Valuation Uncertainty

Comments on IVS discussion paper issued in September 2010

By: Andrew Butter[1]

1: Do you agree that it is only when material, or abnormal, uncertainty attaches to a valuation on a specific time or date that that specific disclosure is necessary when the valuation is reported? If not please explain why you consider that an uncertainty statement should be provided in all cases.

These questions have already been asked and answered perfectly adequately in International Valuation Standards (IVS)[2].

The standards note that sometimes markets are in "disequilibrium" (which is a less convoluted way of saying *"when material, or abnormal, uncertainty attaches to a valuation on a specific time or date"),* and it is reasonably clear that the person doing the valuation that purports to comply with IVS should always check to see if the market-derived data that they are relying on might be, or might have been, tainted by market disequilibrium.

And if so, that the person doing the valuation should (a) report that to his/her client (b) consider qualifying the valuation or reporting Other Than Market Value if the criteria for Market Value are not met, with the implicit proviso that the purpose of the valuation must be taken into account.

Thus, to address the first question, there would be no need to mention that "in the opinion of the person doing the valuation", the market-derived data used for the valuation was not taken from a market in disequilibrium, since it could be assumed that anyone diligently following the guidance of IVS would have (a) checked that and (b) reported it.

On the other hand, IVS also says (repeatedly) that the valuation should be explained properly, and in that context it would hardly require a huge effort for the person doing the valuation to say (a) "I have checked to see whether there is material, or abnormal uncertainty" (b) "having checked, diligently, I can say, in my professional and expert opinion, there is none". In the light of that reasoning, the question would appear to be rather trivial.

Granted, to pick up on this point it is necessary to read IVS quite carefully, also unfortunately no attempt was made in IVS to define the word "disequilibrium", nor is the word mentioned in the Index.

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[2] For example International Valuation Standards 2007 pg 81-82 and IVS 2000 pg 99-100

In that regard, a simple way to improve IVS might be:

A: To mention the word “disequilibrium” in the Index.

B: To define “disequilibrium” more carefully, paying particular care to communicate that disequilibrium is a symptom of market prices being higher that the “fundamental” (as in a bubble), as well as being lower that the “fundamental” (as in the “bust” that typically follows a bubble).

C: To define the word “fundamental” (which is presented as it is commonly used), as “Other-Than-Market-Value”, and to clarify that by definition, a market is not in disequilibrium when the Market Value is equal to the Other-Than-Market-Value.

Example:
A good example that illustrates the various issues, is perhaps the recent “credit crunch” which originated in USA, and was caused primarily by over-optimistic valuations of housing used to collateralise securitized debt. In retrospect it is clear that from about 2003 to 2008 the US Housing market was going through a period of “disequilibrium”, which was not generally recognised or reported, in the valuations, in accordance with the guidance provided by International Valuation Standards.

The fact that valuations were not being done in accordance with IVS, was not a secret, for example in July 2003 the International Valuation Standards Committee wrote to the Bank of International Settlements, explaining to them that the valuations that were, at that time, (and still are), being used for the purpose of assessing capital adequacy of banks and financial entities all over the world, were, quote: “fundamentally flawed and bound to be misleading”[3].

It is hard to imagine how that statement could have been expressed more clearly, or in more simple English. Although in retrospect it is perhaps unfortunate that the letter did not provide an explanation that “non-experts” might have understood.

It may be worthwhile to speculate what might have transpired if (a) BIS had understood the significance of the letter (b) they had acted on it (there is no record in the public domain of any reply) (c) if the principles touched on in IVS had been expanded and given more weight, so that non-experts could understand their significance.

But most important, (d) if regulators instead of; allowing accounting standard setters to concoct their own flawed and misleading valuation standards (for example in FASB and IFRS), or simply ignoring the issue of how to do a proper valuation (as did the Basel II Guidelines), had instead simply mandated that all valuations should be done, strictly in accordance with International Valuation Standards.

[3] IVSC letter to BIS dated 30 July 2003: http://www.bis.org/bcbs/cp3/invastco.pdf

Sadly what transpired was that five years later, almost to the day, on 21st July 2008, the Secretary to the Treasury of USA, Mr. Henry Paulson announced, "The US Banking System is a Safe and Sound One"[4].

