# ACTSC 431 — Loss Model I

CLASSNOTES FOR FALL 2018

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## 1 Lecture 1 Sep 06

## 1.1 Introduction and Overview

Course Objective In Loss Model I, the focus of our study is to learn the basic methods which are used by insurers to quantify risk from mathematical/statistical models, in order for insurers to make various decisions<sup>1</sup>. By quantifying risk, it helps us monitor underlying risks so that not only are we aware of them, but also so that we can take actions or preventive measures against them.

Our main interest of this course is:

- to quantify and seek protection against the loss of funds due either to too many claims or a few large claims;
- to reduce adverse financial impact of random events that prevent the realization of reasonable expectations.

The main model that shall be the focus of this course is **models for liability risk**.

## Definition 1 (Liability Risk)

A *liability risk* is a risk that insurance companies assume by selling insurance contracts.

In particular, the liability that we shall focus on is **insurance** claims.

We are Interested in modelling the total amount of claims, i.e. the **aggregate claim amount**, of a group fo insurance policies over a

<sup>1</sup> e.g. setting premiums, control expenses, deciding for reinsurance, etc.

Many of the models that we shall see later in the course are also applied for other types of risks, e.g. investment risk, credit risk, liquidity risk, and operational risk. given period of time. In the actuarial literature, there are two main approaches that have been proposed to model the aggrement claim amount of an insurance portfolio, namely:

- individual risk model;
- collective risk model.

#### 1.1.1 Individual Risk Model

## Definition 2 (Individual Risk Model)

In an individual risk model, the aggregate claim is modeled by

$$S = \sum_{i=1}^{n} Z_i$$

where n is a deterministic<sup>2</sup> integer that represents the total number of insurance policies, and  $Z_i$  is a random variable for the potential loss of the i<sup>th</sup> insurance policy.

² i.e. fixed

made!

## 66 Note

Since a policy may or may not incur a loss<sup>3</sup>, we have that

$$P(Z_i = 0) > 0.$$

Thus, in an individual risk model, we may also express the aggregate claim amount as

$$S = \sum_{i=1}^{n} X_i I_i$$

where  $I_i$  is the indicator function about the claimant of policy i, while  $X_i$  represents the size of the claim(s) for the  $i^{th}$  policy provided that there is a claim.<sup>4</sup>

<sup>4</sup> This is actually incorrect, despite being in the recommended textbook.

See Appendix A.1.

<sup>3</sup> Since a claim may or may not be

However, in an individual risk model, according to Dhaene and Vyncke  $(2010)^5$ ,

A third type of error that may arise when computing aggregate claims follows from the fact that the assumption of mutual independency of the individual claim amounts may be violated in practice.

<sup>5</sup> Dhaene, J. and Vyncke, D. (2010). The individual risk model. https://www. researchgate.net/publication/ 228232062\_The\_Individual\_Risk\_ Model

Due to complications such as this, the individual risk model will not be the focus of our studies.

#### Collective Risk Model 1.1.2

## Definition 3 (Collective Risk Model)

In a collective risk model, the aggregate claim is modeled by

$$S = \sum_{i=1}^{N} X_i,$$

where N is a non-negative integer-valued random variable that denotes the number of claims among a given set of policies, while  $X_i$  denotes the size of the i<sup>th</sup> policy.

#### 66 Note

In a collective risk model, we need to determine:

- the distribution of the total number of claims for the entire portfolio, i.e. the distribution of N; and
- the distribution of the loss amount per claim, i.e. the distribution of  $X_i$ .

In this course, the primary focus of our studies will be on collective risk models.

Terminologies To end today's lecture, the following terminologies are introduced:

## Definition 4 (Severity Distribution)

The severity distribution is the distribution of the loss amount of the amount paid by the insurer on a given loss/claim.

## **Definition 5 (Frequency Distribution)**

The *frequency distribution* is the distributino fo the number of losses/claims paid by the insurer over a given period of time.

#### 66 Note

The frequency distribution is typically a discrete distribution.

## **Definition 6 (Aggrement Payment / Loss)**

The aggregate payment (loss) is the total amout of all claim payments (losses) over a given period of time.

## 66 Note

There is a distinction between an aggregate payment and an aggregate loss, since an aggregate payment is "essentially" an aggregate loss after certain claim adjustments, such as deductibles, limits, and coinsurance.

## 2 Lecture 2 Sep 11th

## 2.1 Review of Probability Theory

Firstly, we shall review the definition of a random variable.

## Definition 7 (Random Variable)

Let  $\Omega$  be a sample space and  $\mathcal{F}$  its  $\sigma$ -algebra<sup>1</sup>. A **random variable** (rv)  $X:\Omega\to(\Omega,\mathcal{F})$  is a function from a possible set of outcomes to a measurable space  $(\Omega,\mathcal{F})$ . Within the context of our interest, X is real-valued, i.e.  $(\Omega,\mathcal{F})=\mathbb{R}$ .

 $^{\scriptscriptstyle 1}$  For definitions of  $\Omega$  and  ${\cal F}$ , see notes on STAT330.

#### 2.1.1 Discrete Random Variables

#### Definition 8 (Discrete Random Variable)

A discrete random variable (drv) is an rv X that takes only countable (finite) real values.

### 66 Note

Let X be a drv.

• The probability mass function (pmf) of X is: for  $i \in \mathbb{N}$ ,

$$p(x_i) = P(X = x_i)$$

• The cumulative distribution function (cdf) of X is

$$F(x) = P(X \le x) = \sum_{x_i \le x} p(x_i).$$

• The kth moment of X is<sup>2</sup>

$$E[X^k] = \sum_{i \in \mathbb{N}} x_i^k p(x_i)$$

if  $E[X^k]$  is finite.

• Some commonly seen/introduced discrete distributions are: Poisson, Binomial, Negative Binomial

<sup>2</sup> This implicitly uses the Law of the Unconcious Statistician.

## Example 2.1.1

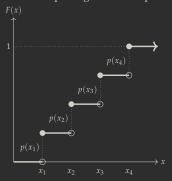
Let *X* take values from  $\{x_1, x_2, x_3, x_4\}$ , and

$$p(x_i) = P(X = x_i)$$
 for  $i = 1, 2, 3, 4$ .

The cdf of *X* is

$$F(x) = \begin{cases} 0 & x < x_1 \\ p(x_1) & x_1 \le x < x_2 \\ p(x_1) + p(x_2) & x_2 \le x < x_3 \\ 1 - p(x_4) & x_3 \le x < x_4 \\ 1 & x \ge x_4 \end{cases}$$

It is recommended to visualize the cdf first before putting it down in pencil.



#### 66 Note

- It is important that we stress the need for showing right continuity in the graph.
- *Note that the cdf always sums to* 1.
- The "jumps" at  $x_i$  correspond to  $p(x_i)$ , for i = 1, 2, 3, 4.

## Definition 9 (Probability Generating Function)

Suppose a drv X only takes non-negative integer values. The proba-

bility generating function (pgf) of X is defined as

$$G(z) = E\left[z^X\right] = \sum_{k=1}^{\infty} z^k p(k)$$

where we note that if  $\max X = n$ , then p(m) = 0 for all m > n.

## 66 Note

- The pgf uniquely identifies the distribution of the drv<sup>3</sup>.
- To get the probability for  $k \in \{0, 1, 2, ...\}$ , we simply need to do

$$p(k) = \frac{1}{k!} G^{(k)}(x) \Big|_{x=0}.$$

<sup>3</sup> This was given as is without proof, and I cannot find any resources that proves this.

## Example 2.1.2 (Lecture Slides: Example 1)

Consider a drv *X* with pmf

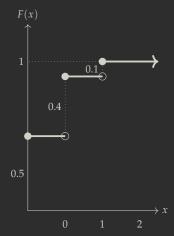
$$p(x) = P(X = x) = \begin{cases} 0.5 & x = 0 \\ 0.4 & x = 1 \\ 0.1 & x = 2 \end{cases}$$

Its cdf is

$$F(x) = P(X \le x) \begin{cases} 0 & x < 0 \\ 0.5 & 0 \le x < 1 \\ 0.9 & 1 \le x < 2 \\ 1 & x \ge 2 \end{cases}$$

and its pgf is

$$G(z) = E\left[z^X\right] = 0.5 + 0.4z + 0.1z^2.$$



#### Continuous Random Variables 2.1.2

## Definition 10 (Continuous Random Variable)

A continuous random variable (crv) takes on a continuum of values.

#### 66 Note

Let X be a crv.

•  $\exists f: X \to \mathbb{R}$  called a probability density function (pdf) such that its cdf is

$$F(x) = \int_{-\infty}^{x} f(y) \, dy,$$

and consequently by the Fundamental Theorem of Calculus, we have

$$f(x) = F'(x).$$

• *The kth moment of X is* 

$$E[X^k] = \int_{\mathcal{X}} x^k f(x) \, dx$$

so long that  $E[X^k]$  is defined.

• Some commonly introduced distributions are: Uniform, Exponential, Gamma, Weibull, and Normal.

## Definition 11 (Moment Generating Function)

Let X be an rv. The **moment generating function** (mgf) of X is, for  $t \in \mathbb{R}$  (appropriately so),

$$M_X(t) = E\left[e^{tX}\right] = \int_X e^{tx} f(x) dx$$

provided that the integral is well-defined.

The mgf is also defined for drvs.

#### 66 Note

- The mgf uniquely determines the distribution of its rv<sup>4</sup>
- With the mgf, we can obtain the kth moment of an rv X by

$$E\left[X^k\right] = \frac{d^k}{dt^k} M_X(t) \Big|_{t=0}$$

<sup>4</sup> This shall, also, not be proven in this course.

#### Example 2.1.3 (Lecture Notes: Example 2)

Consider an exponential rv X with pdf<sup>5</sup>

<sup>5</sup> When not explicitly stated, it shall be assumed that domains at which we did not specify *x* shall have probability 0.

$$f(x) = 0.1e^{-0.1x}, x > 0.$$

Its cdf is

$$F(x) = \int_{-\infty}^{x} f(y) \, dy = \begin{cases} 1 - e^{-0.1x} & x \ge 0\\ 0 & \text{otherwise} \end{cases}$$

and its mgf is

$$M_X(t) = E\left[e^{tX}\right] = \int_0^\infty e^{tx} 0.1 e^{-0.1x} dx$$
  
=  $0.1 \int_0^\infty e^{(t-0.1)x} dx$   
=  $\frac{0.1}{0.1 - t}$ ,  $t < 0.1$ ,

where we note that we must have t < 0.1, for otherwise the value of the exponent would render the integral undefined.

#### Definition 12 (Hazard Rate Function)

For a crv X, the hazard rate function (aka failure rate) of X is defined as

$$h(x) = \frac{f(x)}{\overline{F}(x)} = -\frac{d}{dx} \ln \overline{F}(x),$$

where  $\bar{F}(x) = 1 - F(x)$  is the survival function<sup>6</sup>

<sup>6</sup> You should be familiar with this if you have studied for Exam P.

#### 66 Note

• We may also express the survival function in terms of the hazard rate by

$$\overline{F}(x) = e^{-\int_{-\infty}^{x} h(y) \, dy}.$$

• In terms of limits, we can express the hazard rate function, for small

enough  $\delta > 0$ , as

$$h(x) = \frac{f(x)}{\overline{F}(x)} = \frac{F'(x)}{\overline{F}(x)}$$

$$\approx \frac{F(x+\delta) - F(x)}{\delta \overline{F}(x)}$$

$$= \frac{P(x < X \le x + \delta)}{\delta F(X > x)}$$

$$= \frac{1}{\delta} P(x < X \le x + \delta \mid X > x).$$

We can make sense of this expression by recalling the notion of the probability of survival from Exam MLC<sup>7</sup>, where if a life has survived over x, the hazard rate is the probability that the life does not survive beyond another  $\delta$  <sup>8</sup>.

<sup>&</sup>lt;sup>7</sup> This also tells us that the hazard rate gets its name from life insurance.

<sup>&</sup>lt;sup>8</sup> From the perspective of life insurance, the greater the probability, the more likely the claim is going to happen.

## 3 Lecture 3 Sep 13th

## 3.1 Review of Probability Theory (Continued)

## 3.1.1 Continuous Random Variables (Continued)

Example 3.1.1 (Lecture Notes: Example 3 — Hazard Rate of Weibull Distribution)

Suppose  $X \sim \text{Wei}(\theta, \tau)$  with pdf

$$f(x) = \frac{\tau(\frac{x}{\theta})^{\tau} e^{-(\frac{x}{\theta})^{\tau}}}{x}, \quad x > 0,$$

<sup>1</sup> Weibull Survival Function

where  $\theta$ ,  $\tau > 0$ . Find its hazard rate function.

#### Solution

We first require the survival function<sup>1</sup>:

 $\overline{F}(x) = \int_{x}^{\infty} \frac{1}{y} \tau \left( \frac{y}{\theta} \right)^{\tau} e^{-\left(\frac{y}{\theta}\right)^{\tau}} dy$   $= \int_{\frac{x}{\theta}}^{\infty} \frac{1}{u} \tau u^{\tau} e^{-u^{\tau}} du \quad \text{where } u = \frac{y}{\theta}$   $= \int_{\frac{x}{\theta}}^{\infty} \tau u^{\tau - 1} e^{-u^{\tau}} du$ 

 $= -e^{-u^{\tau}}\Big|_{\frac{x}{\theta}}^{\infty} = e^{-\left(\frac{x}{\theta}\right)^{\gamma}}$ 

The hazard rate is therefore

$$h(x) = \frac{f(x)}{\overline{F}(x)} = \frac{\tau}{x} \left(\frac{x}{\theta}\right)^{\tau}$$

#### 3.1.2 Mixed Random Variable

We call X a mixed random variable (mixed rv) if it has both discrete and continuous components.

