

Demystifying EVE (Economic Value of Equity)

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Introduction

- EVE Defined.
- EVE is a Regulatory Tool.
- EVE is a Strategic Tool!
- Where is the Value?
- Non-maturity Deposit Behaviors:
 - Balance/Rate Relationship.
 - Decay.
 - Sensitivity to changing interest rates.

EVE Defined

- ACCT101:
 - Assets = Liabs. + Equity.
 - Historical Cost (Static Value).
- ALM101:
 - Assets = Liabs. + Equity.
 - Current Economic Value (Dynamic Value).

EVE Defined

- Q: Does EVE = Fair Value?
- A: Sort of. EVE is the present value of balance sheet cash flows. EVE does not consider value drivers such as liquidity or items like real estate or other fixed assets.



EVE Defined

- Q: So what does EVE do for me?
- A: As a start, it makes the regulators happy.



EVE is a Regulatory Tool

- Along with earnings and liquidity, examiners expect you to measure and monitor EVE on a regular basis.
- This includes “stress testing” EVE in various interest rate change environments.



EVE is a Strategic Tool

- While we all want the regulators to be happy, EVE analysis provides so much more because:
 - Managing earnings while crucial, only highlights short-term performance.
 - Managing value (EVE) highlights long-term franchise value accumulated over many years of solid management decisions.

EVE is a Strategic Tool

- Q: I'm a "going concern". Since we aren't for sale, why do I (or my shareholders) care about franchise value?
- A: Because healthy EVE allows for:
 - More room to assume greater duration risk.
 - Less value sensitivity rising rates.
 - Higher returns on branch/deposit sales.

Where is the Value?

- Not all is equal (value contribution):
 - Investment portfolio, little or no value.
 - Loans, depends on point in rate cycle.
 - Non-maturity Deposits, main source of value.
 - Time deposits, depends on point in rate cycle.
 - Borrowings, little or no value.



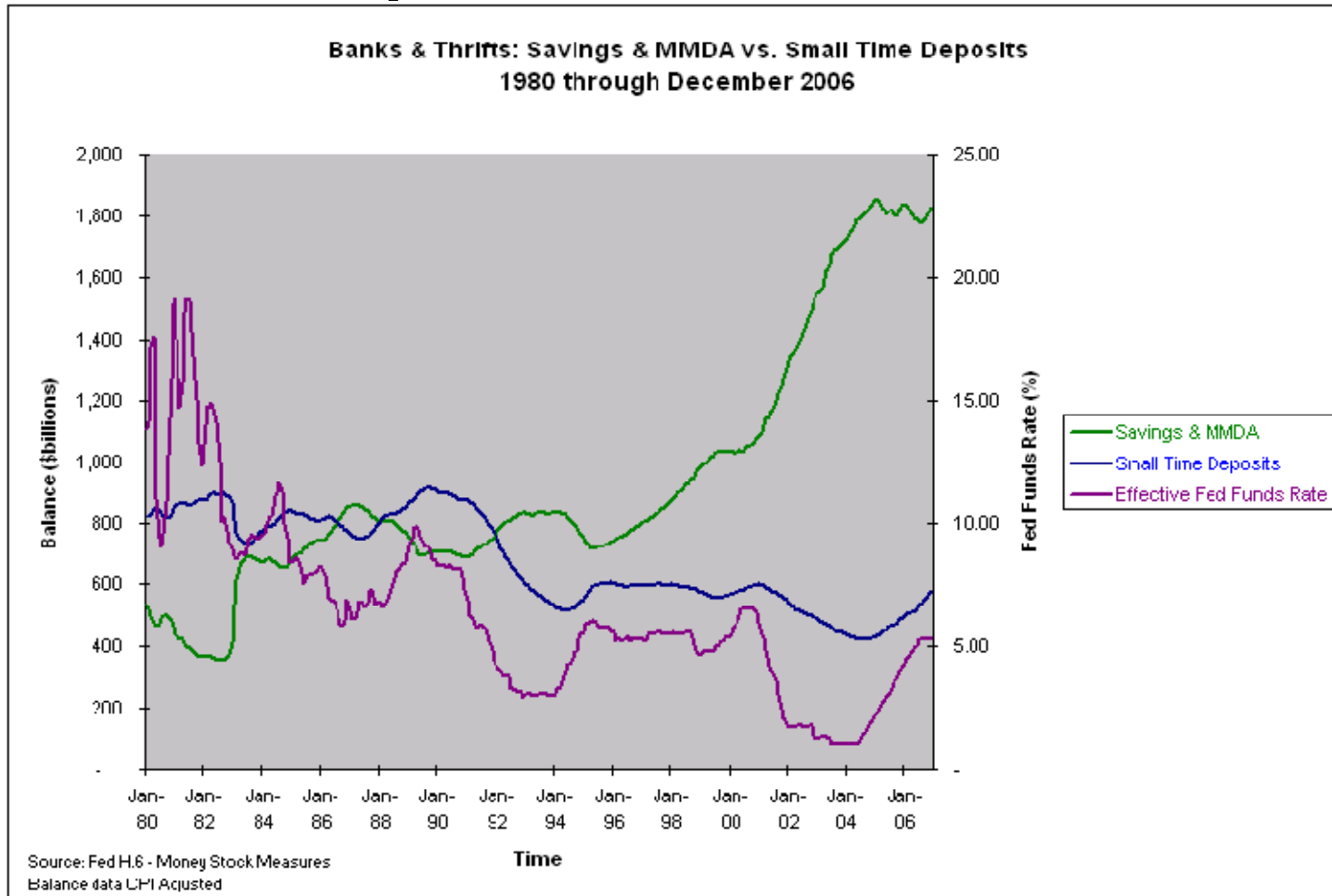
Where is the Value?

- Non-maturity (Core) Deposits are by far the most significant contributor to creating value.
- Q: How do I measure the EV of my core deposits?

Core Deposit Behaviors

- Balances are impacted by:
 - Directional movement of interest rates
 - Overall economic health
 - Inflation
 - Housing/Real Estate
 - “Easy” lending practices
 - Overall economic health
 - Competition/Alternatives
 - Internet
 - Stock Market

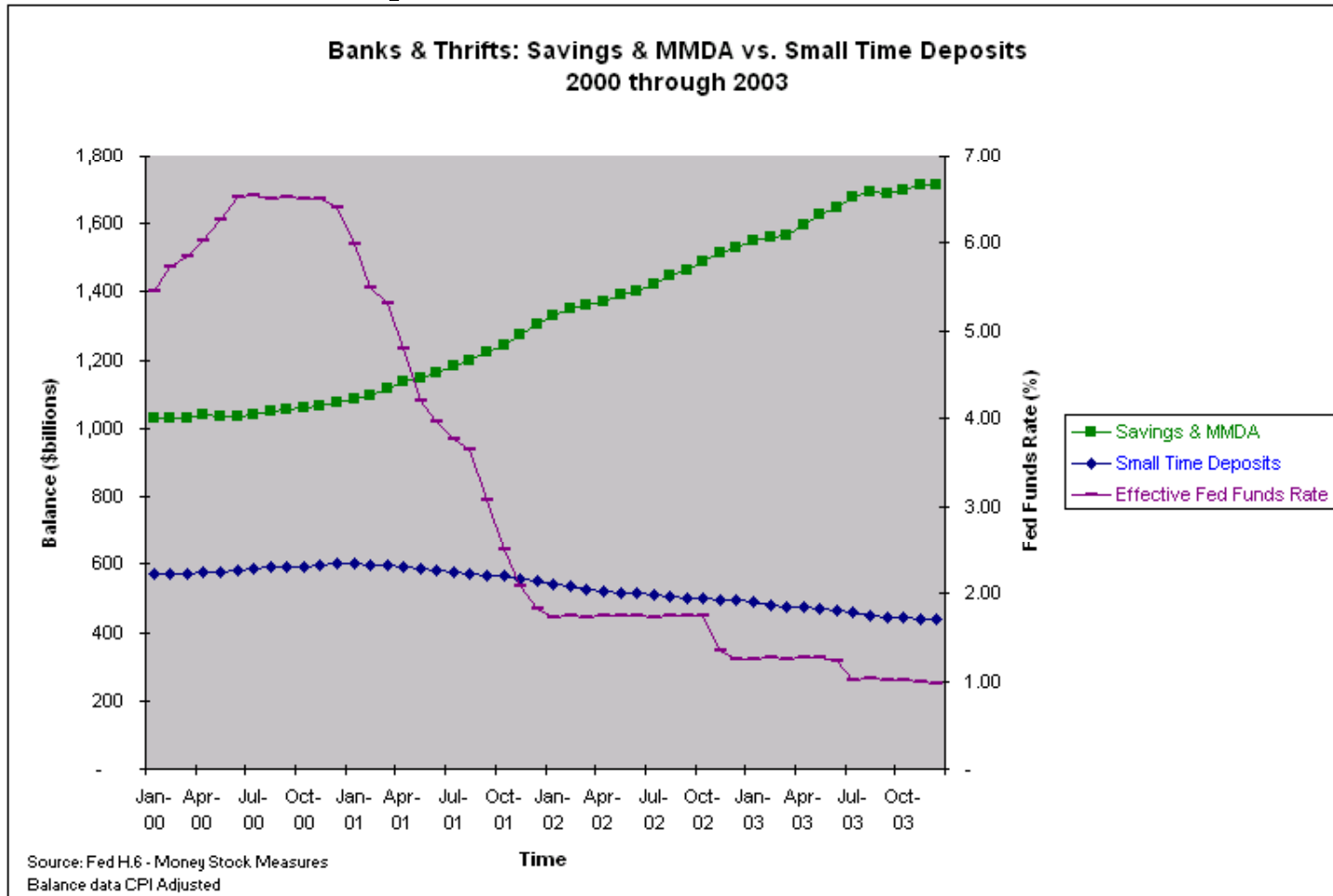
Core Deposit Behaviors



Net Result:

- FF Fell
- Savings Grew
- Time Fell

Core Deposit Behaviors



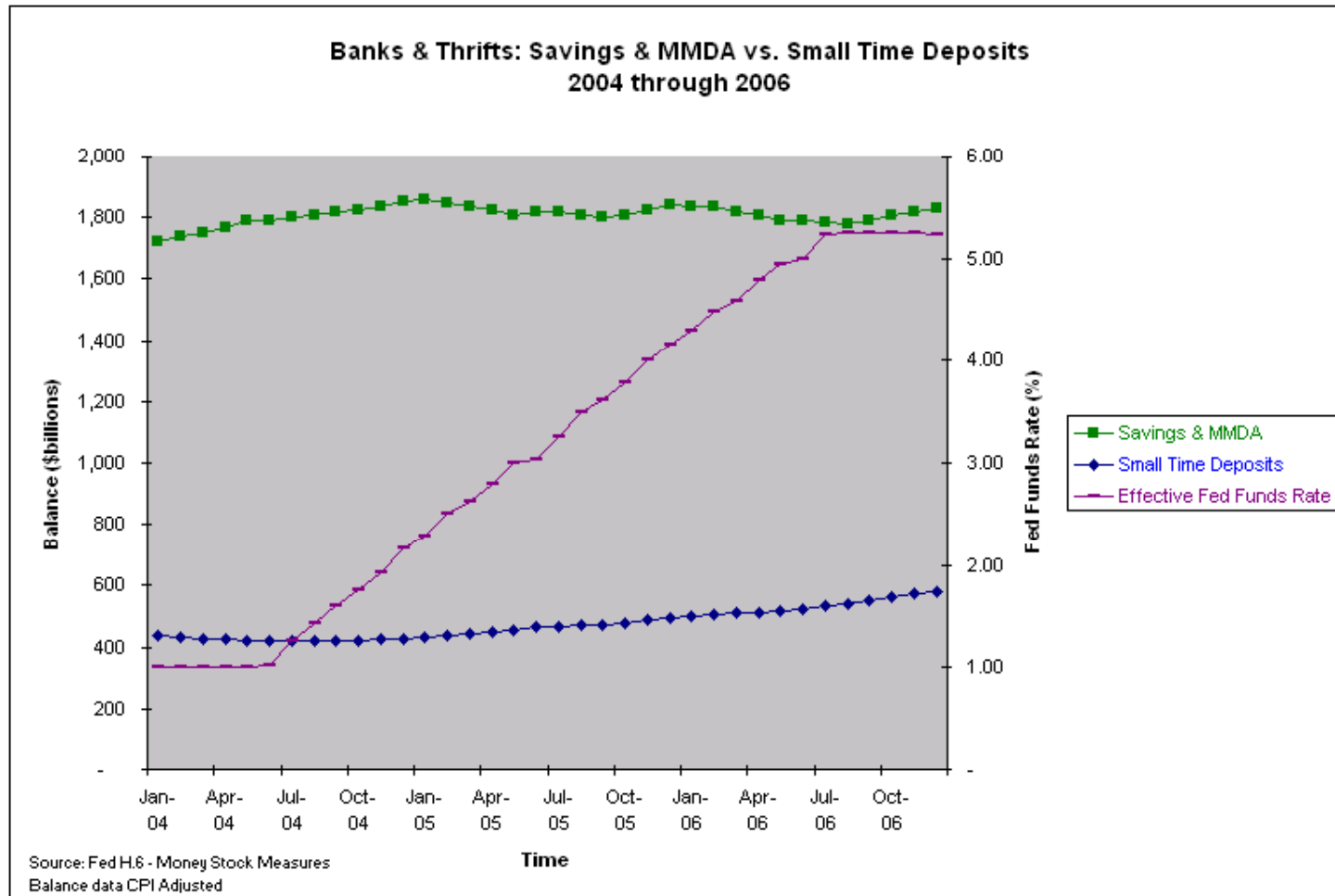
Net Result:

- Savings Grew
- Time Fell
- Lagged Impact

Market:

- March '00 Correct.
- 9/11 attacks

Core Deposit Behaviors



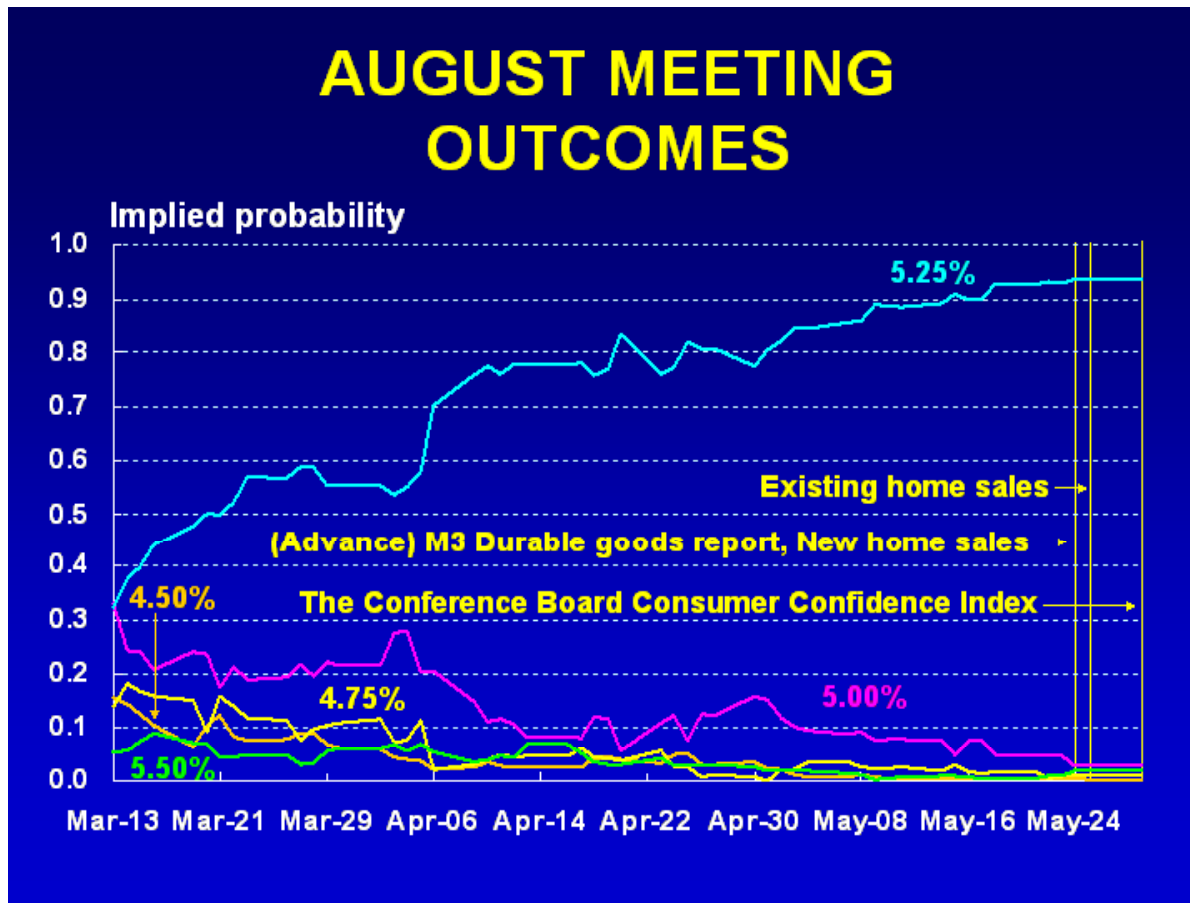
Net Result:

- Savings Stable
- Time Grew
- Lagged Impact

Market:

- Inflation Concern
- Housing Bubble

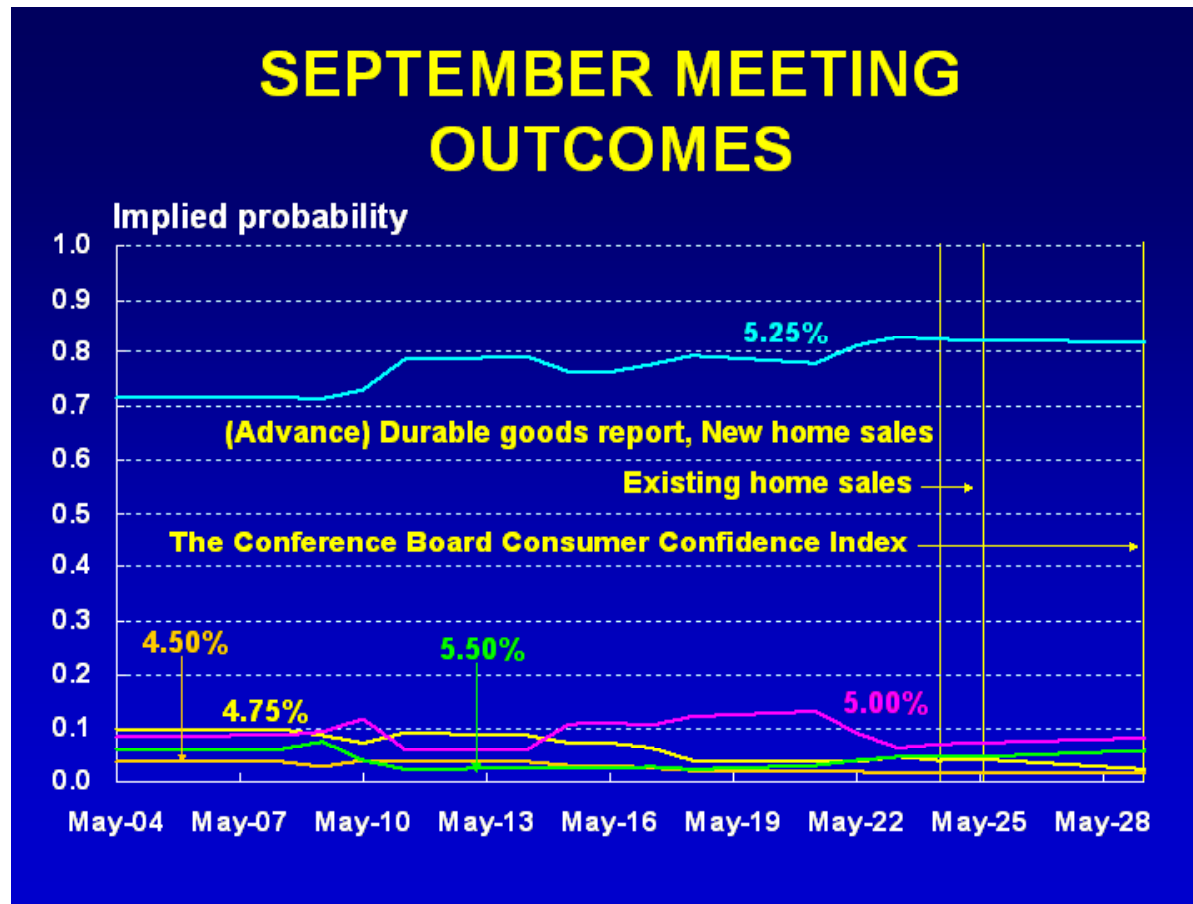
Core Deposit Behaviors



Options on federal funds futures can be analyzed to extract public expectations of future Fed action. The chart shows what markets believe the most likely outcome of upcoming FOMC meetings will be.

Source:
<http://www.clevelandfed.org>
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 Retrieved 05/29/2007

