



## Weekly Post: Managing EVE(or NEV)

October 27, 2016

Dear Clients-

Economic Value of Equity (EVE), also called Net Economic Value (NEV), is arguably one of the most important ALM measures and yet one of the most misunderstood. NEV is quite often mistakenly perceived as "yet another regulatory risk measure." Here are some reasons why this perception isn't valid and how EVE is more than just "another regulatory risk measure".

- EVE is an accepted measure of a bank's (or credit union's) value, as explained below. (Source: [Periodic Valuation Informed Decisions LLC.](#))

### ASSET APPROACH

Under the Asset Approach, the aggregate value of the underlying assets owned by the subject is to be considered net of its liabilities. This value can be presented in terms of either the proceeds from liquidation or the cost of replacing the assets. Values derived using these methodologies represent cash flows that are available in lieu of those available to the business as a going-concern. The liquidation proceeds could be considered as a minimum alternative value and the replacement cost as a maximum alternative value.

- The ratio of EVE to equity, the value-to-book multiple, identifies the balance sheet unrealized gain. A high ratio implies that there is significant value to be released as future income.
- Exploiting rate cycles may increase EVE value. ALCO and Board members often discuss the global economies and rate movement. Taking actions on these market views affect the EVE, which provides you the feedback on your strategies effectively.
- Under regulations, % change of EVE under multiple rate shocks seem hypothetical. But an EVE historical trend provides you the realism.

Therefore, the Board should be aware of the trends of EVE, which can depict the health and profitability of your institution. This Post uses a sample bank below to highlight the importance of EVE.

### Challenges

- What factors affect my EVE values?
- How should I manage the EVE to enhance value?

### Solution

Risk Officer™ provides historical reported Equity and EVE values. The *Peer Report*, in *Peer Group Comparison APP*, contains your historical equity values.

### Market Wisdom - Art Hilliard\*

The Process is the Process

Whether the investor buying your loans is a hedge fund, private investor or another bank or credit union, the loan sale process is still the same:

- Seller issues a tape
- Buyer performs analysis and provides a bid
- Seller accepts the bid
- Buyer issues a Letter of Intent and all parties execute
- Seller provides loan files to buyer for due diligence
- Buyer reviews loan files and responds to seller with kickouts and price adjustments
- Seller agrees to new terms
- Buyer issues a Purchase and Sale Agreement and Interim Servicing agreement. All parties execute
- Seller sends collateral file to the buyer
- Buyer reviews collateral and wires funds for purchase
- Post sale, the seller transfers servicing 30-60 days later

If one has never done it, the process may look intimidating. Actually, it is pretty simple, and you are never in it alone. If assistance is needed, Loan sale advisory is provided through TFO.

Art Hilliard has been in the mortgage industry for 29 years. He has originated, managed secondary marketing, securitizations and settlements, provided mortgage financial advisory and performed multiple mortgage portfolio sales and acquisitions. He was past president of the Illinois Mortgage Bankers Association.



Select Banks for Peer Group

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ABA Number:    
 Bank:    
 City:    
 Client Type: Bank    
 All State

Charter Type: All Type    
 District: All Distric    
 Asset Size: all    
 Distance(mile): all    
[16 banks](#)   

The *Download All Strategies in Trade Simulation*, reports the EVE historical trends. You can go back to previous cycles by changing the dates as shown below to download other previous EVE results.

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Jun 2016  Download All Strategies

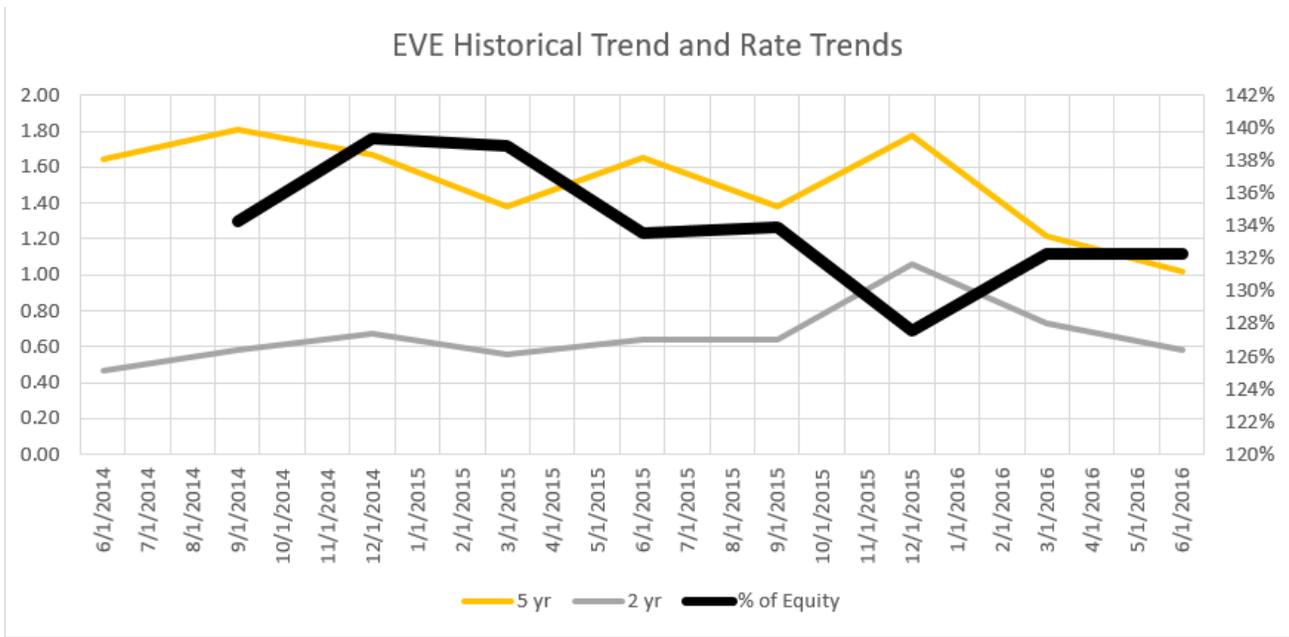
Given the historical trends of book equity and EVE, you can plot the trend of the value-to-book multiple. A rising trend would indicate your institution’s value increasing on the economic value basis. For example, the fixed rate loan values have increased when the rates have fallen. Or, replace borrowings by non-maturity deposit accounts add higher intangible value to EVE.

**Numerical Example**

I calculated the trend of EVE to Book Equity ratio, value-to-book multiple, using a hypothetical bank. The thick black line represents the multiple, measured by right hand side axis. I also provide the five year and two year rates in the Figure. This bank has duration of over 9 years at the beginning of the sample period and the duration gradually lowers to 7, and therefore this bank is quite liability sensitive. For this reason, the Figure presents the following obserations:

- The value-to-book multiple is sensitive to the rate changes. You can dampen the variations (or the EVE volatility) by lowering the duration. This bank has high duration and hence is sensitive to the rate change
- The value-to-book multiple changed from 132% to 127%, a drop of 5% of the equity book value. Over the same period, the five year rate rises by 40 bpt. The duration number specifies the relationship between rate rising and the multiple falling, and the duration magnitude is consistent with this observed relationship. If you anticipate rates to fall, then a longer duration would lead to higher multiple.
- This bank is particularly sensitive to the five year and other longer term rates. Therefore, the bank may mitigate the yield curve risk or may proactively take such a position.
- Different banks are sensitive to different areas of the yield curve, referred to as the key rates. If your bank has a negative duration, then the trend of the multiple can be significantly different to that in the Figure. The EVE may rise with the rates instead.

The Board and the ALCO would benefit and gain by better understanding of the institution’s value by monitoring the trends of the multiple and EVE. These figures will enable your senior management team to decide on the tradeoffs in adjusting the balance sheet sensitivity, product offerings, and profitability. A review of local and national economic conditions can lead to adjusting the balance sheet. The trend analysis provides you a timely feedback.



**Conclusion:**

The economic value of equity, EVE (or NEV) and the related % change of EVE are not just regulatory interest rate risk measures. They measure your institution’s value and help guide your balance sheet risk and return tradeoff analysis. The trend analysis gives you continual feedback as there are many factors that affect your institution’s value, not just your strategic plan.

This feedback enables you to monitor and adjust your strategies monthly or quarterly. As you recall in previous posts, THC’s platform enables senior management to develop realistic strategic plans and reduce risk by performing what-if impact analysis.

*If you have any questions regarding the EVE Trend reports, please do not hesitate to contact THC.*

Regards,  
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