SPECIAL REPORT: HIGHLY PROFITABLE COMMUNITY THRIFTS

Office of Thrift Supervision / November 2003

Executive Summary

The thrift industry reported record levels of profitability for the 2001, 2002 and the first half of 2003, including consecutive quarterly income records for the first two quarters of 2003. Industry profitability in 2003, as measured by return on average assets (ROA), also set consecutive quarterly records at 1.30 percent and 1.34 percent, respectively. However, the industry median ROA continues to lag the industry average, indicating that smaller thrifts have not experienced the same level of earnings expansion in recent years as the broader industry. The median industry ROA for the first two quarters of 2003 was 0.81 percent and 0.82 percent, respectively.

The issue of lagging profitability of smaller thrifts is important to OTS since the vast majority of thrift institutions (89 percent) have assets less than $1 billion. Despite years of industry consolidation, two-thirds of OTS supervised thrift institutions maintain assets of less than $250 million. The combined assets of this latter group represent approximately 6 percent of the industry's aggregate assets. OTS recently completed a review of industry profitability with a focus on identifying the characteristics of smaller thrifts that consistently generate high levels of profitability. For purposed of this review, we define highly profitable community thrifts (HPCT) as those having assets less than $1 billion and quarterly ROAs consistently in the top quartile among their peers.

There were several traits of HPCTs that contributed to their success. The HPCTs were generally more active lenders with a focus on residential mortgages, while also offering a broader array of other community loans products. HPCTs held a higher relative level of direct whole loans and lower level of investment securities. The group also had the strongest operating fundamentals, including stronger capital levels, lower interest rate risk and good asset quality. Not surprisingly, the group generally received better examination ratings, particularly in the management component rating.

The findings of our review are discussed more fully below. Though we compare and contrast the HPCT's general operating characteristics to other thrifts, the success traits we identified are not necessarily "recipes" for other thrifts to follow. Operating plans and strategic decisions must be carefully considered before adoption. Thrift Boards' must critically assess their institution's strengths and weaknesses and pursue only those strategies that management can implement, monitor and control in a safe and sound manner. The results of our review are not intended to endorse any particular operating strategy.

Profitability Among Industry Segments

The thrift industry has reported record levels of profitability over the past two and half years. Much of the earnings strength reflects the very strong performance of many of the largest thrift institutions. Since industry data are "weighted averages" – weighted by assets – results from larger institutions' data will have a disproportionate impact on the aggregates. OTS closely analyzes median industry data to gain better perspective on what is happening to the "central tendency" or profitability of the more average thrift. In addition, we evaluate key measures within peer asset bands and by operating strategies to identify risks and assess trends across various segments of the thrift industry.

The median industry ROA has remained below the mean ROA for much of the past decade leading some to surmise that smaller, community-based thrifts are inherently less profitable than larger thrifts with regional, multi-regional, or even nationwide reach. The median ROA for the thrift industry was 0.81 percent for the first half of 2003, well under the industry mean ROA of 1.32. This is not unique to the thrift industry; small bank ROA is also lower than bank aggregate ROA.[1]

There are various reasons why smaller thrift profitability lags the industry average. Most mutual thrifts have smaller asset bases. Mutual thrifts do not operate under intense shareholder pressure to maximize profits, pay dividends or repurchase stock. Mutual thrifts often "share" profitability with their owners – depositors – by offering higher interest rates and lower fees on deposit accounts. The influx of new charters, especially in the late 1990s, also tends to suppress the median ROA since these thrifts are usually smaller and less profitable than more mature thrifts. Of the 947 thrifts operating at June 2003, 16 percent were chartered since the end of 1995. Other reasons for lagging profitability tend to vary among thrifts and are regularly monitored by examination and supervisory staff.

Community Thrift Profitability

Are community-based thrifts – thrifts with assets less than $1 billion – inherently less profitable than larger thrifts? We believe the answer is, no – some community thrifts, even very small ones, generate highly competitive ROAs. An even more select group are those community thrifts that consistently post very strong ROAs, a group we have termed "highly profitable community thrifts" or HPCTs.

