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Strategic Estimation of Asset Fair Values

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Abstract: We examine whether fair value (FV) input levels and estimation sources are related to FV inflation, the difference between an insurer's FV estimate and the consensus FV estimate across the security's holders. FV inflation is higher, and self-estimation more likely, when insurers report using Level 3 inputs when the consensus level is 2. Regardless of the level, FV is greater when self-estimated. Public insurers that inflate FV through self-estimation potentially obfuscate detection by reporting the use of Level 2 inputs. Insurers with stronger incentives to appear financially healthy choose to self-estimate, resulting in greater aggregate portfolio FV inflation.

Keywords: Fair value, Level 1, Level 2, Level 3, SFAS 157, insurance companies, regulatory capital, asset values, estimation bias

JEL classification: G21, G22, G31, M41

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1. Introduction

Financial statements issued under U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards report certain assets and liabilities at fair value (FV). Since

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