## 66 Note

 Mixed rvs are important in modeling insurance claims, e.g., the loss amount is usually a continuous random variable with a probability mass at 0.

The following is a type of mixed random variable:

#### Definition 14 (Deductibles)

Let X be an rv and d be a fixed value.

$$[X-d]_+ = egin{cases} X-d & x \geq d \ 0 & \textit{otherwise} \end{cases}$$

#### 66 Note

If X be an rv and d a fixed value, the deductible  $[X-d]_+$  has a mass point at 0 since

$$P([X-d]_{+} = 0) = P(X < d) > 0$$

## 66 Note

Let  $\{x_1, x_2, ...\}$  be a sequence of real numbers in an increasing order. Suppose X is a rv that takes on values on the real, and has a density function f on each interval  $(x_i, x_{i+1})$ , and has discrete mass points at the boundaries of these intervals, i.e.

$$P(X = x_i) = p(x_i) > 0 \quad i \in \mathbb{N}.$$

Since X is an rv, it must be the case that

$$\sum_{i\in\mathbb{N}} p(x_i) + \sum_{i\in\mathbb{N}} \int_{x_i}^{x_{i+1}} f(x) \, dx = 1.$$

In other words, we treat the discrete and continuous part of a mixed rv separately.

The cdf of a mixed rv X is

$$F(x) = P(X \le x) = \sum_{i \in \mathbb{N}} p(x_i) \mathbb{1}_{\{x_i \le x\}} + \sum_{i \in \mathbb{N}} \int_{x_i}^{x_{i+1}} f(y) \mathbb{1}_{\{y \le x\}} dy.$$

The kth moment of X is

$$E\left[X^{k}\right] = \sum_{i \in \mathbb{N}} (x_{i})^{k} p(x_{i}) + \sum_{i \in \mathbb{N}} \int_{x_{i}}^{x_{i+1}} x^{k} f(x) dx.$$

The mgf of X is

$$M_X(t) = E\left[e^{tX}\right] = \sum_{i \in \mathbb{N}} e^{tx_i} p(x_i) + \sum_{i \in \mathbb{N}} \int_{x_i}^{x_{i+1}} e^{tx} f(x) dx.$$

## Example 3.1.2 (Lecture Notes: Example 4)

Assume a claim amount of an insurance policy is modeled by a nonnegative rv X which has probability mass of p and 0, and otherwise continuous with a pdf f over  $(0, \infty)$ . Find its cdf, kth moment, and mgf.

#### Solution

The cdf of *X* is

$$F(x) = \begin{cases} p + \int_0^x f(y) \, dy & x \ge 0\\ 0 & \text{otherwise} \end{cases}$$

The *k*th moment of *X* is

$$E\left[X^{k}\right] = \int_{0}^{\infty} x^{k} f(x) dx.$$

The mgf of *X* is

$$M_X(t) = p + \int_0^\infty e^{tx} f(x) \, dx.$$

## 3.2 Distributional Quantities and Risk Measures

This chapter introduces us to some distributional quantities for a given rv X. These distributional quantities are informative values to describe the characteristics of a risk.

## 3.2.1 Distributional Quantities

## Definition 15 (Central Moment)

The kth central moment of an rv X is defined as

$$E\left[\left(X-E(X)\right)^k\right].$$

#### 66 Note

The second central moment is the variance. The square root of the variance is the standard deviation.

## Example 3.2.1 (Lecture Notes: Example 5)

Consider an rv 
$$Y = \begin{cases} Y_1 & U = 1 \\ Y_2 & U = 2 \end{cases}$$
, where  $Y_1 = 0$ ,  $Y_2 \sim \text{Exp}(10)$ , and  $P(U = 1) = P(U = 2) = 0.5$ .

<sup>2</sup> This notation is just syntatic sugar for saying  $Y_1 = Y \mid (U = 1)$  and  $Y_2 = Y \mid (U = 2)$ .

- 1. Find the cdf of *Y*.
- 2. Find the mean and variance of Y.
- 3. Let  $Z = \frac{1}{2}Y_1 + \frac{1}{2}Y_2$ . Does Z have the same distribution as Y? Answer this by solving the mean and variance of Z.

## Solution

1. Note that

$$F(y) = P(Y_1 \le y \mid U = 1)P(U = 1) + P(Y_2 \le y \mid U = 2)P(U = 2).$$

Observe that

$$P(Y_1 \le y \mid U = 1) = \begin{cases} 1 & y \ge 0 \\ 0 & y < 0 \end{cases}$$

and

$$P(Y_2 \le y \mid U = 2) = \begin{cases} 1 - e^{-10y} & y \ge 0 \\ 0 & y < 0 \end{cases}$$

Therefore

$$F(y) = \begin{cases} 1 - \frac{1}{2}e^{-10y} & y \ge 0\\ 0 & y < 0 \end{cases}$$

2. The mean of *Y* is

$$E(Y) = E(Y \mid U = 1)P(U = 1) + E(Y \mid U = 2)P(U = 2) = 10 \cdot \frac{1}{2} = 5.$$

To calculate the variance of *Y*, we require

$$E[Y^{2}] = E[Y^{2} \mid U = 1]P(U = 1) + E[Y^{2} \mid U = 2]P(U = 2)$$
$$= (Var(Y_{2}) + E(Y_{2})^{2}) \cdot \frac{1}{2} = 100.$$

Therefore

$$Var(Y) = 100 - 5^2 = 75.$$

3. The mean of Z is

$$E[Z] = E[\frac{1}{2}Y_1 + \frac{1}{2}Y_2] = 5.$$

The variance of *Z* is

$$Var(Z) = \frac{1}{4} Var(Y_1) + \frac{1}{4} Var(Y_2) = 25.$$

Therefore, *Z* does not have the same distribution as Y.

## Definition 16 (Quantiles)

The 100p% quantile (or percentile) of an rv X is a set  $\pi_p$  such that

$$\pi_v = \{ x \in X \mid P(X < x) \le p \le P(X \le x) \}.$$

This definition may also be presented as: any number  $\pi_v$  such that

$$P(X < \pi_p) \le p \le P(X \le \pi_p).$$

## 66 Note

• If X is a continuous random variable, we have that  $P(X < \pi_p) =$  $P(X \leq \pi_p)$  and so we have to define the quantile as

$$\pi_p = F^{-1}(p)$$

where  $F^{-1}$  is the inverse function of F, the cdf of X.

- A quantile can be a set of numbers.
- $\pi_{0.5}$  is called the **median** of X.

Graphical method to interpret this notion will be included.