An ordinary person with a capacity for understanding simple English; might have reasonably concluded that if the person who had previously been head of the most profitable and powerful bank in USA, was giving a "valuation opinion" on all the banks in USA, in his capacity as the Secretary to the Treasury of the United States of America, then the capital adequacy of the banks in USA was probably "Safe and Sound".

That was an opinion of value, but it was not based on valuations done in accordance with IVS. Subsequent events have shown that "opinion of value", and/or the underlying valuation upon which it relied, were worthless. In fact there is good reason to suppose they were "fundamentally flawed and bound to be misleading", evidenced by the collapse of Lehman Brothers almost immediately afterwards, followed by the chaotic spectacle of various branches of the US Administration "saving" the "safe-and-sound-banks".

It is suggested that the following questions would have been more pertinent to a discussion of valuation uncertainty:

A: Do you agree that all valuations of any significance; should be prepared strictly in accordance with International Valuation Standards?

B: Do you agree that if IVS had been mandated by banking regulators in 2000, and had been properly implemented, there would not have been a credit crunch?

C: Do you agree that if IVS was mandated now, that would help resolve the chaos that was created by the credit crunch; and mitigate another one?

It is further suggested that the correct answer to all three questions, is emphatically "YES"!!

Uncertainty:

One criticism of the Discussion Paper is that the word "Uncertainty" is not properly defined.

There are many different definitions of uncertainty. For example the Heisenberg uncertainty principle states that for elementary particles "certain pairs of physical properties, such as position and momentum, cannot be simultaneously known to arbitrarily high precision"[5].

Could that be an analogy for one of the challenges of valuation? As if for example, the more that is known about the value of something at one particular moment in time, less is known about the propensity for value to change, over time.

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[4] Henry Paulson comment on television reported by The Times: http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article4368749.ece

[5] Wikipedia

Equally, another way to express the uncertainty principle is that the act of measuring the attributes of a particle (value) can change the attributes being measured; just as how the reliance on ratings (a form of valuation) changed the "value" of securitized debt. Or to take an example from the document, the price a Rembrandt painting might achieve at auction, might well be predicated by the valuations of a few experts.

But perhaps "Uncertainty" in the context of this document simply means "uncertainty about the future"? If so, this debate is surely more about "prediction", and less about "valuation", as it is commonly defined?

Or could uncertainty be something to do with the way valuation is done, and what some "users" read-into valuations?

It is intriguing that a discussion of uncertainty at this juncture, makes no mention of the huge shock that the world's financial systems have endured, given those "unforeseen" events can be traced, quite easily, to imperfections in valuation.

And it is unsettling that a discussion of valuation, which surely is at its core, an activity where precision, is important? Opens with "uncertainty" over what is meant by the word, uncertainty.

The Purpose of Valuation

Most valuation standards stipulate that the purpose of any valuation must be properly defined and communicated to the "user". Yet such "health warnings" are seldom taken seriously, either by the "manufacturer" or the "user"; any more than health-warnings that explicitly warn of the dangers to the users of shotguns, of shooting themselves in the foot (as in using valuations incorrectly).

Perhaps one of the root causes of uncertainty in valuation; lies not so much in the process of valuation, but in the uncertainty of defining the purpose of valuation?

For example, in the housing bubble which preceded Secretary Paulson's statement on the safety of the US Banking system, lenders had stipulated that prior to writing a mortgage; a valuation should have been done, strictly in accordance with the highest standards of valuation, in America, at that time (not IVS).

Those valuations stated that on the day of the transaction it would have been reasonable to suppose that the house in question could have been sold to another buyer in an "arm's length transaction", at or around, the price that the transaction was actually concluded.

Such a valuation would have been useful to the buyer who might have wanted to know that he/she was not selling the house too cheap, equally it would have been useful to the seller, who might have wanted to know that he/she was not paying too much. And it would have been useful to the lender who might have wanted to know that the buyer and the seller had not been colluding to pump up the "price" so that the buyer could get a bigger mortgage.

But the lender needed to know something else. Which was what minimum price would it be reasonable to suppose that the house would be able to be sold for at some indeterminate, or specified, time in the future; in the event that the borrower did not service the loan.

Granted, IVS as it is currently conceived, does not provide any guidance for "doing a valuation" for the future. Yet a valuation done strictly in accordance with IVS in USA in 2006, would have reported that the housing market was in disequilibrium and was at least 40% over priced.

That is something that anyone competent in valuation would have most certainly concluded after a couple of hours of analysis to estimate the Other Than Market Value of housing in USA, strictly in accordance with IVS Guidelines[6].

