

We have been given $a_i^{pre}(t)$ and $a_{ij}^{post}(t)$, and a Markov Chain X_t . We assume a constant discount factor $v = \frac{1}{1+i}$.

What is the Cash flow induced

We define $I_i(t) = \chi_{X_t=i}$. Which mean that you would get the following annuity at time t : $\sum_{i \in S} a_i^{pre}(t) \times I_i(t)$. Which transition (death) benefit would you get at time t ? You get $a_{ij}^{post}(t)$ if you are in state i at time t and in state j at $t + 1$? ie $a_{ij}^{post}(t) \times I_i(t) \times I_j(t + 1)$. In sum for the death benefit $\sum_{i,j \in S^2} a_{ij}^{post}(t) \times I_i(t) \times I_j(t + 1)$.

So the cash flow at times t can be calculated as

$$A(t) = \sum_{i \in S} a_i^{pre}(t) \times I_i(t) + \sum_{i,j \in S^2} a_{ij}^{post}(t) \times I_i(t) \times I_j(t + 1)$$

$$\tilde{A}(t) = \sum_{i \in S} a_i^{pre}(t) \times I_i(t) + \sum_{i,j \in S^2} a_{ij}^{post}(t) \times I_i(t) \times I_j(t + 1) \times v$$

What is the value of this insurance cash flow?

We define the **Mathematical Reserve** as

$$V_j(t) = \mathbb{E}[PV \text{ of future CF} \mid X_t = j]$$

$$= \mathbb{E}\left[\sum_{\tau=0}^{\infty} v^{\tau} \tilde{A}(t + \tau) \mid X_t = j\right]$$

In order to calculate the mathematical reserve you can substitute \tilde{A} in the formula below and ultimately what you need to calculate (keeping in mind the linearity of the \mathbb{E} functional as the following quantities:

$$\mathbb{E}[I_i(t + \tau) \mid X_t = j] = p_{ji}(t, t + \tau)$$

$$\mathbb{E}[I_i(t + \tau) \times I_k(t + \tau + 1) \mid X_t = j] = ?$$

How do we do this?

$$\mathbb{E}[I_i(t + \tau) \times I_k(t + \tau + 1) \mid X_t = j] = P[X_{t+\tau+1} = k, X_{t+\tau} = i \mid X_t = j]$$

Now we do the same as in the proof of the Chapman-Kolmogorov-Equation]

$$\begin{aligned}
 \mathbb{E}[I_i(t + \tau) \times I_k(t + \tau + 1) | X_t = j] &= P[X_{t+\tau+1} = k, X_{t+\tau} = i | X_t = j] \\
 &= \frac{P[X_{t+\tau+1} = k, X_{t+\tau} = i, X_t = j]}{P[X_t = j]} \\
 &= \frac{P[X_{t+\tau+1} = k, X_{t+\tau} = i, X_t = j]}{P[X_t = j]} \times \frac{P[X_t = j, X_{t+\tau+1} = i]}{P[X_t = j, X_{t+\tau+1} = i]} \\
 &= P[X_{t+\tau} = i | X_t = j] \times P[X_{t+\tau+1} = k | X_t = j, X_{t+\tau} = i] \\
 &= p_{ji}(t, t + \tau) \times p_{ik}(t + \tau, t + \tau + 1)
 \end{aligned}$$

If we put now all things together we can calculate the mathematical reserves as follows

$$\begin{aligned}
 V_j(t) &= \mathbb{E}\left[\sum_{\tau=0}^{\infty} v^{\tau} \tilde{A}(t + \tau) | X_t = j\right] \\
 &= \sum_{\tau=0}^{\infty} v^{\tau} \left(\sum_{i \in S} a_i^{pre}(t + \tau) \times p_{ji}(t, t + \tau) + \sum_{i, j \in S^2} a_{ij}^{post}(t + \tau) p_{ji}(t, t + \tau) \times p_{ik}(t + \tau, t + \tau + 1) \right)
 \end{aligned}$$

