Exercise 1.8

Continuation of Exercise 1.7 where it was considered a portfolio of 1-year term life insurance independent policies from the file `LIFEinsurance.csv` that specifies age and insured amount for each policy, using the mortality table in the file `mortality.csv` with the additional benefit of twice the insured amount in case of accidental death, assuming that 1 out of 10 deaths is accidental (no matter the age). Build a collective risk model that approximates the results obtained by the individual risk model in Exercise 1.7.

```
using Distributions , Statistics , CSV , DataFrames , Plots
```

Data input

mort =

	AGE	qx
1	0	0.00115
2	1	0.00115
3	2	0.001155
4	3	0.00116
5	4	0.00117
6	5	0.001175
7	6	0.001185
8	7	0.001195
9	8	0.001205
10	9	0.00122
more		
111	110	1.0

```
mort = DataFrame(CSV.File("mortality.csv")) # mortality table
```

```
begin
    k = 1/10 # proportion of deaths caused by an accident
    q = Dict(mort.AGE .=> mort.qx) # Dictionary: a function that maps age -> qx
end;
```

policy =

	AGE	INSAMOUNT
1	49	9.2
2	26	3.1
3	59	10.7
4	46	12.6
5	30	5.1
6	38	8.7
7	36	5.9
8	47	6.2
9	24	2.1
10	41	11.8
more		
10000	37	9.8

```
policy = DataFrame(CSV.File("LIFEinsurance.csv")) # life insurance portfolio
```

Individual risk model

For each insurance policy $j \in \{1, \ldots, r\}$ (in this example $r = 10,000$) it is defined an indivual claim random variable X_j as follows:

$$X_j = c_j D_j (1 + A_j)$$

where:

$c_j =$ insured amount for policy j

$q_j =$ mortality rate for policy j

$D_j \sim$ *Bernoulli* random variable with parameter $0 < q_j < 1$

$A_j \sim$ *Bernoulli* random variable with parameter $\kappa = \frac{1}{10}$ (proportion of accidental deaths)

The insurance portolio individual claims are represented by a collection of r random variables $\{X_1, \ldots, X_r\}$ where $\mathbf{Ran}\, X_j = \{0, c_j, 2c_j\}$ for each $j \in \{1, \ldots, r\}$. Therefore, under an individual risk model the **total claims** random variable is given by:

$$S = X_1 + \cdots + X_r = \sum_{j=1}^{r} c_j D_j (1 + A_j)$$

The theoretical mean and variance of S accordingly to to the individual risk model, considering all D_j and A_j independent random variables, are given by:

$$\mu_S = \mathbb{E}(S) = \mathbb{E}\left(\sum_{j=1}^{r} c_j D_j (1 + A_j)\right) = \sum_{j=1}^{r} c_j q_j (1 + \kappa)$$

$$\sigma_S^2 = \mathbb{V}(S) = \mathbb{V}\left(\sum_{j=1}^{r} c_j D_j (1 + A_j)\right) = \sum_{j=1}^{r} c_j^2 q_j [1 + 3\kappa - q_j (1 + \kappa)^2]$$

Let's now define a random variable N to count the number of claims:

$$N = \sum_{j=1}^{r} \mathbb{1}_{\{X_j > 0\}} = \sum_{j=1}^{r} D_j$$

The theoretical mean and variance of N accordingly to to the individual risk model are given by:

$$\mu_N = \mathbb{E}(N) = \mathbb{E}\left(\sum_{j=1}^{r} D_j\right) = \sum_{j=1}^{r} \mathbb{E}(D_j) = \sum_{j=1}^{r} q_j$$

$$\sigma_N^2 = \mathbb{V}(N) = \mathbb{V}\left(\sum_{j=1}^{r} D_j\right) = \sum_{j=1}^{r} \mathbb{V}(D_j) = \sum_{j=1}^{r} q_j (1 - q_j)$$

where in the calculation of $\mathbb{V}(N)$ all the covariances $\mathbb{Cov}(D_i, D_j) = 0$ for all $i \neq j$ since $D_1, \ldots, D_r$ are assumed independent in this excercise.

```
begin
    ES = 0.0
    VS = 0.0
    EN = 0.0
    VN = 0.0
    r = length(policy.AGE)
    for j ∈ 1:r
        qj = q[policy.AGE[j]]
        cj = policy.INSAMOUNT[j]
        ES += (1 + k)*cj*qj # Same as ES = ES + (1 + k)*cj*qj
        VS += (cj^2) * qj * (1 + 3k - qj * (1 + k)^2)
        EN += qj
        VN += qj * (1 - qj)
    end
    println("E(S) = ", ES)
    println("V(S) = ", VS)
    println("E(N) = ", EN)
    println("V(N) = ", VN)
end
```

```
E(S) = 345.3497998500011
V(S) = 4202.942121519234
E(N) = 34.59349999999978
V(N) = 34.43467652314959
```

```
begin
    # Version using `Bernoulli` from the `Distributions` package
    m = 100_000
    S = zeros(m)
    N = zeros(Int, m)
    # The macro @time measures execution time
    @time for j ∈ 1:r
        Accident = rand(Bernoulli(k), m) # vector of size m
        Death = rand(Bernoulli(q[policy.AGE[j]]), m) # vector of size m
        N = N .+ Death
        S = S .+ (policy.INSAMOUNT[j] .* Death .* (1 .+ Accident))
    end
end
```

```
  9.026864 seconds (806.99 k allocations: 16.799 GiB, 11.94% gc time, 1.
77% compilation time)
```

```
begin
    println("sim M(S) = ", median(S))
    println("sim E(S) = ", mean(S))
    println("sim V(S) = ", var(S))
    println("sim E(N) = ", mean(N))
    println("sim V(N) = ", var(N))
    simVaR = quantile(S, 0.995)
    println("sim VaR(0.995) = ", simVaR)
end
```

```
sim M(S) = 342.6000000000001
sim E(S) = 345.238147
sim V(S) = 4247.253153637927
sim E(N) = 34.58524
sim V(N) = 34.6370005124051
sim VaR(0.995) = 526.8
```

Collective risk model

The counting random variable N represents the *frequency* (total number of claims in a given period) and the random variable Y represents the *severity* of any claim (in monetary units). The **total claims** random variable is now given by:

$$S = Y_1 + \cdots + Y_N$$

where: $N = \sum_{j=1}^{r} \mathbb{1}_{\{X_j > 0\}} = \sum_{j=1}^{r} D_j$

and $Y_1, Y_2, \ldots$ are iid as the severity random variable Y. Clearly $\operatorname{Ran} N = \{0, 1, \ldots, r\}$ in this case. Since $D_1, \ldots, D_r$ are independent BUT not identically distributed, it is not guaranteed that the probability distibuton of N is *Binomial* but we may wonder if there exists some sort of "average" value $0 < q_N < 1$ such that the probabilty distribution of N could be fairly approximated by a *Binomial* model with parameters r and q_N. In such case it must be true that $\mathbb{E}(N) = rq_N = \mu_N = \sum_{j=1}^{r} q_j$ and therefore:

$$q_N = \frac{1}{r}\sum_{j=1}^{r} q_j$$

```
qN = 0.003459349999999978
```

```
qN = EN / r
```

Let's now compare the variance of a $\text{Binomial}(r, q_N)$ random variable and σ_N^2 obtained under the individual risk model:

```
(34.4738, 34.4347)
```

```
r * qN * (1 - qN), VN
```

Not exactly the same but probably fair enough. Remember that the collective risk model is an *approximation*. In terms of standard deviation, this approximation will use a frequency with slightly more variability, but less that 0.1% higher:

```
begin
    dif = 100 * (√(r * qN * (1 - qN) / VN) - 1) # in %
    println(round(dif, digits = 2), "%")
end
```

```
0.06%
```

Let's now deal with severity. The random variable Y_1 represents the amount to be paid for the first (positive) claim, which may come out of any of the r policies in the insurance portfolio, but considering that the policyholders have different probabilities of dying within a year, depending on their age. Let's assume that the probability of being the first claim is proportional to their probability of dying:

$$Y_1 = Z(1 + A)$$

where $A \sim \text{Bernoulli}(\kappa = \frac{1}{10})$ and:

$$\mathbb{P}(Z = c_j) = \frac{q_j}{\sum_{j=1}^{r} q_j} = \frac{q_j}{\mathbb{E}(N)}\,, \qquad j \in \{1, \ldots, r\}$$

For the second claim Y_2 we have a problem: Y_2 has dependence with Y_1 since the policy of the first claim should be now discarded since under this life insurance portfolio only one claim per policy is possible (sampling WITHOUT replacement), and therefore the usual assumption of $Y_1, Y_2, \ldots$ being iid is not striclty possible. But again, this is an *approximation* and under a sufficiently large insurance portfolio, the probability of picking twice or more times the same policy in sampling WITH replacement could be sufficiently low, with the advantage that in sampling WITH replacement the iid assumption for the severities would be correct.

Considering a set of r different policies, in uniform sampling with replacement $n < r$ policies, what is the probability that all the n policies are picked just once? This is just like the classical probability *birthday problem*

$$\frac{\#\text{ all different}}{\#\text{ with replacement}} = \frac{r(r-1)\cdots(r-n+1)}{r^n} = \left(1-\frac{1}{r}\right)\left(1-\frac{2}{r}\right)\cdots\left(1-\frac{n-1}{r}\right)$$

Since in this exercise $\mathbb{E}(N) = 34.59$ let's take $n = 35$ and $r = 10,000$

```
0.942170951915911
```

```
begin
    n, rr = 35, 10_000
    prod(1 .- collect(1:(n-1)) ./ rr)
end
```

Eventhough in this case it would not be uniform sampling, the sampling probability for each policy is bounded above by:

$$\mathbb{P}(Z = c_j) \leq \frac{\max\{q_j : j = 0, 1, , \ldots, r\}}{\mathbb{E}(N)}$$

```
0.00036105048636304735
```

```
q[maximum(policy.AGE)] / EN
```

With an average value of:

```
8.252995504935951e-5
```

```
q[Int(round(mean(policy.AGE)))] / EN
```

And since the collective risk model is an approximation, we will assume for the severity that $Y_1, Y_2, \ldots$ are iid as a random variable $Y = Z(1 + A)$ as defined above, and compare results with those obtained by the (more accurate) individual risk model:

```
begin
    qq = zeros(r)
    for j ∈ 1:r
        qq[j] = q[policy.AGE[j]]
    end
    p = qq ./ sum(qq)
    C = Categorical(p) # check this in the Distributions package
end;
```

```
simSeverity (generic function with 1 method)
```

```
function simSeverity(n) # Severity simulator
    clients = rand(C, n)
    Z = policy.INSAMOUNT[clients]
    A = rand(Bernoulli(k), n)
    Y = Z .* (1 .+ A) # Y = (Y1,...,YN)
    return Y
end
```

And finally, the collective risk model simulation:

```
begin
    B = Binomial(r, qN) # P = Poisson(EN) would also work in this case since E(N) ≈
    V(N)
    mm = 100_000
    nn = rand(B, mm) # simulating frequency N, or: n = rand(P, m) using Poisson
    Sc = zeros(mm)
    @time for i ∈ 1:mm
        Sc[i] += sum(simSeverity(nn[i]))
    end
end
```

```
13.908614 seconds (2.00 M allocations: 29.941 GiB, 11.80% gc time)
```

```
begin
    println("sim M(Sc) = ", median(Sc))
    println("sim E(Sc) = ", mean(Sc))
    println("sim V(Sc) = ", var(Sc))
    println("sim VaR(0.995) = ", quantile(Sc, 0.995))
end
```

