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VIEWPOINTS

Four Keys to Better Asset Valuations

BY NOAH GOTTDIENER

The Financial Stability Forum, which is chaired by Mario Draghi, governor of Italy's central bank, recently asked the International Standards Accounting Board to form a new group of senior bankers and regulators to examine the vexing challenge of valuing securities in illiquid markets.

The credit crisis has spawned a spirited debate about whether and to what extent the application of fair-value accounting contributed to the global writedowns. A growing and coordinated chorus of voices has recently asked that fair-value rules be relaxed when markets become illiquid, to avoid "creating the impression of losses," as one fair-value critic put it. To those on the other side of the debate, such a proposal enables obfuscation and contravenes the principles underlying transparent financial reporting. In the refined and polite world of accounting, it is an unusual and highly polarizing debate.

It need not be so. In April the Financial Stability Forum itself, under Mr. Draghi's leadership, spearheaded the development of a report that focused on ensuring symmetry between the development of complex financial instruments and the tools we used to value those instruments. The report retains the core rationale underlying fair-value accounting, while addressing some of the key criticisms of the practice. Four principles are key.

First, valuations need to be as serious and complex as the underlying assets — which means that one cannot simply check an asset off the list after building one plausible model and expect past to be prologue. Highly technical and complex assessments of value must be an iterative and dynamic process, with actual and projected performance compared and financial models tweaked every quarter at every point in the cycle.

Second, in addition to being dynamic, valuations need to be purpose-built. A significant contributor to the massive writedowns over the last six months has been the failure to account for an asset's intended function, which has very real implications for how that asset should be valued. For example, the appropriate valuations for purposes of accounting for a merger or for providing collateral for an overnight loan are very different. What can an asset be sold for under current conditions and over what period of time? How does this vary if one shortens or lengthens the time horizon? How does it vary under different market scenarios? There is no single best "valuation" for any asset and, as a result, serious valuations need to illustrate what's happening a couple of standard deviations away from the top of the bell curve.

Third, the need for independent and objective analysis is more pressing than ever. The complexity of these new instruments increases agency problems, as the fewer people who understand a product, the harder it is to get an independent valuation (as we independent evaluators are wont to point out). It's critical that conflicts of interest be avoided. The team who created a new structure or designed the new model may not be able to give an objective evaluation. Likewise, managers at firms who have significant compensation riding on the values their analysts assign to the firm's assets may also have an objectivity challenge. But, if they're the only ones who understand what's going on, where do you turn? The creation of an independent class of valuation professional capable of keeping up with innovations and free from perverse compensation incentives — firewalled inside banks and hedge funds or working for independent companies — is critical both to the perception and to the reality of accurate valuation.

Finally, transparency is vital, not just with respect to the final numbers, but also for the process by which those numbers were derived. Arcane instruments increase the need for transparent valuation so that investors can understand the methodology and make their own judgments regarding its efficacy.

As the standards board prepares to convene bankers and regulators this month in London to move the process forward, parties on both sides of the valuation debate would be well-served to adopt the forum's approach.

Mr. Gottdiener is the chief executive officer of Duff & Phelps Corp., a provider of financial advisory and investment banking services.

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