

MANAGING EXTREMES **Willis Re** MARKET VALUE AND APPRAISAL VALUE

A Conceptual Proposal to Use Appraisal Value as a Supplementary Basis for Financial Valuation

2010 CAS Annual Meeting
November 10, 2010

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Introduction **Willis Re** MANAGING EXTREMES

- Question:
 - Mark to Market accounting is:
 - The best thing since sliced bread
 - The handiwork of the devil
 - All of the above
 - None of the above

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Introduction **Willis Re** MANAGING EXTREMES

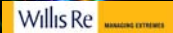
- Financial crisis led to scrutiny of Mark to Market accounting
- Differing views
- Strong opinions
- Let's sort out some conceptual clarity
- Then propose a new framework for moving forward

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MARK TO MARKET  MANAGING EXTREMES

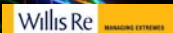
False Accusations Against Mark to Market



Mark to Market  MANAGING EXTREMES


- Myth #1:
 - Mark to Market violates premise of “going concern”
 - “Thus it appears that Fair value/mark-to-market is liquidation accounting imposed on going concerns.”
 - CAS Request for Proposals: Putting Mark to Market on a Going Concern Basis:
 - <http://www.casact.org/members/index.cfm?fa=viewArticle&articleID=963>

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Mark to Market  MANAGING EXTREMES


- Myth #2:
 - If “Held to Maturity”, then don’t use Mark to Market
 - Mark to Market uses sale price
 - We’re not going to sell
 - Ergo, wrong to use Mark to Market

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Mark to Market 

- What's wrong with these 2 myths?
 - They overlook a foundational concept:
 - Imputation

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Mark to Market 

- Imputation
 - To impute value = to assign value
 - When using Mark to Market, we're using imputation
 - The firm has no plans to sell assets or liabilities
 - Other firms have been buying and selling
 - We can observe the sale prices of these assets and liabilities
 - Thus we can use the market prices to assign or "impute" value to the firm's assets and liabilities, even though the firm has no plans to sell

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Mark to Market 

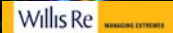
- Summary
 - Resist temptation to disqualify Mark to Market for
 - Going concern
 - Held to maturity
 - Some of the accusations against Mark to Market are misguided
- Mark to Market is a valid basis of valuation

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MARK TO MARKET  MANAGING EXTREMES

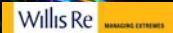
Conceptual Foundations of Mark to Market



Conceptual Foundations of Mark to Market  MANAGING EXTREMES

- Why should we use Mark to Market?
- What's so great about Mark to Market anyway?

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Conceptual Foundations of Mark to Market  MANAGING EXTREMES

- Efficient markets hypothesis
- No arbitrage pricing

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Efficient Markets Hypothesis

- Efficient Markets Hypothesis
 - All public data is baked into market prices
 - Market price is inherently correct at all times
- Implies: always use market price as exclusive basis for valuation

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Efficient Markets Hypothesis

- Problem (via Professor Shiller):
 - We know there are bubbles and panics
- Conclusions:
 - Can't say that market price is inherently correct
 - Can't say that market price is exclusive basis of valuation

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No Arbitrage Pricing

- "No arbitrage" is another reason that market price is important
- If you tried to buy/sell at prices different than market, arbitrageurs would force prices back
- In other words:
 - Can't / don't sell at less than market price
 - Can't / don't buy at more than market price

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No Arbitrage Pricing

- Doesn't say that market prices are "inherently correct"
- If you're going to sell something, market price is the reality of what you'd get
 - Then market price should be the only basis for valuation
- But what if you're not selling?
 - Concept of imputation means that market price is still valid
 - But not necessarily exclusive basis of valuation

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BEYOND MARK TO MARKET

Appraisal Value as a Supplementary
Bases for Valuation



Market Price

- Market Price
 - Valid? Yes. Perfectly accurate? Not always
 - Drawbacks:
 - Excess volatility relative to new information
 - Bubbles and panics
 - Non-experts can affect market price
 - Not stable, not robust across time
 - Market price reflects current situation
 - Often not good predictor of likely future prices

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Appraisal Value

- What is Appraisal Value?
 - The value of the estimated sale price
 - From a knowledgeable, non-distressed seller
 - To a knowledgeable, non-euphoric buyer
 - As estimated by independent experts

