single-family mortgages, consumer loans, commercial loans, and non-residential mortgage loans.

As shown in the chart, most noncurrent loan rates increased slightly during the first quarter. The exception was noncurrent commercial loans which fell to 1.32 percent of all commercial loans from 1.38 percent last quarter. Noncurrent loan rates for consumer loans, single-family mortgages, and non-residential mortgages all increased 6 basis points during the first quarter from the prior quarter.

*** Chart 9 ***

Noncurrent consumer loans as a percent of all consumer loans increased to 95 basis points in the first quarter from 89 basis points in the fourth quarter, continuing a gradual, but steady, two year increase. Two years ago, the noncurrent consumer loan rate was 69 basis points. Part of the increase in the noncurrent consumer loan ratio reflects thrifts' increased credit card lending. Although minor compared to commercial banks' credit card lending, thrifts' credit card loans increased to 1.1 percent of aggregate industry assets from 0.9 percent one year ago.

Beginning in the first quarter of 1997, detailed delinquency data are available for each thrift consumer loan type. Credit card loans had the highest noncurrent rate of all types of thrift consumer loans. At the end of the first quarter, the noncurrent loan rate for credit cards was 1.68 percent. Education loans had the next highest noncurrent rate -- 1.47 percent. Other types of thrift consumer loans and their noncurrent loan rates at the end of the first quarter were as follows: home improvement loans (0.73 percent); auto loans (0.64 percent); home equity loans (0.53 percent); loans secured by deposits (0.43 percent); and mobile home loans (0.38 percent).

The noncurrent loan rate for single-family mortgages increased to 1.27 percent in the first quarter from 1.21 percent in the prior quarter. As with total troubled assets, the increase in noncurrent single-family mortgages during the first quarter was entirely attributable to the increase in noncurrent loans held by "work out specialist" thrifts. Absent these thrifts, the industry's noncurrent rate for single-family loans would have been 1.06 percent for both the first quarter and the prior quarter.

Consolidation Continues to Reduce the Number of Insured Depositories

Consolidation has significantly reduced the number of federally insured financial institutions since 1993. Between 1993 and 1996, there have been few failures of federally insured depositories - the numbers being reduced primarily through consolidation. Commercial banks declined by 1,430, or 13 percent, over this 3 year span to 9,528 at the end of 1996. Over the same period, credit unions fell by 925, or 8 percent, to 11,392. OTS-regulated thrifts declined by a net 335 institutions, or 20 percent, to 1,334 at the end of 1996. Reflecting "intra-industry" consolidation, the rate of decline for all thrifts was somewhat slower, falling 15 percent - a level commensurate to the decline in commercial banks. The number of all federally insured thrifts fell to 1,924 at the end of 1996 from 2,262 three years earlier.

From the end of 1993 through the end of 1996, 399 thrifts "exited" OTS-regulation. Over the same period, 64 thrifts "entered" OTS-regulation either through conversions from other insured institutions or as start-up thrifts. The majority (52%) of the number of OTS-regulated thrift "exits" from the 1993 to 1996 period were due to "intra- industry" consolidation. Over this timeframe, 207 thrifts left OTS-regulation as a result of intra-industry consolidation - that is these thrifts remained as thrifts either as state-chartered savings banks or were absorbed by another OTS-regulated thrift.

The most significant consolidation outside the thrift industry continues to be commercial bank acquisitions of thrifts. From the end of 1993 through the end of 1996, 137 thrifts, with combined assets of \$73 billion, were acquired by commercial banks. Bank acquisitions of thrifts accounted for 34 percent of the 399 OTS-regulated thrift exits since 1993.

The number of thrift institutions regulated by OTS declined to 1,302 at the end of the first quarter from 1,334 last quarter. The decline of 32 thrifts in the most recent quarter represented an annualized decline of 9.6 percent. However, aggregate assets of OTS-regulated thrifts declined just 2.5 percent on an annualized basis during the first quarter.

The same trend of decline in numbers of thrifts and assets has been experienced by the industry since 1993 as shown in the chart that follows. While the number of OTS- regulated thrifts declined 22 percent from 1,669 at the end of 1993 to its present level, assets remained relatively stable, declining just 1.3 percent from \$775 billion at the end of 1993 to \$765 billion in the first quarter of 1997.