#### Example 3.2.2 (Lecture Notes: Example 1)

Find the 100p% quantile of the loss distribution  $F(x)=1-e^{-\frac{x}{\theta}}$ , x>0.

#### Solution

Note that *F* is the cdf of an exponential distribution, which is a continuous distribution. Therefore,

$$F(\pi_p) = 1 - e^{-\frac{\pi p}{\theta}} = p \implies \pi_p = -\theta \ln(1 - p).$$

## Example 3.2.3 (Lecture Notes: Example 2)

Find the median  $\pi_{0.5}$  for the following cdf

$$F(x) = \begin{cases} 0 & x < 0 \\ 0.6 + 0.4(1 - e^{-\frac{x}{3}}) & x \ge 0 \end{cases}$$

#### Solution

Since F(0) = 0.6 and F is an increasing function, we have that F(x) = 0 for all x < 0. Therefore

$$\pi_{0.5} = 0.$$

#### Example 3.2.4 (Lecture Notes: Example 3)

Find the median  $\pi_{0.5}$  for a loss X with pmf

$$p(0) = 0.25$$
,  $p(1) = 0.25$ ,  $p(2) = 0.5$ .

#### Solution

The cdf of *X* is

$$F(x) = \begin{cases} 0 & x < 0 \\ 0.25 & 0 \le x < 1 \\ 0.5 & 1 \le x < 2 \\ 1 & x \ge 2 \end{cases}$$

since F(x) = 0.5 when  $1 \le x < 2$ , we have that

$$\pi_{0.5} = [1, 2].$$

## 4 Lecture 4 Sep 18th

## 4.1 Distributional Quantities and Risk Measures (Continued)

## 4.1.1 Risk Measures

#### Definition 17 (Risk Measure)

A **risk measure** is a mapping from the loss rv to the real line  $\mathbb{R}$ .

## Klugman, Panjer & Wilmot (2012) <sup>1</sup> on risk measure:

The level of exposure to risk is often described by one number, or at least a small set of numbers. These numbers are necessarily functions of the model and are often called 'key risk indicators'. Such key risk indicators indicate to risk managers the degree to which the company is subject to particular aspects of risk.

To ensure its solvency, insurers will have to charge on these risks, i.e. we have to **price these exposures to risks**.

## Definition 18 (Premium Principle)

A premium principle (or insurance pricing) is a rule for assigning a premium to an insurance risk.

#### 66 Note

The following are some of the common principles used by insurers:

<sup>1</sup> Klugman, S. A., Panjer, H. H., and Willmot, G. E. (2012). *Loss Models: From Data to Decisions*. John Wiley & Sons, Inc., 4th edition • Expectation Principle

$$\Pi(X) = (1 + \theta)E(X), \quad \theta > 0$$

• Standard Deviation Principle

$$\Pi(X) = E(X) + \theta \sqrt{\operatorname{Var}(X)}, \quad \theta > 0$$

• Dutch Principle

$$\Pi(X) = E(X) + \theta E([X - E(X)]_+), \quad \theta > 0$$

One particular measure is known as the Value-at-Risk (VaR).

## 4.1.1.1 Value-At-Risk

## Definition 19 (Value-at-Risk (VaR))

The Value-at-Risk (VaR) is a quantile of the distribution of aggregate losses, i.e. the VaR of a risk X at the 100%p level is defined as<sup>2</sup>

$$\pi_p = \operatorname{VaR}_p(X) = \inf\{x \in \mathbb{R} : P(X > x) \le 1 - p\}$$
$$= \inf\{x \in \mathbb{R} : P(X \le x) \ge p\}.$$

<sup>2</sup>I must find out why we define using inf instead of min (see following remark), and I will not take "safe definition" as an answer without full justification.

## 66 Note

- VaR is often called a quantile risk measure.
- VaR is the standard risk measure used to evaluate exposure to risks.
- VaR measures the amount of capital required by the insurer to remain solvent, with high certainty, in the face of large claims.
- *In practice, p is generally high:* 99.95% *or as low as* 95%.

#### Remark

Observe that

$$B = \{x \in \mathbb{R} \mid F_X(x) \ge p\} = (A, \infty) \text{ or } [A, \infty)$$

This remark basically points out that the left endpoint of the interval *B* is always included, which should be quite clear by right-continuity of *F*.

for some  $A \in \mathbb{R}$ , since F is an increasing function. Now let  $x_0 \in B$  such that

$$F(x_0) = P(X \le x_0) \ge p \quad \land \quad F(x_0-) = P(X < x_0) \le p,$$

i.e. it is not necessary that  $P(X = x_0) = p$  (see the two example graphs on the margin).

Let  $\{x_n\}_{n\in\mathbb{N}}$  be a decreasing sequence of points on  $\mathbb{R}$  such that  $x_n\to x_0$ as  $n \to \infty$ . Since F is right-continuous, we have that  $F(x_n) \to \overline{F(x_0)}$  as  $n \to \infty$ . Therefore,

$$B = [x_0, \infty)$$

This justifies the definition of  $\pi_n$ .

#### 66 Note

• *Note that by definition, we have* 

$$P(X < \pi_p) \le p \le P(X \le \pi_p)$$

• If X is a crv whose cdf is strictly increasing, i.e. no constant points, then

$$\pi_p = F^{-1}(p)$$

since  $P(X < \pi_v) = P(X \le \pi_v)$ .

## \* Warning (Shortcomings of VaR)

- VaR cannot tell us the size of the potential loss in the 100(1-p)%cases, making it difficult for us to prepare the right amount in order to safeguard against insolvency.
- VaR actually fails to satisfy properties to be a coherent risk measure<sup>3</sup>, for example, subadditivity.
- VaR is extensively used in financial risk management of trading risk over a fixed (usually short) time period, which are usually normally distributed, and VaR satisfies all coherency requirements.
- In insurance losses, instead of normal distributions, in general, skewed distributions are used, and in this cases, VaR is flawed as it lacks subadditivity.

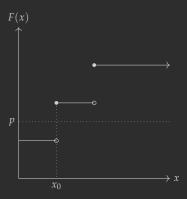


Figure 4.1: Discrete cdf

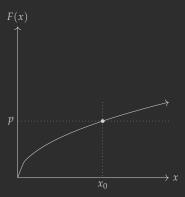


Figure 4.2: Continuous cdf The lecturer asserts that we can really define VaR using min instead of inf, but even with this, I am not completely satisfied or convinced.

<sup>3</sup> See Appendix A.2.

#### Example 4.1.1

Suppose that *X* has a Pareto distribution with cdf

$$F(x) = 1 - \left(\frac{\theta}{x+\theta}\right)^{\alpha}, \quad x > 0$$

where  $\alpha$ ,  $\theta > 0$ . Find  $VaR_p(X)$ .

#### Solution

Since *F* is continuous and strictly increasing, we have that

$$\pi_p = F^{-1}(p) = \theta \left[ (1-p)^{-\frac{1}{\alpha}} - 1 \right]$$

## Example 4.1.2

Find  $VaR_{0.95}(X)$ ,  $VaR_{0.5}(X)$ , and  $VaR_{0.3}(X)$  for a random loss with pmf

$$p(0) = 0.25$$
,  $p(1) = 0.25$ , and  $p(2) = 0.5$ .

#### Solution

Note that the cdf of *X* is

$$F(x) = \begin{cases} 0 & x < 0 \\ 0.25 & 0 \le x < 1 \\ 0.5 & 1 \le x < 2 \\ 1 & x \ge 2 \end{cases}.$$

Therefore,

$$VaR_{0.95}(X) = 2$$
,  $VaR_{0.5}(X) = 1$ , and  $VaR_{0.3}(X) = 1$ .

#### 4.1.1.2 Tail-Value-at-Risk

To compensate for the weakness of VaR at giving us the size of the loss *X* of which we cannot measure, we use the **Tail-Value-at-Risk**.

#### Definition 20 (Tail-Value-at-Risk (TVaR))

Let X be an rv. The **Tail-Value-at-Risk (TVaR)** of X at the 100p% level, denoted as  $TVaR_p(X)$ , is defined as the average of all VaR values above the level p, and expressed as

TVaR also has the following names, used by different regions:

- Conditional Tail Expectation (CTE)
   NA
- Tail Conditional Expectation (TCE)
- Expected Shortfall (ES) EU

$$\text{TVaR}_p(X) = \frac{1}{1-p} \int_p^1 \text{VaR}_\alpha(X) \, d\alpha = \frac{1}{1-p} \int_p^1 \pi_\alpha \, d\alpha$$

By considering the average of VaR from p's going up to 1, we take into account even the extreme cases of which VaR fails to account for.

Perhaps a clearer definition would be the following, although the expression is only sensible if *X* is a crv:

## Definition 21 (Tail-Value-at-Risk (TVaR))

Let X be an rv. The **Tail-Value-at-Risk (TVAR)** of X at the 100p% level, denoted  $TVaR_p(X)$ , is the expected loss given that the loss exceeds the 100p percentile (or quantile) of the distribution of X, expressible as

$$ext{TVaR}_p(X) = E[X \mid X > \pi_p] = rac{1}{\overline{F}(\pi_p)} \int_{\pi_p}^{\infty} x f(x) \, dx.$$

Note that the two definitions agree with one another:

$$\frac{1}{1-p} \int_p^1 \pi_\alpha \, d\alpha = \frac{1}{1-F(\pi_p)} \int_p^1 F^{-1}(\alpha) \, d\alpha$$
$$= \frac{1}{\overline{F}(\pi_p)} \int_{\pi_p}^1 x f(x) \, dx$$

where we let  $\alpha = F(x)$  as substitution.

#### 66 Note

While it is not difficult to notice that

$$TVaR_{\nu}(X) \geq VaR_{\nu}(X)$$
,

the proof is also simple:

$$\begin{split} \text{TVaR}_p(X) &= \frac{1}{1-p} \int_p^1 \pi_\alpha \, d\alpha \\ &\geq \frac{1}{1-p} \pi_p \int_p^1 d\alpha = \pi_p = \text{VaR}_p(X). \end{split}$$

## Example 4.1.3

Find  $TVaR_p(X)$  for  $X \sim Exp(\theta)$ .

### Solution

Since *X* is a crv, and  $F(x) = 1 - e^{-\frac{x}{\theta}}$ , we have that

$$\pi_p = F^{-1}(p) = -\theta \ln(1-p).$$

Therefore,

$$TVaR_{p}(X) = \frac{1}{1-p} \int_{p}^{1} \pi_{\alpha} d\alpha = \frac{-\theta}{1-p} \int_{p}^{1} \ln(1-\alpha) d\alpha$$

$$= \frac{-\theta}{1-p} \int_{-\infty}^{\ln(1-p)} ue^{u} du \quad \text{let } u = \ln(1-\alpha)$$

$$= \frac{-\theta}{1-p} \left[ ue^{u} \Big|_{-\infty}^{\ln(1-p)} - \int_{-\infty}^{\ln(1-p)} e^{u} du \right] \text{ by IBP}$$

$$= \frac{-\theta}{1-p} \left[ (1-p) \ln(1-p) - (1-p) \right]$$

$$= \theta [1 - \ln(1-p)]$$

## 66 Note

From the last example, by the memoryless property of  $Exp(\theta)$ , notice that we may also do

$$\begin{aligned} \text{TVaR}_{p}(X) &= E[X \mid X > \pi_{p}] = E[X - \pi_{p} + \pi_{p} \mid X > \pi_{p}] \\ &= E[X - \pi_{p} \mid X > \pi_{p}] + E[\pi_{p} \mid X > \pi_{p}] \\ &= E[X] + \pi_{p} \end{aligned} \tag{4.1}$$

## 5 Lecture 5 Sep 20th

## 5.1 Distrbutional Quantities and Risk Measures (Continued 2)

## 5.1.1 Risk Measures (Continued)

Before ending this section, we introduce a notion that is related to TVaR.

#### Definition 22 (Mean Excess Loss)

Let X be an rv, and  $d \in \mathbb{R}$ . The mean excess loss, denoted  $e_X(d)$ , is defined as

$$e_X(d) = E[X - d \mid X > d]$$

and  $e_X(d) = 0$  for those d such that P(X > d) = 0.

## • Proposition 1 (Relation of TVaR $_p(X)$ and $e_X(d)$ )

For a crv X, we have

$$TVaR_{p}(X) = e_{X}(\pi_{p}) + VaR_{p}(X)$$

#### Proof

By Equation (4.1), we have that

$$\text{TVaR}_p(X) = E[X - \pi_p \mid X > \pi_p] + \pi_p = e_X(\pi_p) + \pi_p.$$

## • Proposition 2 (Expection from Survival Function)

Let X be a non-negative rv such that  $E[X^k] < \infty$ , for any  $k \in \mathbb{N} \setminus \{0\}$ . Then<sup>1</sup>

$$E\left[X^{k}\right] = k \int_{0}^{\infty} x^{k-1} \overline{F}(x) \, dx$$

<sup>1</sup> Note that this works for the discrete case as well, by replacing  $\int$  with  $\Sigma$ .

