Consider NEV in Interest Rate Risk Decisions

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Interest rate risk has been a key topic of discussion within the credit union industry since the Federal Open Market Committee took unprecedented action to drop the effective Fed funds rate to zero in response to the financial crisis of 2008.

Arguably the top priority for each regulatory agency is its concern for how well the industry is positioned for the next rising rate cycle, especially since the Fed revealed last summer that economic activity warranted a reversal of its quantitative easing program and the possibility of a 2015 increase in the short-term funds rate. A recent article in *The Wall Street Journal* highlighted this heightened concern over rising rate risks, placing a particular emphasis on net economic value sensitivities.

Ironically, for several reasons, higher market rate conditions actually appear to present the best long-term earnings performance scenario for many small to mid-sized credit unions. Also, current observations of the industry reveal that many credit unions face significant income challenges under flat- and falling-rate conditions, both of which are still very plausible scenarios. This presents a problem as credit unions cannot maintain or increase income and hedge net economic value.

Advocates for the value-based model will argue that NEV should be viewed as an indicator of financial strength or weakness under a variety of rate scenarios. Credit unions should be careful how they employ this value-based model since the sole source of ongoing stability and growth in capital for credit unions is net income.

It is important to note that the impact of cash flow replacement, which is critical to gauging future income levels and volatility/sensitivities, is ignored within the NEV model. In a short explanation, the NEV model merely quantifies cash flows and re-pricing from the existing balance sheet and reports this information in present economic value terms. Said a different way, it effectively reports the mismatch risk position (i.e. static gap position) of a credit union's current existing balance sheet using complex financial mathematics.

This does not mean that credit unions should ignore the information provided in the NEV analysis. To best understand why our regulators hold the model in high regard, credit unions must contemplate balance sheet risk management from multiple viewpoints. Naturally, as a going concern, income and capital replenishment and growth remain a critical driver behind balance sheet strategy tactics. However, should a credit union's risk condition deteriorate for any reason to a point where assets and/or liabilities have to be liquidated, loss of capital may result from changes in valuations.

In this regard, credit unions and their risk management systems should be careful to recognize that market rate exposures may have more far-reaching implications than margin and earnings sensitivities.

Financial risks (earnings, liquidity, credit) in the credit union industry are collectively interlinked. Therefore, risk management systems should help quantify the degree to which various interest rate conditions may impact liquidity (cash flow, investment/collateral valuations, access to external wholesale funding channels) and appreciate that potential interest rate-driven deterioration in asset quality (income-to-debt ratios, free cash flow, collateral valuations, etc.) often will accelerate all downside financial risk exposures that affect capital.

Accordingly, financial risks should not be examined separately and distinctly from one another, but rather analyzed in a parallel fashion to best assess short- and long-term capital adequacy. This explains the emergence of enterprise risk management concepts that hold the key to alleviating regulatory concerns regarding your approach to controlling economic value risks.

Additionally, stress testing should be an exercise taken seriously and not viewed as another fruitless task to satisfy documentation requirements. Consider the following: Every institution likely assumes that it will maintain itself as a going concern before unexpectedly realizing it is about to experience their demise. This kind of perspective may help you better appreciate the big picture viewpoint of the regulators.

About the author

Darnell has been working at Darling Consulting Group since 1996. As a Managing Director, Darnell has experience working directly with community banks and credit unions, providing guidance and advice on strategies to strengthen overall performance through proactively managing balance sheet risks and prudently making use of capital markets instruments. Additionally, Darnell offers counsel to financial institutions that seek independent third-party advice on enhancing the overall effectiveness of their ALM function. He is a writer on various topics related to asset liability management and is a contributor to several professional publications. He is a speaker and active educator, who has enjoyed participating in a wide range of educational programs for the banking industry, including the ABA's *Stonier School of Banking* and the Graduate School of Banking at Louisiana State University.

Prior to joining DCG, Darnell was a field office examiner with the Federal Deposit Insurance Corporation (FDIC) in the department of Safety and Soundness. He has received a B.S. in finance from Bentley College and a M.S. in finance from Boston College.

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