---

[1] Bank and thrift median ROA measures are not directly comparable due to the large number of subchapter S corporation (S corporation) banks. S corporations are not taxed at the institution level so ROAs, which are calculated on an after tax basis, tend to be significantly higher for S corporation institutions than non-S corporation institutions. As of June 30, 2003, there were 1,943 S corporation commercial banks (25 percent of all banks) and 58 S corporation thrifts (6 percent of all thrifts). The high number of S corporation banks compared to thrifts can skew median and other ROA comparisons.

Our review identified 87 community thrifts that met the criteria for consistently high levels of profitability. We evaluated the general characteristics and operational performance measures of these HPCTs to identify common traits that distinguish the group from other thrifts.

HPCTs were defined as those generating an ROA in the top quartile among all community thrifts in 2001, 2002 and the first half of 2003. Though the focus of our review was on the most recent two-and-a-half years, longer-term trends and changes in lending, funding and profitability were also analyzed. We excluded some groups of thrifts to identify observations that are more meaningful for typical thrifts. Those excluded from the review were:

1) "S" corporation thrifts;
2) Newer thrifts – those commencing operations after 1994;
3) Thrifts with significant trust activities – trust assets under management totaling more than five times their total assets; and
4) Thrifts that were not OTS regulated from 1998 through the second quarter of 2003 (to avoid data fluctuations from thrifts entering or leaving the system).

Highly Profitable Thrift Population

A total of 87 community thrifts (assets less than $1 billion) and 12 larger thrifts met the highly profitable criterion (see chart below). Among community thrifts, thirteen percent of the review group here "highly profitable." Nearly 19 percent of larger thrifts in the review group met the criteria. The ROA of the 87 HPCTs was 1.48 percent versus 0.67 percent for other thrifts of similar size. The 12 highly profitable larger thrifts had a ROA of 1.73 percent as compared to 1.13 percent for other larger thrifts.

Thrift Category	Number	Percent of Review Group	Return on Assets (Trailing 10 Quarters)
Community Thrifts			
1. Highly Profitable	87	12.85%	1.48%
2. All Other	590	87.15%	0.67%
Larger Thrifts			
1. Highly Profitable	12	18.75%	1.73%
2. All Others	62	81.25%	1.13%

Overview of HPCT Review Findings

The review findings are encouraging for community thrifts and the results generally echo the findings in our 1997 Special Report titled *Review of Highly Profitable OTS-Regulated Thrifts*[2], although the methodologies differed between the two reviews. The overall findings of our current review indicate that:

1. HPCTs were active lenders yet maintained good asset quality.
The HPCTs were more active portfolio lenders, held fewer "wholesale" assets (investment securities and mortgage-backed securities), had better efficiency ratios, and maintained good asset quality despite holding relatively more whole loans in portfolio.

2. HPCTs' loan portfolio was moderately more diverse than their peers.
With only a few exceptions, HPCTs offered and held a full complement of loans associated with a typical community-based financial institution – mortgages, consumer and commercial loans.

3. Most HPCTs had well-rated management.
The "M" exam component factor was the toughest in which to receive a "1" (highest) rating from OTS. About 44 percent of HPCTs received a "1" M exam rating on their latest exam compared to 30 percent for all other OTS-regulated thrifts.

4. There was no geographic concentration of HPCTs.
Few states had a higher than average number of HPCTs and only Ohio had a sizable difference in the percent of highly profitable thrifts (16.1 percent) compared to the percent of all thrifts in the state (9.4 percent). North Carolina, Tennessee, Colorado, and Iowa were slightly over-represented among HPCTs, while Illinois, Maryland, Kentucky, and Texas were under-represented.

5. Smaller community-based thrifts can generate quite strong ROAs.
Sixteen of the 87 HPCTs (18 percent) had assets less than $50 million, and 48 institutions (55 percent) had assets between $50 and $250 million. The remaining HPCTs (23) had assets from $250 million to $1 billion.

6. Stock thrifts were over-represented among HPCTs.
Stock thrifts representing 61 percent of this group compared to 45 percent of all other community thrifts.