## Proof

Firstly, note that since  $E[X^k] < \infty$  for all  $k \in \mathbb{N} \setminus \{0\}$ , we have that  $\overline{F}(x)$  decays faster than  $x^k$  as  $x \to \infty$ . Now

$$E\left[X^{k}\right] = \int_{0}^{\infty} x^{k} f(x) dx \quad \therefore \text{ Law of the Unconscious Statistician}$$

$$= \int_{0}^{\infty} x^{k} dF(x) \quad \therefore dF(x) = f(x) dx$$

$$= -\int_{0}^{\infty} x^{k} d\overline{F}(x)$$

$$= -\left[x^{k} \overline{F}(x)\right]_{0}^{\infty} - \int_{0}^{\infty} kx^{k-1} \overline{F}(x) dx\right] \quad \therefore \text{ IBP}$$

$$= k \int_{0}^{\infty} x^{k-1} \overline{F}(x) dx$$

#### Example 5.1.1

Calculate  $e_X(d)$  and  $TVaR_p(X)$  for a Pareto distribution X with cdf

$$F(x) = 1 - \left(\frac{\theta}{x + \theta}\right)^{\alpha}, \quad x > 0,$$

where  $\alpha > 1$  and  $\theta > 0$ .

#### Solution

Using 6 Proposition 2,

$$e_X(d) = \int_0^\infty P(X - d > x \mid X > d) \, dx = \int_0^\infty \frac{P(X - d > x, X > d)}{P(X > d)} \, dx$$

$$= \int_0^\infty \frac{P(X > x + d)}{P(X > d)} \, dx = \int_0^\infty \frac{\overline{F}(x + d)}{\overline{F}(d)} \, dx$$

$$= \int_0^\infty \left( \frac{d + \theta}{x + d + \theta} \right)^\alpha dx = \frac{(d + \theta)^\alpha}{1 - \alpha} \left( \frac{1}{x + d + \theta} \right)^{\alpha - 1} \Big|_0^\infty$$

$$= \frac{d + \theta}{\alpha - 1}$$

By Example 4.1.1, we have

$$\pi_p = \theta \left[ (1-p)^{-\frac{1}{\alpha}} - 1 \right]$$

and so

$$\begin{aligned} \text{TVaR}_p(X) &= e_X(\pi_p) + \pi_p \\ &= \frac{\theta \left[ (1-p)^{-\frac{1}{\alpha}} - 1 \right] + \theta}{\alpha - 1} + \theta \left[ (1-p)^{-\frac{1}{\alpha}} - 1 \right] \\ &= \frac{\theta (1-p)^{-\frac{1}{\alpha}}}{\alpha - 1} + \frac{\theta (\alpha - 1)(1-p)^{-\frac{1}{\alpha}}}{\alpha - 1} - \theta \\ &= \frac{\theta \alpha (1-p)^{-\frac{1}{\alpha}}}{\alpha - 1} - \theta \end{aligned}$$

#### • Proposition 3 (Expected Deductible)

We have

$$E([X-d]_+) = \int_d^\infty \overline{F}(x) \, dx$$

By the Law of the Unconscious Statistician and IBP on the last step,

$$E([X-d]_{+}) = \int_{d}^{\infty} (x-d) \, dF(x) = -\int_{d}^{\infty} (x-d) \, d\bar{F}(x) = \int_{d}^{\infty} \bar{F}(x) \, dx$$

### • Proposition 4 (An Expression for Mean Excess Value)

If  $\bar{F}(d) > 0$ , we have

$$e_X(d) = \frac{\int_d^\infty \bar{F}(x) dx}{\bar{F}(d)}$$

#### Proof

Observe that by **\oldot** Proposition 3, we have

$$e_X(d) = E[X - d \mid X > d] = \frac{E[(X - d)\mathbb{1}_{X > d}]}{P(X > d)}$$
$$= \frac{E([X - d]_+)}{\bar{F}(d)} = \frac{\int_d^\infty \bar{F}(x) \, dx}{\bar{F}(d)}$$

## 5.2 Severity Distributions — Creating Severity Distributions

Recall the definition of a severity distribution.

## Definition (Severity Distribution)

A **severity distribution** is a distribution used to describe single random losses in an insurance portfolio.

When a loss occurs, the full amount of the loss is not necessarily the amount paid by the insurer, since an insurance policy typically involves some form of adjustment (e.g. **deductible**, **limit**, **coinsurance**). A distinction needs to be made between the actual loss prior to any of the adjustments (aka **ground-up loss**) and the amount ultimately paid by the insurer.

Our goal is to find a reasonable model for the **ground-up loss** rv *X*. The following are two desirable properties for *X*:

- $Im(X) = \mathbb{R}_{>0}$ , since losses are positive;
- pf of *X* is right-skewed, since we want the "tail" of the distribution to be not heavy.

- The motivation for this property is due to the 20-80 rule: 20% of the largest claims account for 80% of the total claim amount.

THERE ARE two approaches to constructing a severity distribution:

- Parametric approach<sup>2</sup>: specify a "form" for the distribution with a finite number of parameters.
- Nonparametric approach: no form is specified; the distribution is constructed directly from the empirical data.

A weakness of the **Nonparametric approach** is, if there is not enough data, such as in catasthropic risks, is becomes difficult to obtain reliable information. We shall look at one such example in this approach.

## Definition 23 (Empirical Distribution Function)

Let  $\{X_1, \ldots, X_n\}$  be an iid sample of a risk X. Then its empricial distribution function (edf) is defined as

$$\hat{F}_n(x) = \frac{1}{n} \sum_{i=1}^n \mathbb{1}_{\{X_i \le x\}}, \quad x \in \mathbb{R}.$$

#### Remark

Simply put, the edf assigns a probability of  $\frac{1}{n}$  to each sample point  $X_i$ .

#### Example 5.2.1

Consider a random sample of a risk with size 5: {30,80,150,150,200}. Find the edf of the risk.

#### Solution

The edf is given by

$$\hat{F}_n(x) = \frac{1}{5} \sum_{i=1}^5 \mathbb{1}_{\{X_i \le x_i\}} = \begin{cases} 0 & x < 30 \\ \frac{1}{5} & 30 \le x < 80 \\ \frac{2}{5} & 80 \le x < 150 \\ \frac{4}{5} & 150 \le x < 200 \\ 1 & x \ge 200 \end{cases}$$

<sup>2</sup> This approach shall be the focus of this course.

# 6 Lecture 6 Sep 25th

# *6.1 Severity Distributions* — *Creating Severity Distributions* (Continued)

The Parametric Approach The following is a graph showing the process of a parametric approach:

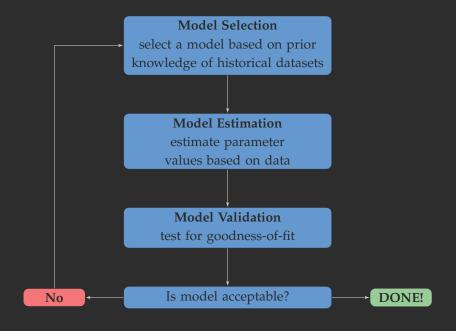


Figure 6.1: Process of a Parametric Approach

Common Techniques in Creating New Parametric Distributions Before diving into the topic, first, a definition:

# Definition 24 (Parametric Distribution)

A parametric distribution is a set of distribution functions, of which each member is determined by specifying one or more parameters.