A diligent and professionally-minded valuation person might even have pointed out in the valuation that there are very many historical precedents, where a market that is in disequilibrium (on the high side), corrects; often catastrophically.

A prudent banker in possession of such a valuation opinion, might have concluded that it would be imprudent, or perhaps insane, to write a mortgage with an LTV of more than 60% at that time. But sadly, IVS was not adopted, and it was not used, if it had been, starting in about 2004, alarm bells would have started ringing.

There is nothing wrong with International Valuation Standards (not that improvements are not possible), the only mistake was that it was not implemented in 2000.

Accounting for the Future

In the example given in the Discussion Paper, owners of Rembrandt paintings commonly seek out the services of a valuation expert to give them an opinion on the price their painting might sell for, in auction, in the future, as might the owner of a house who was contemplating selling it.

So if it is normal to do a valuation, or more precisely, to give an opinion of value, for something that might happen one or six months in the future, why not five years; and why should guidance not be provided for doing that, in a robust set of valuation standards?

With respect to the "difficulty" in reliably delivering such a valuation, surely if a third-party expert was hired to do the easy job of a "sales-comparison" valuation at the time of the transaction; it would make sense to hire an even better expert to do the much more difficult job of "predicting the future"? But instead of commissioning such valuations from experts in valuation following proscribed valuation standards, during the housing bubble in USA, the lenders relied on their own non-expert resources, or later, they foolishly relied on the lottery of credit-default-swaps, to deliver the valuation opinions that they needed to do their jobs properly.

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[6] The Value of Housing in USA and UK: http://www.marketoracle.co.uk/Article6250.html

History has shown that they failed, miserably. They would have been much better served if they had commissioned a valuation done according to IVS, and they would have been even better served if they had commissioned a valuation done in line with the principles of IVS, that applied to a date in the future.

Recommendations:

A: IVS should include a chapter explaining to potential buyers of valuation services, how to properly specify what they want to buy, or in other words, how to properly define the purpose of valuation, which is applicable for their needs.

B: IVS should expand on the issue of disequilibrium (as above).

C: There should be a chapter in IVS giving guidance on how to do a valuation with the date of valuation, some time in the future; this would include a discussion of uncertainty and how to measure that.

D: Persons engaging in selling valuation services should be obliged by regulation to keep a record of the accuracy of valuations they did that applied to the future (for example an estimate to a house-owner of how much he might expect to sell a house for, compared to what it was actually sold for), and that "track-record" should be audited, and the results of the audit should be made available to potential customers.

E: IVSC should refrain from attempting to tailor their valuation standards to accounting or other standards. And instead of accounting, banking, and other standard setters attempting to "re-invent" the valuation wheel, they should simply define the purpose of the valuations they require. IVS should simply outline in their guidelines how to do a valuation for that specific purpose.

2: Do you believe that the Board has identified all major sources and types of material valuation uncertainty? If not please identify what additional causes of uncertainty exist and how often you encounter these in practice.

The Board has not properly identified "disequilibrium" in markets as a source of valuation uncertainty.

3: Do you agree with the Board's conclusion that an explanation of any abnormal uncertainty identified and an explanation of the impact this has on the valuation (a qualitative statement) is more helpful to users in understanding the valuation than a purely numeric expression of the range of possible values created by the uncertainty (a quantitative statement)?

A competent valuation person should be able to provide a quantitative estimate of uncertainty, if the purpose of the valuation requires it. But it is not always necessary, so the best criteria would be "does the buyer of the valuation want to pay for this"?

4: Do you think the IVSB should include an explicit requirement in the proposed IVS 105, Valuation Reporting, to disclose any material uncertainty or is the principle that requires valuation reports not to be ambiguous or misleading sufficient?

As discussed above, IVS covers this point perfectly adequately, although there is scope for improvement. The most important issue that is not properly covered is guidance for buyers of valuation, as is also discussed above.

5 Do you consider that there are cases where a qualitative statement of the causes and impact of uncertainty on the valuation is inadequate and should be either augmented or replaced by a quantitative statement?

IVS covers this issue perfectly adequately; the question of how much more should be provided should simply be an issue of how much the buyer of the valuation wants to pay.

6: Do you consider that it would be helpful if IVSC developed guidance on methods for making a quantitative disclosure of uncertainty under specific circumstances?

Yes, discussed above.