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Fair Value of Liabilities: The Financial Economics Perspective

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Abstract

In this paper we present the fundamental approaches of financial economics to valuation. Three methods are demonstrated by which financial economists account for risk. We illustrate how these methods relate to one another and how they can be applied in the valuation of risky corporate bonds, guaranteed investment contracts (GICs) with and without interest rate contingencies, and whole life insurance. Next, we discuss how these models treat orthogonal risks, such as the kind often covered by insurance contracts. Demand side and supply side diversification are treated, and liquidity risk is then considered. We conclude with a summary of the benefits of decomposition and transparency.

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