Some common techniques are the following:

- Multiplication by a constant
- Raising to a power
- Exponentiation
- Mixture of distributions

# 6.1.1 Multiplication By A Constant

This transformation is equivalent to applying inflation uniformly across all loss levels, and is known as a change of scale.

# • Proposition 5 (Multiplication by a Constant)

Let X be a crv with cdf  $F_X$  and pdf  $f_X$ . Let Y = cX for some c > 0. Then

$$F_Y(y) = F_X\left(\frac{y}{c}\right)$$
,  $f_Y(y) = \frac{1}{c}f_X\left(\frac{y}{c}\right)$ .

#### Proof

$$F_Y(y) = P(Y \le y) = P(cX \le y) = P\left(X \le \frac{y}{c}\right) = F_X\left(\frac{y}{c}\right)$$
$$f_Y(y) = \frac{d}{dy}F_Y(y) = \frac{d}{dy}F_X\left(\frac{y}{c}\right) = \frac{1}{c}f_X\left(\frac{y}{c}\right)$$

# Definition 25 (Scale Distribution)

We say that a parametric distribution is a **scale distribution** if Y = cY for any positive constant c is from the same set of distributions as X.

It is clear that we have the following result:

# Corollary 6

The parameter c in ♠ Proposition 5 is a scale parameter, and Y is a scale distribution.

#### Example 6.1.1

Let  $X \sim \text{Exp}(\theta)$  with pdf

$$f_X(x) = \frac{1}{\theta} e^{-\frac{x}{\theta}}, \quad x > 0.$$

Let y = cX with c > 0, it follows that

$$f_Y(y) = \frac{1}{c} f_X\left(\frac{y}{c}\right) = \frac{1}{c\theta} e^{-\frac{y}{c\theta}}, \quad y > 0.$$

Thus  $Y \sim \text{Exp}(c\theta)$  and so Y is a scale distribution. In particular, the exponential distribution belongs to a family of scale distributions.

# Definition 26 (Scale Parameter)

A parameter  $\theta$  is called a **scale parameter** of a parametric distribution X if it satisfies the following condition: the parametric value of cX is  $c\theta$  for any positive constant c, and other parameters (if any) remain unchanged.

## Example 6.1.2

From Example 6.1.1, we had that

$$f_X(x) = \frac{1}{\theta}e^{-\frac{x}{\theta}}, \quad x > 0.$$

We showed that  $Y = cX \sim \text{Exp}(c\theta)$ . Therefore, the parameter  $\theta$  is a scale parameter.

#### Example 6.1.3

Determine whether the lognormal distribution  $X \sim \text{LogN}(\mu, \sigma^2)$ , i.e.  $ln(X) \sim N(\mu, \sigma^2)$ , is a scale distribution or not. If yes, determine whether it has any scale parameter.

## Solution

Let Y = cX for some c > 0. Observe that

$$\ln Y = \ln c X = \ln c + \ln X \sim N(\mu + \ln c, \sigma^2).$$

For the last equation, note that if we let  $Z = \ln X \sim N(\mu, \sigma^2)$ 

$$E\left[e^{t(Z+\ln c)}\right] = e^{t\ln c}e^{\mu t + \frac{\sigma^2 t^2}{2}} = e^{t(\mu + \ln c) + \frac{\sigma^2 t^2}{2}}$$

we see that the above is the mgf of  $N(\mu + \ln c, \sigma^2)$ . Thus we have that Y has the same distribution as X and so it is a scale distribution. However, we also see that it has no scale parameters.

# 6.1.2 Raising to a Power

# • Proposition 7 (Raising to a Power)

Let X be a crv with pdf  $f_X$  and cdf  $F_X$  with  $F_X(0) = 0$ . Let  $Y = X^{\frac{1}{\tau}}$ . If  $\tau > 0$ , then

$$F_Y(y) = F_X(y^{\tau}), \quad f_Y(y) = \tau y^{\tau - 1} f_X(y^{\tau}), \quad y > 0,$$

while if  $\tau < 0$ , then

$$F_Y(y) = 1 - F_X(y^{\tau}), \quad f_Y(y) = -\tau y^{\tau-1} f_X(y^{\tau}), \quad y > 0.$$

# Proof

When  $\tau > 0$ ,

$$F_Y(y) = P(Y \le y) = P(X^{\frac{1}{\tau}}) = P(X \le y^{\tau}) = F_X(y^{\tau})$$

and

$$f_Y(y) = \frac{d}{dy} F_Y(y) = \frac{d}{dy} f_X(y^{\tau}) = \tau y^{\tau - 1} f_X(y^{\tau}).$$

When  $\tau < 0$ ,

$$F_Y(y) = P(Y \le y) = P\left(X^{\frac{1}{\tau}} \le y\right) = P\left(X \ge y^{\tau}\right) = \overline{F}_X(y^{\tau})$$

and

$$f_{Y}(y) = \frac{d}{dy}F_{Y}(y) = \frac{d}{dy}(1 - F_{X}(y^{\tau})) = -\tau y^{\tau-1}f_{X}(y^{\tau}).$$

## Example 6.1.4

Let  $X \sim \operatorname{Exp}(\theta)$  and  $Y = X^{\frac{1}{\tau}}$  for  $\tau > 0$ , we have

$$F_Y(y) = F_X(t^{\tau}) = 1 - e^{-\frac{y^{\tau}}{\theta}} = 1 - e^{-\left(\frac{y}{\alpha}\right)^{\tau}},$$

where  $\alpha = \theta^{\frac{1}{\tau}}$ . In particular, we have that  $Y \sim \text{Wei}(\alpha, \tau)$ .

# 6.1.3 Exponentiation

# • Proposition 8 (Exponentiation Method)

Let X be a crv with pdf  $f_X$  and cdf  $F_X$ . Let  $Y = e^X$ . Then

$$F_Y(y) = F_X(\ln y), \quad f_Y(y) = \frac{1}{y} f_X(\ln y).$$

# Proof

We have

$$F_Y(y) = P\left(e^X \le y\right) = P(X \le \ln y) = F_X(\ln y)$$

and

$$f_Y(y) = \frac{d}{dy}F_Y(y) = \frac{d}{dy}F_X(\ln y) = \frac{1}{y}f_X(\ln y).$$

# Exercise 6.1.1 (Lognormal Distribution)

Let  $X \sim N(\mu, \sigma^2)$ . The cdf and pdf of  $Y = e^X$  is

$$F_Y(y) = F_X(\ln y) = \Phi\left(\frac{\ln y - \mu}{\sigma}\right)$$

$$f_Y(y) = \frac{1}{y} f_X(\ln y) = \frac{1}{y} \frac{1}{\sqrt{2\pi}\sigma} e^{-\frac{1}{2} \cdot \left(\frac{\ln y - \mu}{\sigma}\right)^2}$$

# 6.1.4 *Mixing Distributions*

The rationale behind mixing distributions is to define an rv X conditional on a second rv, say  $\Theta$  (aka **mixing rv**). The mixing rv  $\Theta$  can either be discrete or be continuous, which leads to two types of mixtures:

- **discrete mixture**: when  $\Theta$  is discrete; and
- **continuous mixture**: when  $\Theta$  is continuous.

