Ladies and gentlemen,

FVA during the Crisis?

- Research seems to indicate
  - FVA has not been a problem
    - as it has hardly been applied
    - if discretion and Standard's safeguard exercised
  - Only full M-t-M might have spiral effect

- Do Markets know better?
- Relevance of Fair Value
  - representing the essential properties of market value?
  - determination by competing market forces?
  - resolving different entity-specific expectations into one price of objective quality?

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The research so far has not provided sufficient evidence whether FVA has contributed to the crisis or not. However, one has to admit that, on this question, research is extraordinarily difficult as so many factors can play a role.

It appears that FV in the form of Level 1 which is pure Mark-to-Market pricing is considered as a potential source of danger; however, so far, it has not been applied outside trading and safeguards in the Standards like the "Other-than-temporary-impairment" principle have helped in avoiding undue write downs.

On the other hand, a drive towards more fair value is still strong and it could result in problems in the future.

It is therefore imperative to add precision to the sometimes superficial debate about FV. Because if we do not learn from the crises (plural) the lessons on what market prices have to offer and what they may be unable to deliver, we cannot hope for satisfactory development of accounting standards.

So, what can market prices deliver? Do markets know better?

It has been argued that fair value is so relevant because it represents the essential properties of market value: being determined by competing market forces which are supposed to resolve different entity-specific expectations into one price of objective quality.

Market Price Relevance

- The misuse of the EMH: reversal of the thesis
- McKinsey's 3rd cornerstone: The market
  - is not a monolith (with a single point of view)
  - is moved by the interaction of investors
    - With different strategies and beliefs about the future
  - has volatility without information
- Prices are driven in "ranges"
- Market's technical factors
  - Liquidity ?
  - HFT ?

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As Ray Ball[1] has clarified so convincingly: the Efficient Market Hypothesis never has stated that market prices reflect fundamental values and that investors should not question the prices from a fundamental perspective. This "reverse application" of the thesis is in fact a misuse, which is neither intellectually nor logically sound. This argument alone might not convince some Standard Setters. However, the crisis has shown that the thesis itself has more limits than previously thought:

Prices for equity securities do not move only on the basis of information, and not only on the basis of information about the business in question!

I would like to quote from the recent McKinsey book on value[2] as follows: "The third cornerstone is that a company's performance in the stock market is driven by changes in the stock market's expectations, not just the company's actual performance…"[3] Most important, they explain that the market is moved by "the interaction of investors who have different strategies and different beliefs about the future… and the interaction of investors creates volatility that isn't necessarily driven by new information."[4] Their description of the key market forces is eye-opening in its clarity of two major classes of investors, both of which have influence, "but one ultimately drives the range of prices"[5] (to be noted: a range, not a price). Their conclusion is most convincing: "There is a natural volatility to the market even without new information." [6] For our discussion, their findings culminate in the summary: "… short-term market movements are as much about changes in

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[1] Ray Ball, "The Global Financial Crisis and the Efficient Market Hypothesis: What have we learned?" – Journal of Applied Corporate Finance, Volume 21, Number 4, page 8 ff.
[2] Tim Koller, Richard Dobbs, Bill Huyett, "Value: the four cornerstones of corporate finance" - McKinsey & Company, John Wiley & Sons, Inc., November 2010-12-08
[3] Koller/Dobbs/Huyett, p 5
[4] Koller/Dobbs/Huyett, p 63
[5] Koller/Dobbs/Huyett, p 64
[6] Koller/Dobbs/Huyett, p 65

expectations as they are about actual performance. … are also influenced by purely technical factors, such as large investors selling shares to rebalance their portfolios."[7] If prices are driven in "ranges" and represent the outcome of many factors other than information about the company, they logically cannot be taken as an implied representation of a company's fundamental value; which, to begin with, is obviously not what the EMH teaches.

The issue of liquidity has become the most gruesome reality test for financial markets. Of the many failures of financial theory and risk management – including incorrectly assuming stability of correlations – the one that stands out and still is not even close to being defined, understood or controlled is the issue of liquidity. Maybe, because it is influenced by something difficult to put into numbers: confidence that is - and its very slow building-up compared to its swift evaporation.

Liquidity has been ignored by almost all past financial models; indeed it has been mostly assumed to be endlessly available and thus considered no issue at all. This assumption has been the deeper cause of the demise of LTCM and Metallgesellschaft some time ago, and Bear Stearns and Lehmans more recently.

One last point on markets: can prices be representing fundamental values when – on occasion - they become just a function of computer modelled or high-frequency trading, complicated further with issues like "quote stuffing" and cancellation of previous orders?

This only signifies that market prices and fair values derived from them are not ***the*** answer to all valuation questions for all assets in financial reporting. On the other hand, when applied in appropriate ways, it has some very important role to play.