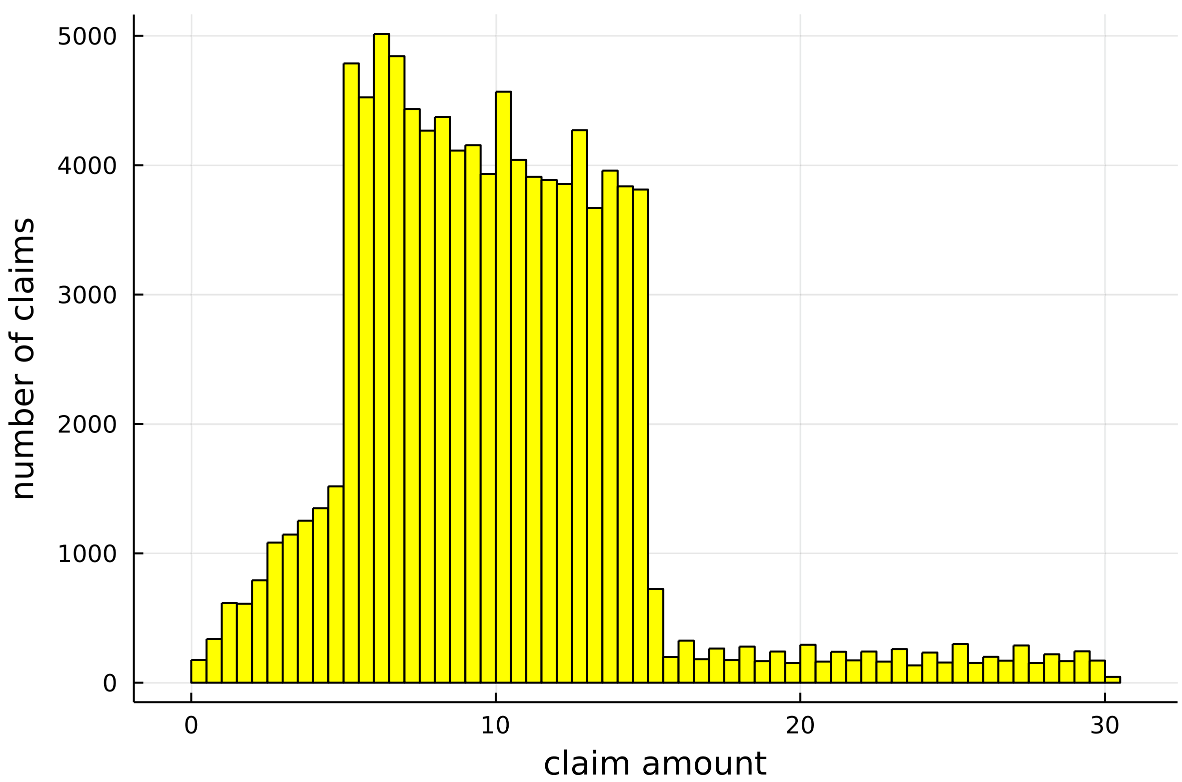
```
sim M(Sc) = 342.70000000000005
sim E(Sc) = 345.186102
sim V(Sc) = 4202.46873433294
sim VaR(0.995) = 525.9005000000005
```

Compare with individual risk model results:

```
begin
    println("sim M(S) = ", median(S))
    println("sim E(S) = ", mean(S))
    println("sim V(S) = ", var(S))
    println("sim VaR(0.995) = ", simVaR)
end
```

```
sim M(S) = 342.6000000000001
sim E(S) = 345.238147
sim V(S) = 4247.253153637927
sim VaR(0.995) = 526.8
```

In this case the collective risk model simulation is taking longer than the individual risk model because of the Categorical simulation from the insured amounts, so let's analyze the severity simulator:

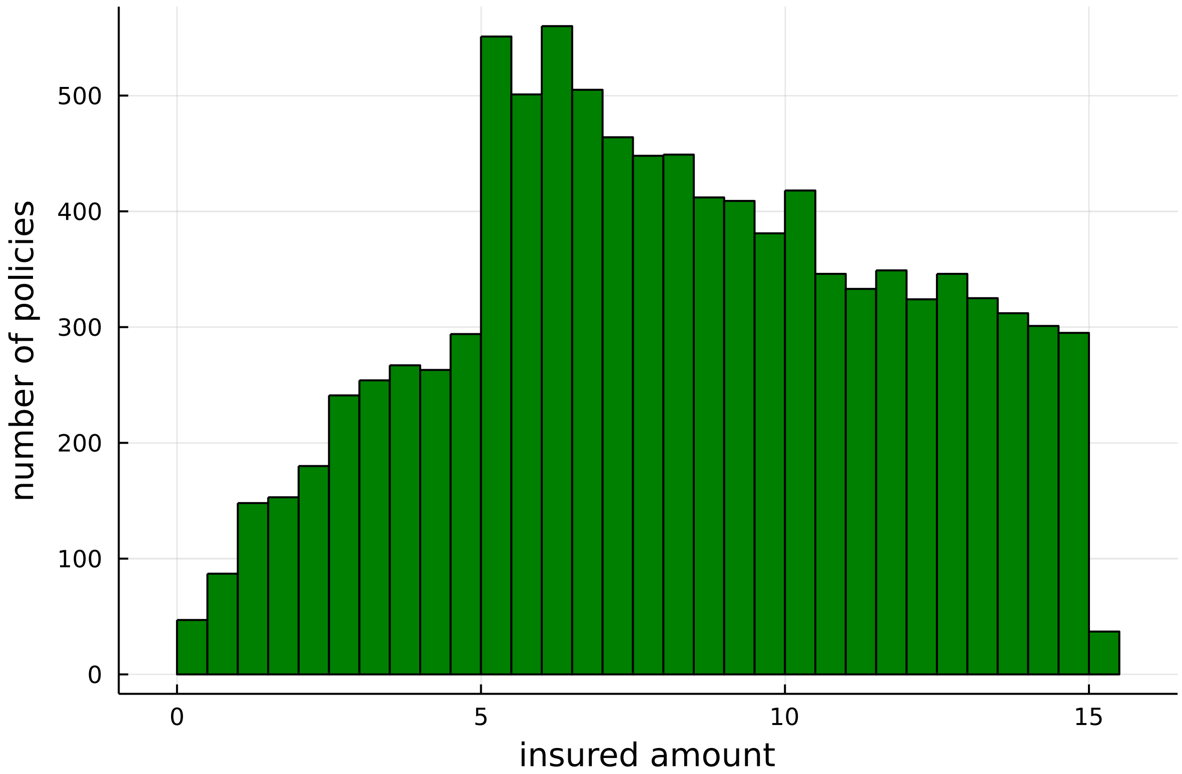



```
begin
    simY = simSeverity(100_000)
    histogram(simY, legend = false, color = :yellow,
              xlabel = "claim amount", ylabel = "number of claims")
end
```

```
30.0
```

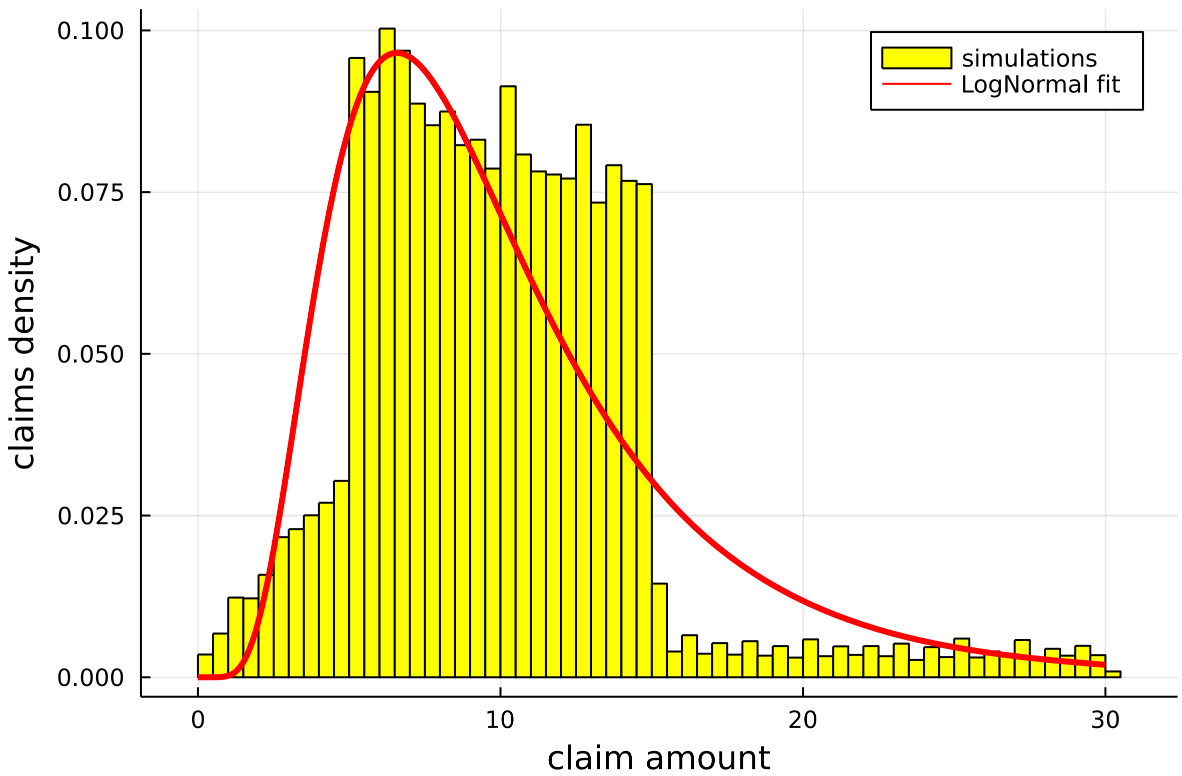
```
2 * maximum(policy.INSAMOUNT)
```

Does not look like any of the well-known and well-behaved probability distributions we are aware of! This is because of the insured amount distribution in this portfolio:




```
histogram(policy.INSAMOUNT, legend = false, color = :green, xlabel = "insured
amount", ylabel = "number of policies")
```

What if we insist in fitting a well-known model for Y in spite of this weird behaviour? Let's give it a try!




```
begin
    fitY = fit_mle(LogNormal, simY)
    y = collect(range(0, 2 * maximum(policy.INSAMOUNT), length = 1_000))
    histogram(simY, normalize = true, label = "simulations",
              color = :yellow, xlabel = "claim amount", ylabel = "claims density")
    plot!(y, pdf.(fitY, y), lw = 3, color = :red, label = "LogNormal fit")
end
```

Doesn't look very well, uh? Let's use it and see what happens:

```
begin
    B2 = Binomial(r, qN)
    m2 = 100_000
    n2 = rand(B2, m2)
    Sc2 = zeros(m2)
    @time for i ∈ 1:m2
        Sc2[i] += sum(rand(fitY, n2[i]))
    end
end
```

```
0.076068 seconds (100.00 k allocations: 32.764 MiB, 21.61% gc time)
```

A lot faster, by far! But what about the results?

```
begin
    println("sim M(Sc) = ", median(Sc2))
    println("sim E(Sc) = ", mean(Sc2))
    println("sim V(Sc) = ", var(Sc2))
    println("sim VaR(0.995) = ", quantile(Sc2, 0.995))
end
```

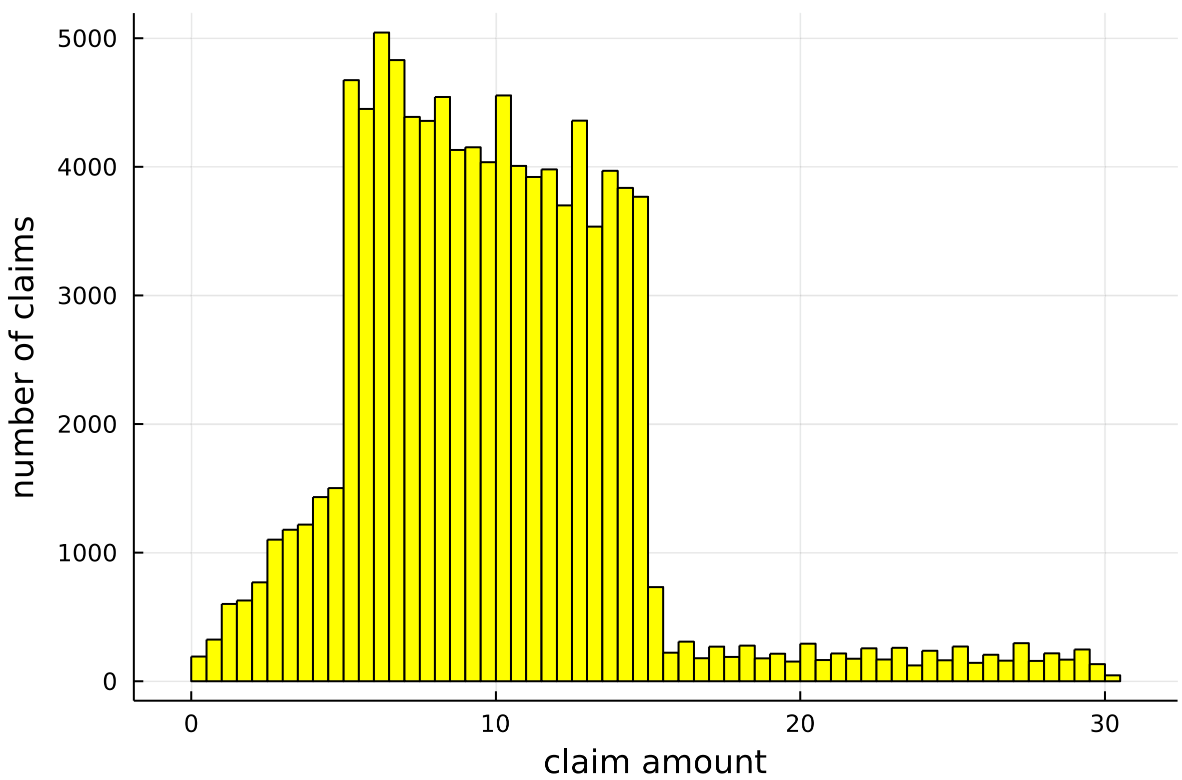
```
sim M(Sc) = 351.0783770534675
sim E(Sc) = 353.78951586442395
sim V(Sc) = 4820.789409156931
sim VaR(0.995) = 546.9173954074676
```

Compare with individual risk model results:

```
begin
    println("sim M(S) = ", median(S))
    println("sim E(S) = ", mean(S))
    println("sim V(S) = ", var(S))
    println("sim VaR(0.995) = ", simVaR)
end
```

```
sim M(S) = 342.6000000000001
sim E(S) = 345.238147
sim V(S) = 4247.253153637927
sim VaR(0.995) = 526.8
```

Well, no surprise, right? Clearly it was not a good parametric fit for Y but... what if we try a non-parametric simulation?




```
begin
    simSeverityNP(n) = quantile(simY, rand(n))
    histogram(simSeverityNP(100_000), legend = false, color = :yellow,
              xlabel = "claim amount", ylabel = "number of claims")
end
```

Bingo! Let's how fast it is in simulating the collective risk model:

```
begin
    B3 = Binomial(r, qN)
    m3 = 1_000
    n3 = rand(B3, m3) # frequency
    Sc3 = zeros(m3)
    @time for i ∈ 1:m3
        Sc3[i] += sum(simSeverityNP(n3[i]))
    end
end
```

```
4.877088 seconds (7.49 k allocations: 763.700 MiB, 1.11% gc time)
```

Too slow just for 1,000 simulations! The problem is we used a very large number of simulations for `simY` (100,000) but to estimate a univariate density it would be more than enough with 1,000:

```
begin
    simY4 = simSeverity(1_000)
    simSeverityNP4(n) = quantile(simY4, rand(n))
    B4 = Binomial(r, qN)
    m4 = 100_000
    n4 = rand(B4, m4)
    Sc4 = zeros(m4)
    @time for i ∈ 1:m4
        Sc4[i] += sum(simSeverityNP4(n4[i]))
    end
end
```

```
  1.688606 seconds (901.60 k allocations: 851.496 MiB, 4.55% gc time, 0.
26% compilation time)
```

Wonderful time! Let's check the results:

```
begin
    println("sim M(Sc) = ", median(Sc4))
    println("sim E(Sc) = ", mean(Sc4))
    println("sim V(Sc) = ", var(Sc4))
    println("sim VaR(0.995) = ", quantile(Sc4, 0.995))
end
```

```
sim M(Sc) = 339.7518727989851
sim E(Sc) = 342.122992640863
sim V(Sc) = 4128.865549567852
sim VaR(0.995) = 520.3986645844842
```

Compare with individual risk model results:

```
begin
    println("sim M(S) = ", median(S))
    println("sim E(S) = ", mean(S))
    println("sim V(S) = ", var(S))
    println("sim VaR(0.995) = ", simVaR)
end
```

```
sim M(S) = 342.6000000000001
sim E(S) = 345.238147
sim V(S) = 4247.253153637927
sim VaR(0.995) = 526.8
```

Fair enough! Faster and pretty close to the individual risk model, in spite of all the approximative assumptions.