---

[2] See http://www.ots.treas.gov/docs/48913.pdf.

Observations on Common Characteristics of HPCTs

Our review of HPCTs disclosed a number of fairly common financial and operational characteristics. While we cannot generalize across the entire group, several patterns are clearly worth noting. Provided below are some observations on the most common characteristics of HPCTs.

HPCTs held a higher percentage of assets in direct loans and less in investment securities.

The HPCT group held 71.3 percent of their assets in direct loans compared to 61.7 percent for all other community thrifts. The retention of higher levels of whole loans resulted in higher interest income that, in turn, produced a higher than average net interest margin. The trailing ten quarters interest income for HPCTs was 6.65 percent of average assets and their NIM was 3.62 percent, as compared to all others where the ratios of interest income and NIM were 6.10 percent and 2.93 percent, respectively.

HPCTs offered and held a full complement of loans.

The largest differences between HPCTs and their peers' loan portfolios were in single-family mortgage loans, as shown in the chart below. Single-family mortgages comprised 42.2 percent of HPCT assets, versus 38.0 percent for other community thrifts, consistent with the earlier finding that HPCTs hold more whole loans. Similarly, across all other loan categories, HPCTs held more direct loans as a percent of assets than all other community thrifts.

Loan Portfolio	**HPCT**	**All Other Comm. Thrifts**	**Difference**
	(Loan balances as a % of total assets)		
1-4 Family mortgage loans	42.2	38.0	4.2
Construction loans	4.6	2.8	1.8
Multi-family mortgage loans	5.2	4.1	1.1
Non-residential mortgages	9.4	8.4	1.0
Consumer loans	5.1	4.1	1.0
Commercial loans	3.5	3.0	0.5

Despite holding higher levels of direct loans, asset quality of HPCTs compared favorably to other community thrifts.

HPCTs showed slightly worse asset quality using the more common measure of asset quality – non-current loans-to-total assets, 0.54 percent versus 0.49 percent for all

other community thrifts.[3] Using the ratio of noncurrent loans-to-total loans however, resulted in a slightly lower ratio for HPCTs (0.76 percent) compared to their peers (0.79 percent), indicating that asset quality is generally strong for HPCT than all others. HPCTs maintained allowances for loan and lease losses (ALLL) that were slightly higher than peer levels. The ratio of ALLL-to-noncurrent loans was 111.1 percent for HPCTs and 106.1 percent for all other community thrifts.

HPCTs benefited from a better than average operating efficiency ratio.[4]

Though HPCTs ratio of general and administrative expense-to-average assets (G&A) was higher than their peers (2.72 percent versus 2.60 percent), stronger core income made up for higher G&A. HPCTs trailing ten quarter operating efficiency ratio was 62.9 percent compared to 75.0 percent for all other community thrifts. The higher than average G&A for HPCTs was primarily attributable to personnel expenses resulting from higher levels of total compensation and a slightly higher number of employees. HPCTs average ratio of assets-to-employees was $3.4 million and average annual compensation expense was $54 thousand per employee during the 10 quarters. All other community thrifts averaged $3.8 million of assets-to-employees and an average annual compensation level of $51 thousand during the review period. HPCTs higher than average levels of employees and compensation were most likely due to more diversified lending products and higher lending volumes.

Noninterest income was higher for the HPCTs than for their peers.

The higher level of noninterest income at HPCTs was largely driven by higher than average loan origination and loan sale volumes. Gains from the sale of assets-held-for-sale and available-for-sale securities measured 64 basis points for HPCTs for the trailing 10 quarters, about triple the 21 basis points for their peers. The difference between other fees and charges, primarily from retail banking activities, was not as great – 60 basis points for the HPCTs and 40 basis points for all other community thrifts.

Capital was slightly higher for HPCTs than at other community thrifts.

HPCT's generally maintained higher levels of capital than others, which contributes to the HPCT's earnings strength, but the difference was not dramatic. At June 30, 2003, the HPCT's equity-to-assets ratio was 11.0 percent compared to 10.5 percent for their peers.