Remark: With this formula we can also calculate the expected cash flows at time t as follows:

$$\mathbb{E}[A(t + \tau) | X_t = j] = \sum_{i \in S} a_i^{pre}(t + \tau) \times p_{ji}(t, t + \tau) + \sum_{i, j \in S^2} a_{ij}^{post}(t + \tau) p_{ji}(t, t + \tau) \times p_{ik}(t + \tau, t + \tau + 1)$$

Thiele Difference Equation this is the relationship between the mathematical reserves between times t and $t + 1$. The relationship is as follows:

$$V_j(t) = a_j^{pre}(t) + v \sum_{k \in S} p_{jk}(t, t + 1) \times (a_{jk}^{post}(t) + V_k(t + 1))$$

To prove this equation we split the time-sum into $\tau = 0$ and the rest. For $\tau = 0$ we get

$$a_j^{pre}(t) + v \sum_{k \in S} p_{jk}(t, t + 1) \times a_{jk}^{post}(t)$$

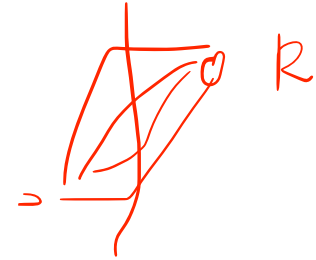
as per above.

In a second step we need to consider **(NEW AND IMPROVED FORMULA:)**

$$\begin{aligned}
 &\sum_{\tau=1}^{\infty} v^{\tau} \left(\sum_{i \in S} a_i^{pre}(t + \tau) \times p_{ji}(t, t + \tau) + \sum_{(i, k) \in S^2} a_{ij}^{post}(t + \tau) p_{ji}(t, t + \tau) \times p_{ik}(t + \tau, t + \tau + 1) \times v \right) \\
 &= \sum_{\tau=1}^{\infty} v^{\tau} \sum_{i \in S} p_{ji}(t, t + \tau) \times \left(a_i^{pre}(t + \tau) + \sum_{k \in S} a_{ij}^{post}(t + \tau) p_{ik}(t + \tau, t + \tau + 1) \times v \right)
 \end{aligned}$$

We can now calculate the quantity $p_{ji}(t, t + \tau)$ as follows, by means of the Chapman-Kolmogorov equation

$$p_{ji}(t, t + \tau) = \sum_{l \in S} p_{jl}(t, t + 1) \times p_{li}(t + 1, t + \tau)$$



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$$\sum_{\tau=1}^{\infty} v^{\tau} \left(\sum_{i \in S} a_i^{pre}(t + \tau) \times p_{ji}(t, t + \tau) + \sum_{i, j \in S^2} a_{ij}^{post}(t + \tau) p_{ji}(t, t - \tau) \right)$$

$$= \sum_{\tau=1}^{\infty} v^{\tau} p_{ji}(t, t + \tau) \times \left(\sum_{i \in S} a_i^{pre}(t + \tau) + \sum_{i, j \in S^2} a_{ij}^{post}(t + \tau) \right)$$

$$= \sum_{\tau=1}^{\infty} v^{\tau} \left(\sum_{l \in S} p_{jl}(t, t + 1) \times p_{li}(t + 1, t + \tau) \right) \times \left(\sum_{i \in S} a_i^{pre}(t + \tau) + \sum_{i, j \in S^2} a_{ij}^{post}(t + \tau) \right)$$

$$= \sum_{l \in S} p_{jl}(t, t + 1) \times v \times \left(\sum_{\tau=0}^{\infty} v^{\tau} p_{li}(t + 1, t + 1 + \tau) \times \left(\sum_{i \in S} a_i^{pre}(t + 1 + \tau) + \sum_{i, j \in S^2} a_{ij}^{post}(t + 1 + \tau) p_{ik} \right) \right)$$

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Remarks:

- 1) For one life we have a recursion of reals $A_x = q_x \times v + p_x \times v \times A_{x+1}$. In case of MR of a Markov model we have a recursion of vectors.
- 2) To solve it one needs boundary conditions as per before with $V_j(\omega) = 0 \forall j \in S$
- 3) Thiele Difference Equations leads to the same results as for the classical life insurance we have seen.

In []: