

Toward Sustainable Finance: The Trouble with Asset Values

Dennis Webb FRICS argues for applying concepts of long-term sustainability to financial processes—essentially telling the truth about value—as short-term asset valuation models continue to feed economic turmoil.



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Sustainability as a concept is routinely applied to the natural world but routinely ignored with respect to the financial environment. A large portion of the population has developed an awareness of conservation principles and at least some respect for nature, but financial beliefs are so embedded in our thinking that we regard them as given, and have allowed institutions to develop based on (what are now obviously) unsustainable premises. The oceans are rising slowly but financial consequences are descending upon us at a frightening rate.

The root of both aspects of sustainability is short-term thinking. Our short-term notions of asset value have fostered unreal perceptions of individual wealth and growth, and enabled enormous financial distortions. Short-term thinking creates a historic myopia and a kind of vacuum in which greed can have a field day. Most recently, otherwise stable assets were allowed to enable extremely *unstable* derivative securities, with (by now) well-known implications for global financial markets.

The good news is that we do have institutional financial structures that can be adapted to

create healthy perceptions of value in a big way. The bad news is that adoption of anything that has tried to get in the way of what had been a very profitable false reality was wholly resisted by existing institutions. The speed with which a clearly unstable system has imploded has been surprising, but so has the extent of global cooperation and the proliferation of new ideas. I am quite optimistic over the *long term*, since there may now be an opening for new understanding and a collective interest in telling the truth. There is hope for Capitalism II.

Wages of conventional wisdom

Short-term notions of value have become embedded in our conventional wisdom, to the point that our collective belief system regarding asset value has moved into a sort of fanciful parallel universe. This collective fantasy has fostered unreal perceptions of individual wealth; one unfortunate, immediate consequence of which is the pain of foreclosure now being experienced by a great many borrowers worldwide. The full measure of its consequences is far greater than foreclosures, however, as our collective sense of loss has

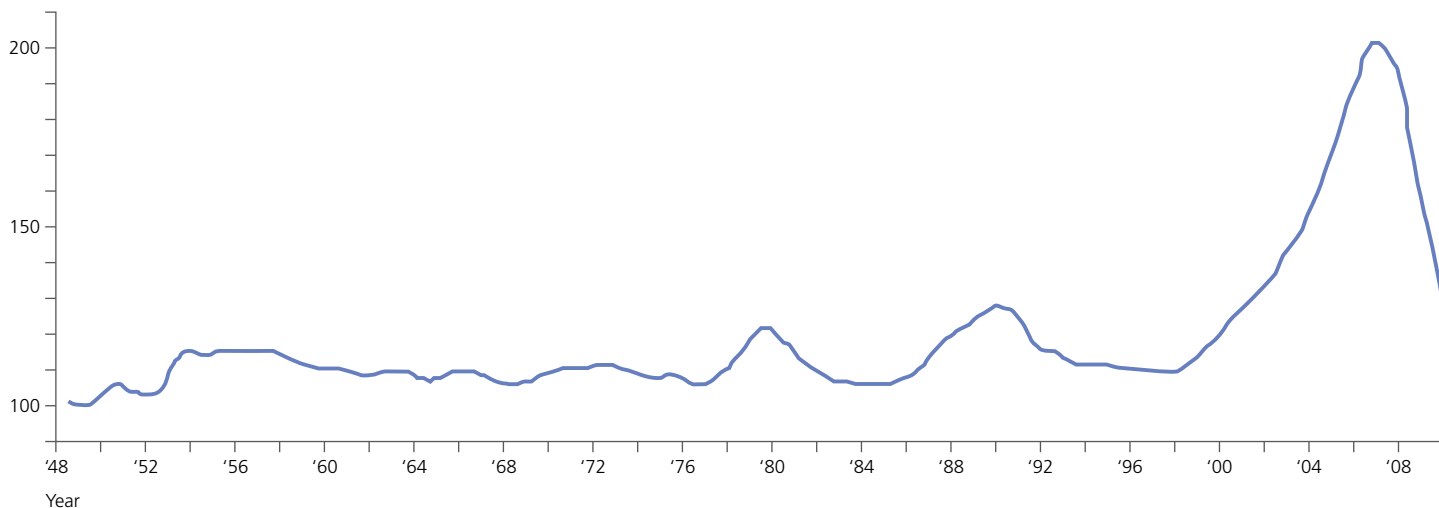


Figure 1: U.S. Inflation-Adjusted Home Prices

become enormous. Perceptions that were outrageously optimistic have turned depressingly pessimistic, and what might have been experienced as a normal return to a relative stable, long-term trend, is instead being viewed with much hand-wringing and grief.

Were individuals really richer, or was the experience guaranteed to be fleeting? Did stable assets really become unstable? Were the foundations of risk analysis realistic and appropriate? Much of the blame for the collapse of the fanciful parallel universe is aimed at the entirely unexpected, widespread/systemic nature of the decline in property values. However, a closer examination of asset pricing reveals that we have not been telling ourselves the truth, and that a decline was inevitable.

What is it with asset prices, anyway?

Real Property assets are among the most stable and least volatile fixed assets over the long term, normally exhibiting a reasonably consistent historic trend over time. Even at present, a *portion* of a property's value is, indeed, quite stable; its *long-term* value is reasonable predictable, and not strongly subject to unexpected events. However, another portion is more directly affected by *short-term* (unsustainable) conditions, which can conspire to inflate or deflate value well beyond an expected range, and exposure to unexpected events can become great. When this happens on a wide scale—when short-term and long-term value components are conflated and confused—a bubble or depression can begin to feed on itself. A positive feedback loop amplifies the value trend in both directions. Property owners experience themselves as unreasonably rich or poor, and derivative securities that are designed to rely on property's fundamental stability can become severely impaired.

Unexpected events do not typically affect the long-term trend, as suggested by Robert Schiller's inflation-adjusted home price index, shown in the chart for the postwar period. The aggregate U.S. data shows that long-term values have been reasonably stable; further, local market values for all property types normally follow cycles that are reasonably well understood. Under such

conditions, asset values can indeed be used to underpin long-term loans and investment, and these observations would argue for high ratings in their associated credit derivative instruments.

The short term is another story, as short term pricing is highly vulnerable to unexpected events. Unsustainable capital market conditions and (local) natural disasters, to name just two, can cause short-term pricing behavior to diverge considerably from the underlying long-term trend. Is short-term pricing a suitable benchmark for long-term decisions? It still may be, *so long as any deviation from the long-term trend is identified and understood*. The outsized risk exposure comes when deviations are not understood; when short-term "frothy" pricing is used as evidence of market value for long-term decisions. The reverse problem arises when prices (of property or derivative paper) are depressed, or when markets fail, impairing the short-term market value of collateral. In either case, the consequences of poorly understood asset values are not trivial.

Are valuers actually helpful?

What happened to the checks built into the property finance system? One such check involves market-value appraisals. Did banks and investors rely on appraisals? If so, did they help, hurt, or do anything useful at all? Appraisals are generally intended to make sure that the collateral has sufficient value to support the loan, but the market value premise is only a snapshot in time. The appraisal typically considers property, its local environment and capital market conditions with reference to other (comparable) transactions and current investor (or home buyer) behavior. This is largely a policing function, where a neutral party (valuer/appraiser) offers an opinion of value that may or may not match the transaction price. But assuming the transaction is consistent with others... what if the entire market has been moved by external conditions, such as easy money, lax lending standards, and other short-term conditions that have big pricing effects. What good does it do the long-term lender to know that a transaction price matches a market skewed by short-term conditions?

For example: What if a lender had made a single-family mortgage loan in 2005 based on a two-value appraisal? Say short-term conditions support a current market value of \$650,000, but also that this value demonstrates a divergence from the long-term trendline based on property type and market area, and another value was concluded at \$400,000. The lender is now faced with a much more firm underwriting basis than with the \$650,000 value alone. There are actually two collateral assets, one valued at \$400,000 and one at \$650,000 – \$400,000 = \$250,000 (hardly a small difference). A long-term loan can reasonably rely on the \$400,000 value, and its expected long-term growth rate. Of course, the growth rate could change, and the value could again be subject to short-term conditions at any future date. Nonetheless, the long-term based value would present less risk of loss than the short-term (current) value. The \$250,000 difference between the two is clearly a riskier component of current asset value, and could be underwritten as such.

What about the reverse situation? What is an appropriate price reference when the market is temporarily depressed? What if the long-term value is \$400,000, but the market will only pay \$280,000, due to oversupply or any number of other current, *short-term* conditions? The \$120,000 below-trend value is also due to short-term conditions. The lower value is meaningless in the long-term, but does reflect an impaired ability to sell now. A recovery to \$400,000 will occur at some point, although its timing is uncertain. The market may even fail entirely (as for certain types of bank-held derivative securities). *It's the ability of the holder to wait that gives the assets value under these conditions.* This is not so different from various commonly-observed impairments, attributable to ownership (undivided interests held by two or more parties, for example), or physical impairments (such as toxic contamination). Impairments are generally cured over time, with the property trading at less than its "stabilized" or long-term value during the impairment period.

It would make sense for valuers to go beyond their current/traditional policing function, and parse their opinion into short- and long-term components. It does no good for valuers to bail out of opining on such issues, on the basis that they should not be involved in underwriting decisions. Valuers are the ones in a position to analyze and understand what is and is not a stable and reliable value. This is not a simple undertaking, to be sure, but an essential step toward establishing popular and institutional awareness of sustainable value.

The Germans are convinced

Just such a method for appraising commercial property under conditions approximating the long-term was established in 1996 by German Pfandbrief mortgage banks for collateral used with highly rated covered bonds. Under this system, valuers provide opinions of "Mortgage Lending Value" (MLV), defined as: *"The mortgage value of a property is the value that can be expected with a high level of surety, derived from the historic perspective of market events at the time of the valuation, on the basis of the durable characteristics, and which will be achieved in normal property transactions over a long period in the future."* The mortgage banks using this system of valuation may lend over the threshold allowed by a property's MLV, but the excess cannot be used as security for covered bonds. Thus, a two-tier risk/cost structure for loans, which is exactly appropriate as

an institutional structure for countering the destabilizing effects of frothy property markets. Its methods are an approximation for getting at a long-term value, and have apparently worked quite well. MLV is now included as part of International Valuation Standard 2, but has apparently not been adopted by any other countries or institutions.

Expanding the role of asset-level valuation

Existing risk-management tools are divorced to a large degree from the underlying assets, making broad assumptions about growth rates (6-8 percent into perpetuity?!), which have been known by valuers to be absurd. The problem is that apparently no one (on Wall Street) thought to ask, confirming that conventional wisdom has been driving their myopic risk analyses. Recognition of MLV, or some other standard that parses short- and long-term perspectives, would provide a much more secure reliable foundation for the higher-level tools used by institutional risk analysts.

The current MLV standard makes a substantial effort to achieve long-term values for income-producing properties, adjusting cap rates, rent levels etc., but so far appears to be less effective with respect to single-family and other owner-occupied and non-income-producing types. However, valuation technologies have continued to advance since the standard was established and they could be brought to bear on the issue by the valuation profession. Such an analysis of the effect of time on value is currently in use for many property and ownership conditions. Examples include highly developed statistical methods (for examining and tracking broad markets), real estate damages (which demonstrate recovery to normal pricing levels over time), marketability impairments (risk of a forced hold) and other methods. Valuers have the tools to parse between short- and long-term conditions, and deliver value opinions based on these premises. Of course, developing uniform methods and training programs will take some doing; but is there really an alternative?

Conclusions

The notion of financial stability should, by now, be ready for prime time. The question is... Are we really committed to adopting a long-term mindset? If so, *someone* needs to attend to the long-term value trends if we are to a) substantially reduce the effects of unexpected events, b) provide some counterbalance to the positive feedback system which encourages both ever-escalating asset values on the one hand, and the collective malaise and liquidity impairments that depress values. If not the valuer (who has been generally marginalized into the role of policeman), then who? Who really understands the assets? If we want to build a sustainable financial system, we may have less fun when bubbles begin to soar but will endure far less grief when they come back to earth. Continuing our historic myopia will not serve the sustainability needs that the future demands. I do believe that what will serve us *long term*, as an achievable and maybe even transformational goal, is widespread understanding of the truth about value. ●

Dennis A. Webb, ASA, MAI, FRICS
primusval.com