Core Deposit Behaviors



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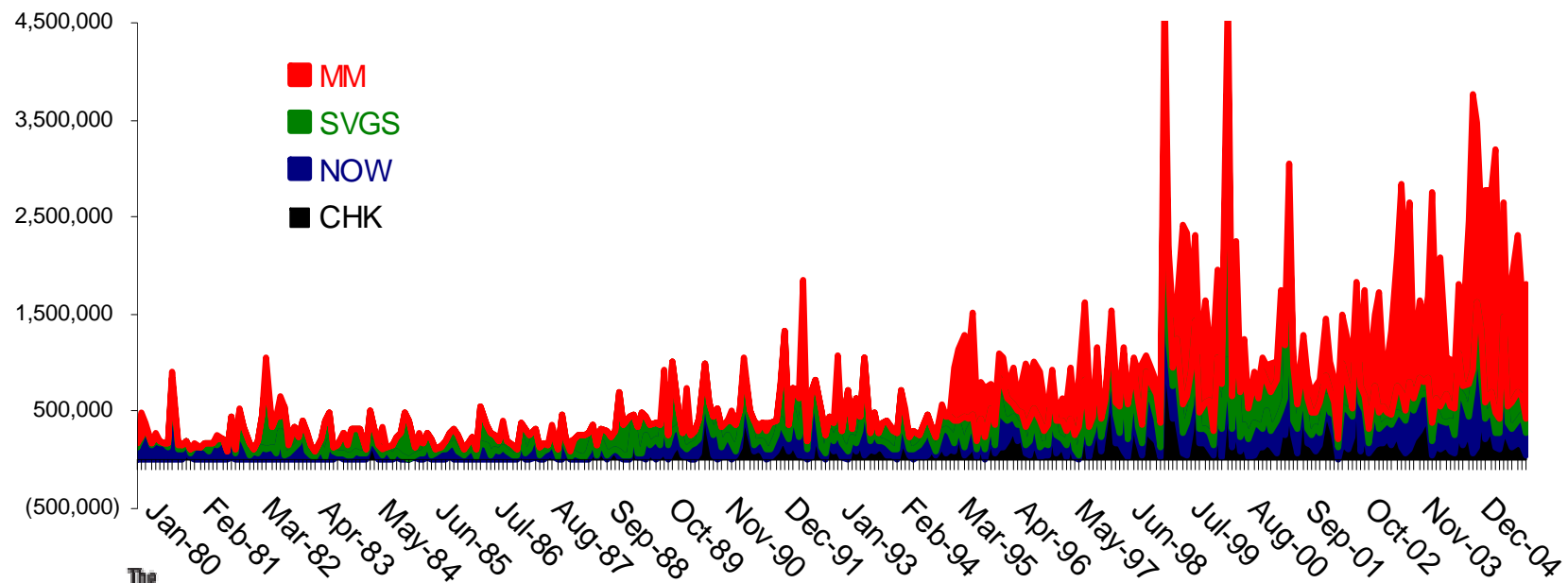
Core Deposit Behaviors

Core Deposit Study:

Account balances by origination date.

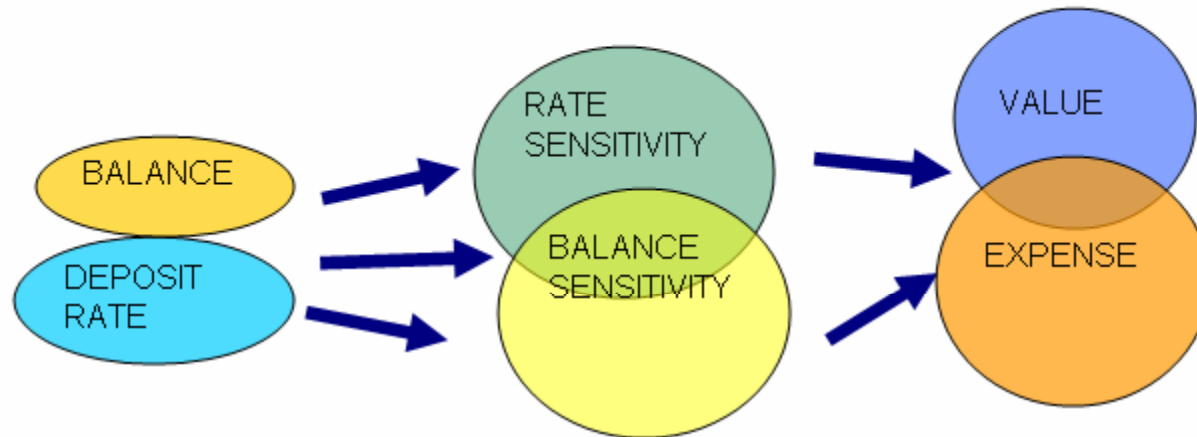
New and closed accounts.

Age or retention.



