The NEV Bandwagon Has A Flat Tire

Do you have a "good NEV" or a "bad NEV"?
Assumptions Determine NEV Results

INTRODUCTION

Recent changes in credit unions' financial structures make it ever more critical to quantify interest rate risk and long-term threats to net worth.

Net Economic Value (NEV) is the "tool d'jour." Proponents of NEV say that it is a good tool for:

- Measuring interest rate risk and long-term threats to earnings and net worth
- Understanding interest rate risk volatility in a credit union's balance sheet
- Quantifying interest rate risk associated with mortgage portfolios
- Understanding potential changes in Credit Union Membership Access Act (CUMAA) capitalization classifications

We disagree with proponents' uses of NEV.

This c. notes is designed to help you understand the dangers of NEV before deciding whether to incorporate NEV into your decision-making process.

IS NEV NEW?

NEV methodology is not as new as some proponents have indicated. We have had much experience with the use of concepts such as NEV dating back to the '80s. We have also had the capability to conduct NEV simulations in our model since the inception of our company in 1991. We could have touted the concept to credit union CEOs many years ago. We have refrained from promoting NEV to credit unions because we believe that to do so would be a disservice to them. We have evidence that shows NEV methodology is inadequate and misleading when attempting to quantify long-term threats to net worth in natural person credit unions.

WHAT IS NEV?

The underlying methodology of NEV is discounted cash flows. Bond traders have used discounted cash flows for a long time as a way to estimate the "present value" of a single bond that is widely traded.

To calculate NEV, take the "present value" of your assets minus the "present value" of your liabilities, and in theory that is your credit union's Net Economic Value. However, the theory doesn't work for natural person credit unions.

Calculation of discounted cash flows requires at least two elements:

- Cash flows (for example, what are a bond's interest payments and maturity?)
- A market-derived discount rate (which is readily available for a security that is widely traded)

SOME PROBLEMS WITH NEV

Proponents of NEV make two assumptions, both of which are dangerous and misleading:

- The discounted cash flow methodology, with its specific requirements for estimating the "present value" of a single bond, is applicable to a natural person credit union's entire balance sheet (i.e., all assets and all liabilities)
- Potential changes in the "present value" (net discounted cash flows) of a balance sheet are reasonable proxies for potential changes in earnings and net worth that could be triggered by changes in market rates

NEV proponents must have overlooked a couple of critical details that, as a result, cause NEV methodology to crumble like a house of cards. Consider this:

- Unlike bonds, there are credit union loan portfolios that are not widely traded
- Most share balances have no contractual maturities and are not widely traded

So, what has to happen to fit this square peg called NEV into the round hole called natural person credit unions? A lot of assumptions have to be made. Someone has to make assumptions, for example, about:

- The maturity of non-maturity share drafts
- The maturity of non-maturity regular shares
- The maturity of non-maturity money market accounts, etc.

Also, assumptions must be made about "appropriate" discount rates for loans and shares that are not widely traded.

We recognize that, when attempting to project future financial results, certain assumptions have to be made. **However, with NEV, a multitude of defendable assumptions can be made about the future behavior of the same thing, like the maturity of non-maturity regular shares which can lead to conflicting results.**

In order for a methodology to provide reliable decision information, *assumptions alone should not determine results*. We have evidence that shows that just by changing one assumption regarding the maturity of non-maturity deposits, a credit union can go from having a "good NEV" to having a "bad NEV."

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EXAMPLE OF NEV IN ACTION
($ in millions)
Current Net Worth: $11.4 = 7.8%

Defendable/ Commonly Used Assumptions*	Rate Scenario	NEV $	% Change	NEV Ratio
#1	current	$ 8.6		6.01%
	+300 bp	$ 1.7	-80.6%	1.23%
#2	current	$ 9.5		6.64%
	+300 bp	$ 3.7	-61.1%	2.71%
#3	current	$12.1		8.44%
	+300 bp	$ 8.8	-27.7%	6.47%
#4	current	$14.2		9.91%
	+300 bp	$12.5	-11.9%	9.26%

*If you would like to learn about the assumptions, please call us at 800.238.7475.

A FEW THINGS TO THINK ABOUT

Question: What is the NEV for this credit union if rates don't change?

Answer: You can't tell. Just by changing one assumption, potentials for NEV range from $8.6 million to $14.2 million. There are many other defendable/common assumptions that could be used to increase the range of results.

Question: What is the NEV for this credit union under a +300 basis point shock?

Answer: You can't tell. Just by changing one assumption, potentials for NEV range from $1.7 million to $12.5 million.

Question: What is the interest rate risk volatility for this credit union?

Answer: You can't tell. Just by changing one assumption, the range of volatility for these defendable/commonly used assumptions is –80.6% to –11.9%.

Question: How much money could this credit union earn or lose if rates go up 300 basis points?

Answer: You can't tell. NEV ignores earnings.

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Question: Under what rate conditions could this credit union be subject to mandatory prompt corrective action (PCA)?

Answer: You can't tell. Regardless of what some proponents say, NEV ratios have nothing to do with the required net worth ratios outlined in CUMAA.

Question: If this credit union reduced operating expenses by 5% and increased fee income by 10 basis points, how would its NEV change?

Answer: It wouldn't change. NEV ignores a credit union's unique operating expense and fee income structure.

Question: If changing one assumption can result in a credit union going from having a "good NEV" to a "bad NEV," what can you conclude about the safety and soundness of this credit union?

Answer: Not a thing.

With evidence like this, we ask:
How can CEOs, managements, boards, regulatory authorities, credit union consultants and brokers truly understand threats to net worth if exchanging one defendable/commonly used assumption with another defendable/commonly used assumption can drastically change NEV results?

Why would some proponents of NEV lead credit unions to believe that if their NEV ratio stays above a certain level in a shock test, that they are in good shape with respect to the net worth requirements and mandatory PCA outlined in the law, when indeed, this may be dangerous and misleading information?

NOTICE TO OUR CLIENTS

If it is suggested that you have NEV simulations available, then we can provide several versions of NEV simulations so you, and those suggesting or requesting the NEV simulations, can see the impact of using a range of defendable/commonly used assumptions for your credit union.

We welcome your questions and comments
You can contact me by telephone at 800.238.7475, or by email at smyers@cmyers.com.

Sally Myers, CEO

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