HPCTs maintained lower than average levels of interest rate risk.

The results of the OTS Interest Rate Risk Model show that HPCTs had generally lower levels of sensitivity and higher exposure levels than for all other community thrifts.

---

[3] Noncurrent loans are loan more than 89 days past due and loans in non-accrual status.

[4] Operating efficiency ratio is the percent of core income consumed by G&A, hence lower ratios are more desirable. For this review, core income was defined as net interest income, fee income, and dividends from Federal Home Loan Bank stock

Higher pre-shock equity-to-assets ratios, fewer holdings of 30-year fixed-rate mortgages and MBS, and longer maturities on borrowings helped HPCTs interest rate risk profile. This was a different finding than in the 1997 study that found higher than average interest rate risk higher in highly profitable thrifts. The high level of refinancing activity in recent years has affected the composition of thrift mortgage loan portfolios, with many institutions holdings holding higher levels of hybrid and adjustable rate loan products. HPCTs were found to hold generally lower levels of 30 year mortgage loans relative to total mortgages as compared to peer thrifts.

The second quarter median sensitivity measure was 83 basis points for the HPCTs and 101 basis points for all other community thrifts. The median exposure measure was 13.6 percent for HPCTs and 11.2 percent for their peers. HPCTs held 10.0 percent of assets in 30-year fixed-rate mortgages and MBS at the end of the second quarter compared to 11.7 percent for all other community thrifts. The weighted average remaining maturity of fixed-rate borrowings was 40 months for HPCTs versus 31 months for their peers.

More HPCTs were rated "1" on their last OTS examination reflecting their overall solid financial condition.

Sixty-one percent of HPCTs were 1-rated versus 36 percent of other community thrifts. HPCTs exam component ratings for "Management" were also better than average but not to the same degree as composite ratings. Forty-four percent of HPCTs received a 1-rating in their last exam for management compared to 29 percent for other community thrifts.

Impact of Thrift Management

Our findings regarding management ratings sparked an offshoot review of the characteristics of "good" thrift management. The management rating is on of the toughest component to rate and the toughest on which to receive a 1-rating. The fact that all HPCTs did not receive 1-ratings for management and composite 1-ratings – or even 1-ratings in earnings – was evidence that our examiners closely evaluate the data and assign ratings giving consideration to important qualitative factors.

So what characteristics do our examiners see in "good" 1-rated management? To help answer this question, we tried to "isolate" the focus on management by reviewing exams (for all thrifts) in which management was rated "1," but other factors (capital, asset quality, earnings, liquidity, and sensitivity) were not. And on the flipside, we reviewed exams in which management was rated "3" while other factors were rated primarily "1," or "2." While ratings, and reasons for ratings were largely unique to each case, there were some common characteristics from both groups of thrift exams reviewed.

Summarized below are the common management characteristics that were most prevalent in each group.

Common Management Strengths

- Prompt resolution of significant regulatory concerns noted in prior exams and progress in addressing recommended corrective actions.
- Maintaining an effective, risk-focused internal audit process.
- Taking an active role in operational oversight and staff guidance.
- Effectively addressing existing problems and potential risks.
- Effective coordination between the Board and management in establishing and carrying out sound policies.
- Consistent director attendance at board meetings and fully informed directors through effective Board from executive management.
- Maintaining current policies and procedures through periodic Board review.
- The board and management have working cooperatively to obtain positive operating results.
- Effective internal controls, especially internal audit and internal asset review.
- An experienced and active board that provides sound oversight, a CEO that does a good job of administering operations, and a capable and stable senior staff.

Common Management Problems

- Management does not take or implement sufficient corrective actions and/or fails to adequately respond to past examination comments and supervisory directives.
- Operating with inadequate loan underwriting or administration policies and procedures.
- Failing to maintain operating policies and procedures that identify, monitor and control significant risks.
- Regulatory violations, especially those dealing with insiders or affiliates, such as "Reg O", insider lending, conflicts of interest and transactions with affiliates.
- Filing inaccurate regulatory financial reports and poorly documented financial reports.