Core Deposit Behaviors

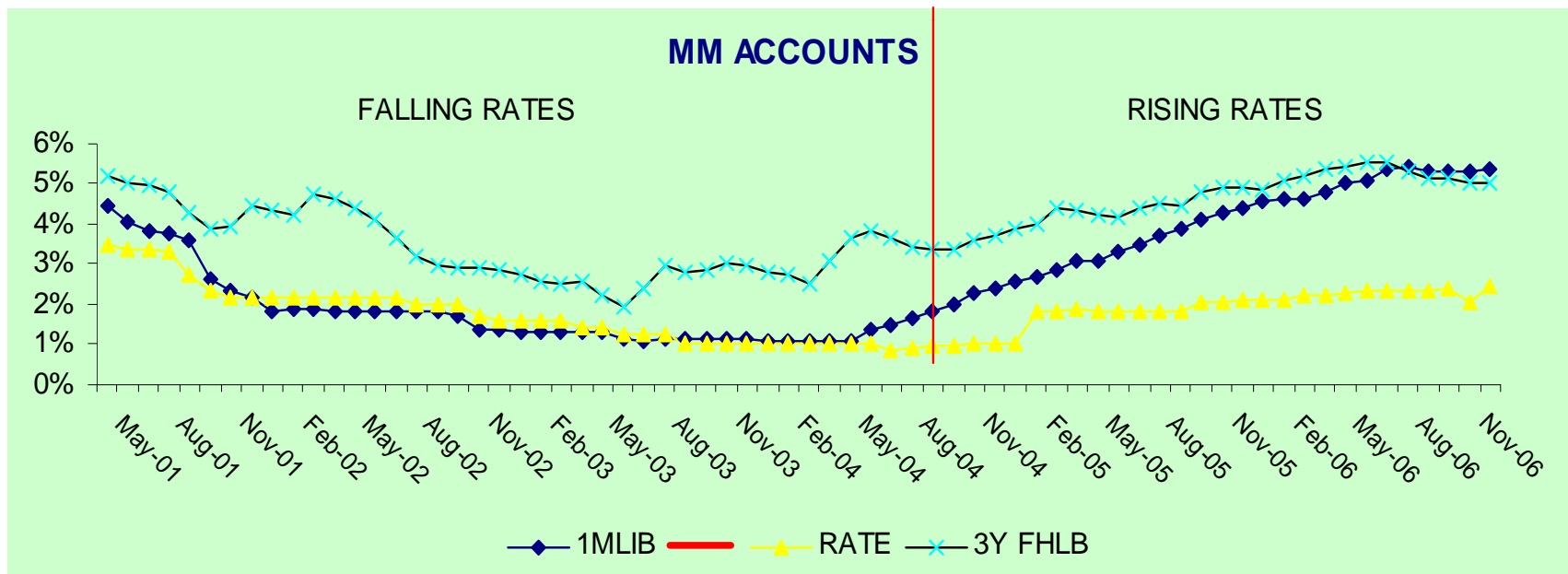
Changing deposit rates impacts...



Core Deposit Behaviors

Modeling administered rates

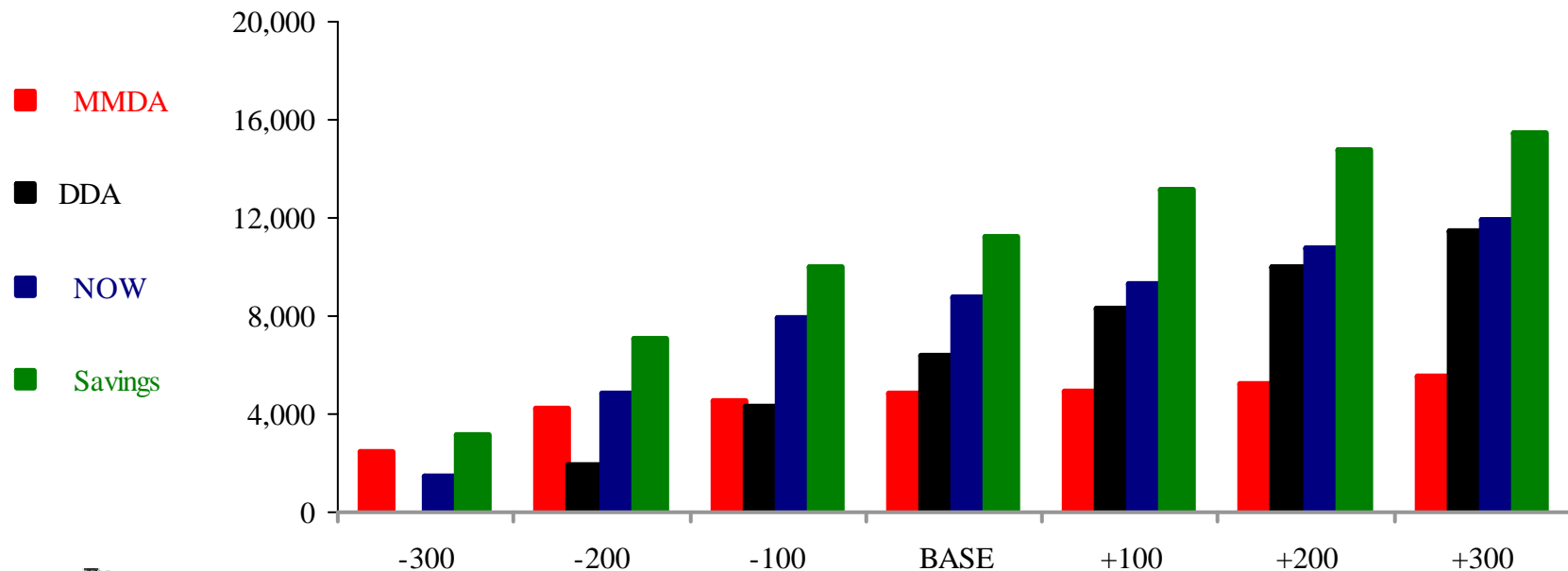
- Deposit Rate and Market Rate Relationships
- Enough Rate Cycles
- Dual Betas – up rates versus down rates
- Correlations/regressions



