COMMENTS ON

INSTITUTIONAL-SPECIFIC VALUE

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Fair Value

Concerns

(i) unacceptable measurement error $\Rightarrow$ volatility

(ii) still have a mixed attribute model

(iii) recognition of entity's credit-worthiness

Fair Value

But ……

(i) other measurement systems also have large errors

(ii) should aim for consistency of measurement

(iii) concerns about own credit-worthiness mitigated by assets being fair valued

Fair Value

- much more like institution-specific value than was originally intended because so many prices unobservable
- depends upon institution’s judgments and knowledge about how the instrument will be used and perform

Fair v Entity-Specific Value

Fair Value	amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction
Entity-Specific Value	value of an asset to the enterprise that holds it the present value of the costs that the enterprise will incur in settling the liability in an orderly fashion over the life of the liability

Difference Between Fair and Entity-Specific Value: Why?

(i) better management/skills that allow the entity to maximise cash flows

(ii) different expectation to the market about cash flows

(iii) different perceptions of risk

(iv) different risk preferences

(v) differences in perceptions about own credit standing

Fair v Entity Value? - 2 examples

1. a loan portfolio

2. own credit risk

Loan Portfolio

- Asymmetric information is endemic

(i) market doesn’t “understand” quality of borrowers

(ii) concerns about selling worst loans

(iii) different discount rates (because of different perceptions/pricing of risk)

Discount rate

- market may sometimes over/under estimate risk, over/under price risk $\Rightarrow$ inappropriate fluctuations in asset values.

BUT

- significant problems in ignoring the market

- better approach?: to build up prudential buffers during periods in which risk is being under estimated/priced.

Market Has a Different View About Credit Quality of Assets

<u>Issue</u>: can we close this information gap?

: if we can, entity value $\Rightarrow$ fair value

: if not, a problem of verifiability/ comparability of entity-specific values

$\Rightarrow$ fair value is the better <u>principle</u>, but needs to be butressed with more information

<u>Issue</u>: the ability of markets to understand/ process this information

Own Credit Risk

The PV of the costs that the enterprise will incur in settling the liability in an orderly fashion over the life of the liability

- value of liabilities should move with movements in <u>risk-free</u> interest rates
- $$FV = \frac{C_t}{1 + (r_f + p)_t} = \frac{C_t}{1 + (r_f + p)_o + \Delta(r_f + p)_t}$$

$$V^* = \frac{C_t}{1 + (r_f + p)_o + (\Delta\, r_f)_t}$$

- implementation?

Summary

- Fair value is the right principle?
- In practice, we end up with a lot of institutional-specific values
- Challenge is to improve information so that institution-specific values $\Rightarrow$ FV
- Liabilities should reflect changes in risk free rates (risk premium ?)