Market Price vs. Appraisal Value

Valuation Basis	Market Price	Appraisal Value
Who	Many buyers and sellers	Handful of individuals
Qualifications	Includes non-experts	Experts only
Data	Can derive from buyers/sellers with opaque information	Requires access to rich underlying data
Transactions	Reflects current environment, even distressed sales	Reflects neutral environment of non-distress, non-euphoria

Market Price vs. Appraisal Value

Situation	Which performs better?
Periods of Euphoria and Panic	Appraisal value
Opaque Assets	Appraisal value
Opaque Conglomerates	Appraisal value
Most Other Situations	Market Price

Market Price vs. Appraisal Value

- Market price has strengths and weaknesses
- Appraisal value has strengths and weaknesses
- Each method's strengths tend to arise in different situations
- Suggests utility of proposing...

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Proposal

- Always record both market price and appraisal value:

	Market Price	Appraisal Value		Market Price	Appraisal Value
Assets			Liabilities		
			Equity		

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Proposal

- Recording both market price and appraisal value would help one analyze:
 - What is the spread between market and appraisal?
 - How does this spread change over time?
 - How does this spread differ by type of asset and liability?

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BOTH MARKET PRICE
AND APPRAISAL VALUE

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Application to the 2008-09 Financial Crisis



Application to Financial
Crisis

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- Regulatory Forbearance
- Mark to Model

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Regulatory Forbearance

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- During crisis, market prices plummeted
 - Lower asset prices → lower recorded capital
 - Leads to concern about required capital
 - Leads to asset sales
 - Causes “price-to-price feedback loop”
- Regulators should have pre-committed to using appraisal value for satisfying required capital
 - Fed “stress tests” = appraisal value

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Mark to Model

- Firms declared “no active market, no market prices, switching to mark to model”.
- Investors extremely suspicious of mark to model
 - Firms abandon market prices when they go down, but not up
 - Company financials have weird mixture, some assets are recorded at market, some at model
 - Using mark to model → less transparency for investors about true market prices.

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Mark to Model

- In contrast, if firms would always publish both market price and appraisal value, then:
 - There’s no self serving “switch” from market to model (appraisal)
 - Publishing appraisal value doesn’t obstruct the view of market price
 - Investors less panicked that firm is hiding something
 - All information completely transparent

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BOTH MARKET PRICE AND APPRAISAL VALUE

Application to Casualty Loss Reserves



Loss Reserves: Appraisal Value

- Do loss reserves satisfy the requirements of appraisal value?
 - Do they measure the value of the estimated sale price between a knowledgeable seller and buyer?
 - No!
 - Buyers and sellers require prices to reflect
 - Time value of money
 - Risk load

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Loss Reserves: Appraisal Value

- Do loss reserves satisfy the requirements of appraisal value?
 - Do they reflect the value of the estimated sale price...
 - As measured by experts?
 - Yes!
 - Related: should recorded value reflect actuary's estimate or management's estimate?
 - As measured by independent experts?
 - Discuss

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Loss Reserves: Market Price

- Solvency II capital regime:
 - Use one year downside in market price for required capital
- Market price ≠ appraisal value
- Many actuarial methods for reserve risk use appraisal value rather than market price
 - Appraisal value → requires multiyear runoff
 - One year horizon → requires market price
 - One year + variability of appraisal value = wrong

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Loss Reserves: Paradigms

Paradigm	Time Horizon	Assumes that After One Year of Downside...	Measures Variability of
Appraisal Value	Multiyear runoff	The firm can rely on preexisting held capital to weather further downside risk	How the market price <u>ought to</u> behave
Market Price	One year	The firm can sell its liabilities or can raise equity capital	How the market price <u>actually</u> (mis)behaves

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MARKET PRICE AND APPRAISAL VALUE

Conclusions



Conclusions

- Proposal: always record both market price and appraisal value
- Each valuation basis complements the other
 - Don't conflate the two; each must remain internally consistent
- Recording both appraisal and market
 - Would have reduced the panic during the financial crisis
 - Would have identified ex-ante the increased risk of a real estate bubble
 - Would be beneficial for casualty loss reserves

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