The principles for measurement bases have to be valid for all businesses – not just banks! And such principles are to be derived from what matters most: value is driven by ***cash flow generation***.

The importance of generating cash flows has been manifested in McKinsey's first and second cornerstones of value: "*companies create value by investing capital from investors to generate future cash flows at rates of return exceeding the cost of that capital*."[8] From this follows – as a corollary – that anything that doesn't increase cash flows via improving revenues or return on capital doesn't create value: the conservation of value principle.[9]

[7] Koller/Dobbs/Huyett, p 77
[8] Koller/Dobbs/Huyett, p 4
[9] Koller/Dobbs/Huyett, p 5

Measurement

Measurement bases
- The dominant issue: cash flow generation
- The ruling source: business activity
- The causal relationship: the business model
- Value turns to income only by cash flow

Cash conversion cycles
- Investing cash into non-cash resources (NCRs)
- combine/transform NCRs (factors) by specific process
- according to an ***inherent economic logic***

Reporting
- at activity-specific values based on
  - the contribution to net cf of the activity
  - tested against market values

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What McKinsey have described here, is the cash conversion cycle of business activities: cash out for non-cash resources and cash-in for the sale of those resources (in trading) or for products and services created with those resources purchased. To understand how a business makes money (as Penman has put it), you need to know the cause of generating and increasing cash flows the economic logic of the activity, its business model.

The centre of attention is the activity, not the assets which serve as tools. The same types of asset can contribute to different activities with different cash flow and valuation consequences; sometimes they contribute only by cash outflows. There are causal relationships between assets and the type of activity that they serve: it is the inherent economic logic of the applied business models.

Valuation has to be performed with activity-compatible values which require focussing on how cash flows are actually generated. The remaining values-at-work have to be tested against market prices for the relevance of changes that have occurred which can be separated into permanent and temporary changes.

Market Price Relevance

<u>Two Aspects of Value :</u>
- Permanent value change: Income recognition
- Temporary value change: Disclosure

<u>Cash flows imminent:</u>
- Trading
- Assets for sale (output)

<u>Cash flows not imminent:</u>
- Temporary value changes
  - Entry price, collateral, challenge of management view
  - Assets not for sale – OTTI

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Here is just a summary overview of the relevance of market prices in different cases. The dominant factor for determining measurement bases is the cash flow contributions to the activity. For cash generating activities, market values are relevant for income reporting if and only if they lead to imminent cash flows or expectations thereof. However, in all other cases, the relevance of the disclosure of market values is dependent on the specific needs and objectives of individual users. Essentially, in these cases, investors have to judge for themselves whether or not market prices have relevance for their individual assumptions about future cash flow developments.

Issues

- Incurred Loss or Expected Loss
  - Activity view over single-item view
- "The Market tells us how it is": 85 – 60 – 85?
  - Who knows better when?
- Business models:
  - Banking Book versus Trading: Securitisation
  - Maturity transformation
  - Long term risk with short term instruments
  - Long term view against trading prices
- Transparency of "bad news"

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Let me close my comments with a few issues that could be addressed when discussing the recent financial crises and their connection with accounting standards.

The first issue to mention is the discussion around the incurred loss or expected loss methodologies for loan loss provisions. The incurred loss philosophy goes hand-in-hand with the focus on single assets instead of the more holistic view of a dynamic activity. I could recommend some research work on how many billions of loan loss provisions were reversed in Europe when banks moved to IFRS 10 years ago. I believe that – instead of being distributed by way of dividends and bonuses – they would have proved quite useful during the financial crises.

The second issue is the contribution of Standard Setters to the loss in confidence by claiming that markets know better because they "tell us how it is". In this regards, I would like to refer to an article in the Financial Times, Jun1, 2009: "Signs of life in distressed debt trade" shows a chart of European Flow Loans, (Source S&P), where bid-prices dropped from 85% of face value in October 2008 to 60% in January 2009, to recover in May 2009 to over 80% again. So, who knows better when?

Last, but not least, I would like to point out that the crises have partly been caused by ignorance about the relevance of different business models when the fund industry jumped into securitised loans as well as SUV's or SIV's based on refunding with mismatch maturity. The instruments created gave the false impression of more liquid instruments, though the underlying business and risk remained long-term. Such mismatch would not have been permitted in the banking book by regulation.

One last comment: In my own practise in the Finance function I have witnessed the benefit of presenting bad news to the markets swiftly and clearly, as they happen.

However, we have experienced recently what I would call the opinion-bias of the markets: when markets are in panic mode, it is not advisable to present better news than analysts have forecast! You will be punished for not being as bad as they tell you that you should be – according to their calculations. This is my last suggestion for research: compare over time the company specific forecasts of analysts with actual further outcomes!

Thank you