*** Chart 10 ***

The relative stability of the OTS-regulated industry's assets in the face of this substantial shrinkage in the numbers of thrifts is attributable to: 1) a large portion (27%) of the exits due to thrift-to-thrift mergers among OTS-regulated thrifts; 2) de novo activity resulting in 66 new federal thrift charters between 1993 and the first quarter of 1997; and 3) strong asset growth in thrifts remaining under OTS regulation.

Asset Growth Strong for Remaining Thrifts

The stability in aggregate OTS-regulated thrift assets since 1993 may be viewed by some as a sign of stagnation and little growth within the industry. Such a view is incorrect. The stability in OTS-regulated thrift aggregate assets when substantial assets are being "lost" to inter-industry consolidation in fact indicates strong asset growth for those thrifts remaining under OTS regulation. The chart that follows presents the asset growth for thrifts that remained at the end of each period, compared to the aggregate assets of thrifts leaving OTS regulation. As shown in the chart, asset growth of remaining thrifts has largely offset the asset losses from exiting thrifts.

*** Chart 11 ***

Growth strategies in general are based on strategic business planning that varies among individual thrifts. For those thrifts adopting a growth strategy (71 percent of all thrifts), asset growth was strong over the first quarter, measuring an annualized 14.9 percent of their beginning assets. (Growth data exclude the impact of thrift-to-thrift mergers.) Thrifts not adopting growth strategies had annualized asset shrinkage of 9.7 percent during the first quarter. Thrifts operating in both the first quarter of 1997 and the fourth quarter of 1996,

experienced aggregate growth of \$6.9 billion, or 3.6 percent annualized, during the first quarter from the prior quarter.

Consistently Strong Earnings Available to Community Based Lenders

Continuing the same general trend that started in 1993, the industry's consumer loans, small business loans, and single-family mortgages all increased in the first quarter from the prior quarter, while investment securities and mortgage pool securities declined. As a percent of total assets, single-family mortgages increased to 50.1 percent in the first quarter from 49.9 percent in the prior quarter. Consumer loans relative to total assets also increased approximately 4 percent in the first quarter to 5.4 percent; commercial and small business loans rose to 1.3 percent from 1.2 percent in the fourth quarter, an 8 percent increase.

Although the thrift industry's ROA has strengthened, it remains below the recent ROA of the commercial banking industry. This has led some to question whether thrifts, as community oriented lenders, can earn a competitive ROA relative to commercial banks or other financial services competitors.

An OTS analysis identified 102 "highly profitable" thrifts that consistently earned an ROA above 100 basis points for each of the last 13 quarters. (ROA in third quarter of 1996 was adjusted to exclude the net impact of the SAIF special assessment.) The average quarterly ROA for these "highly profitable" thrifts is compared to the industry aggregate ROA in the chart that follows.

*** Chart 12 ***

The ROA for the "highly profitable" thrift group has been quite strong with a low of just 150 basis points and a high of 185 basis points. The average ROA for this group over the 13 quarters was 167 basis points. Moreover, these "highly profitable" thrifts are decidedly community based lenders. With just 2 exceptions, these thrifts hold a higher percentage of their assets in single-family mortgages than the industry average. The two exceptions are deemed credit card specialist thrifts since the majority of their assets are comprised of credit card loans. The following chart shows the percentage of assets the highly profitable thrifts hold in single-family mortgages compared to the industry average.

*** Chart 13 ***

Two distinguishing characteristics of the group of highly profitable thrifts were better than average efficiency measures, both for earnings efficiency and for operating efficiency. As a group, the highly profitable thrifts' first quarter earnings efficiency measure of 110.7 percent was approximately 4 percent stronger than the industry first quarter average of 106.5 percent. The difference in operating efficiency was more stark. For the first quarter, the highly profitable thrifts' combined operating efficiency ratio was 51.5 percent -- over 13 percent better than the industry average of 59.5 percent.

FOOTNOTES:

¹ Troubled assets are the sum of noncurrent loans and repossessed assets, net of specific valuation allowances. Noncurrent loans measure loans that are seriously delinquent and are defined as those loans 90 days or more past due plus loans in non-accrual status.