Core Deposit Behaviors

Stress Test EVE

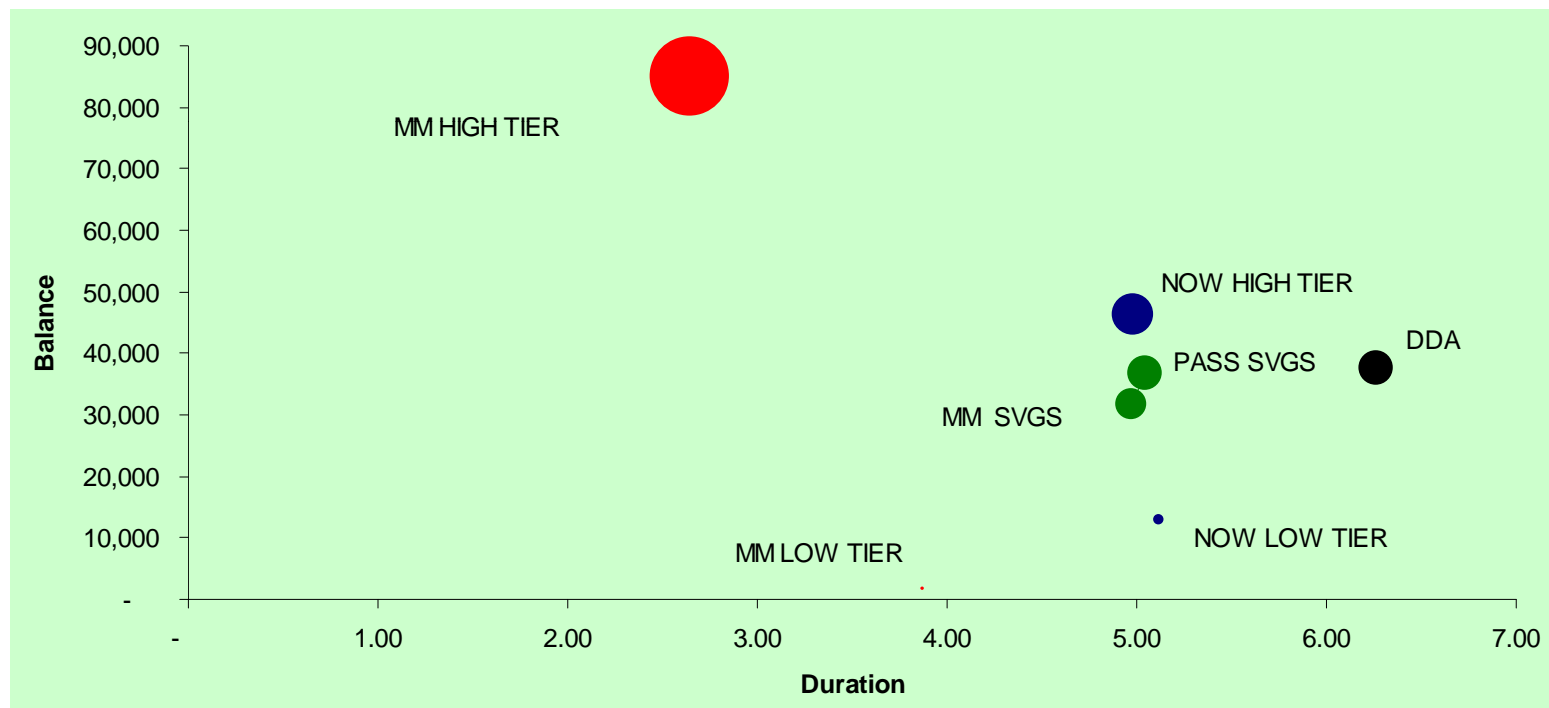
Which Discount Curve?
 Opportunity Cost and Service Charge
 Premium Changes



Core Deposit Behaviors

Pulling it all together.

Where is your sweet spot?



Recap

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