## Definition 27 (Discrete Mixed Distribution)

Let  $\Theta$  be a drv taking values on  $\{\theta_1, \theta_2, \dots, \theta_n\}$  with

$$P(\Theta = \theta_i) = p_i > 0, \quad i = 1, \dots, n,$$

and the rv  $Y_i := X \mid \Theta = \theta_i$  has cdf

$$F_{Y_i}(x) = P(X \le x \mid \Theta = \theta_i), x \in \mathbb{R}.$$

Then X is called a discrete mixed distribution with cdf

$$F_X(x) = \sum_{i=1}^n P(X \le x \mid \Theta = \theta_i) P(\Theta = \theta_i) = \sum_{i=1}^n p_i F_{Y_i}(x).$$

Following the above definition, by the Law of the Unconscious Statistician, we have

$$E[g(X)] = \sum_{i=1}^{n} E[g(X) \mid \Theta = \theta_i] P(\Theta = \theta_i) = \sum_{i=1}^{n} p_i E[g(Y_i)],$$

for any function *g* such that the expectation exists. In particular, we have

$$E[X] = \sum_{i=1}^{n} p_i E[Y_i]$$
 and  $E[X^2] = \sum_{i=1}^{n} p_i E[Y_i^2]$ .

#### Example 6.1.5

Let  $Y_i \sim \text{Exp}(i)$  for i = 1, 2, 3. Define X to be an equal mixture of these three exponential rvs. Fidn the cdf, pdf, and mean of X.

# Solution

The cdf of *X* is

$$\begin{split} F_X(x) &= \sum_{i=1}^3 \frac{1}{3} F_{Y_i}(x) = \frac{(1 - e^{-x}) + (1 - e^{-x/2}) + (1 - e^{-x/3})}{3} \\ &= 1 - \frac{1}{3} \left( e^{-x} + e^{-\frac{x}{2}} + e^{-\frac{x}{3}} \right), x > 0. \end{split}$$

The pdf of *X* is

$$f_X(x) = \frac{1}{3} \left( e^{-x} + \frac{1}{2} e^{-\frac{x}{2}} + \frac{1}{3} e^{-\frac{x}{3}} \right)$$
,  $x > 0$ .

The mean of X is therefore

$$E[X] = \sum_{i=1}^{3} E[Y_i] = \frac{1}{3}(1+2+3) = 2.$$

# 7 Lecture 7 Sep 27th

- 7.1 Severity Distributions Creating Severity Distributions (Continued 2)
- 7.1.1 Mixing Distributions (Continued)

# **■** Definition 28 (Continuous Mixture)

Let  $\Theta$  be a crv with density  $f_{\Theta}$ , and the cdf and pdf of  $X \mid \Theta = \theta$  are given by

$$F_{X|\Theta}(x \mid \theta) = P(X \le x \mid \Theta = \theta) \text{ and } f_{X|\Theta}(x \mid \theta) = P(X = x \mid \Theta = \theta).$$

The unconditional distribution of X is said to be a **continuous mixed distribution** with cdf and pdf

$$F_X(x) = \int_{-\infty}^{\infty} F_{X|\Theta}(x \mid \theta) f_{\Theta}(\theta) d\theta$$
$$f_X(x) = \int_{-\infty}^{\infty} f_{X|\Theta}(x \mid \theta) f_{\Theta}(\theta) d\theta.$$

Furthermore, for any function H,

$$E[H(X)] = \int_{-\infty}^{\infty} E[H(X) \mid \Theta = \theta] f_{\Theta}(\theta) d\theta.$$

# Example 7.1.1

Suppose that  $X \mid \Lambda = \lambda$  is exponentially distributed with mean  $\frac{1}{\lambda}$ , and let  $\Lambda$  be a gamma distributed rv with mean  $\alpha/\theta$  and variance  $\alpha/\theta^2$ , i.e.

$$f_{\Lambda}(\lambda) = rac{ heta^{lpha} \lambda^{lpha-1} e^{- heta \lambda}}{\Gamma(lpha)}$$
 ,  $\lambda > 0$  ,

where  $\Gamma(\alpha) = \int_0^\infty t^{\alpha-1}e^{-t}\,dt$  is the gamma function. Determine the conditional pdf of X.

# Solution

We have

$$f_X(x) = \int_0^\infty f_{X|\Lambda}(x \mid \lambda) f_{\Lambda}(\lambda) d\lambda$$

$$= \int_0^\infty \lambda e^{-x\lambda} \frac{\theta^{\alpha} \lambda^{\alpha - 1} e^{-\theta \lambda}}{\Gamma(\alpha)} d\lambda$$

$$= \frac{\theta^{\alpha}}{\Gamma(\alpha)} \int_0^\infty \lambda^{\alpha} e^{-\lambda(x+\theta)} d\lambda$$

$$= \frac{\theta^{\alpha}}{\Gamma(\alpha)(x+\theta)} \int_0^\infty \left(\frac{y}{x+\theta}\right)^{\alpha} e^{-y} dy \quad \text{where } y = \lambda(x+\theta)$$

$$= \frac{\theta^{\alpha}}{\Gamma(\alpha)(x+\theta)^{\alpha+1}} \int_0^\infty y^{\alpha} e^{-y} dy$$

$$= \frac{\theta^{\alpha}\Gamma(\alpha+1)}{\Gamma(\alpha)(x+\theta)^{\alpha+1}} = \frac{\alpha \theta^{\alpha}}{(x+\theta)^{\alpha+1}}.$$

# • Proposition 9 (Total Expectation and Total Variance)

For any rvs X and  $\Theta$ , provided that the repsective expectation and variance exist, we have

$$E[X] = E[E[X \mid \Theta]]$$

$$Var(X) = E[Var(X \mid \Theta)] + Var(E[X \mid \Theta])$$

#### Proof

$$E[X] = E\left(\int_X x f_{X|\Theta}(x \mid \Theta) dx\right)$$

$$= \int_{\Theta} \int_X x f_{X|\Theta}(x \mid \theta) f_{\Theta}(\theta) dx d\theta$$

$$= \int_X x \int_{\Theta} f_{X,\Theta}(x,\theta) d\theta dx \quad \therefore \text{ Fubini's Theorem}$$

$$= \int_X x f_X(x) dx = E[X].$$

Note that

$$Var(X \mid \Theta) = E[X^2 \mid \Theta] + E[X \mid \Theta]^2.$$

And so

$$E[\operatorname{Var}(X \mid \Theta)] + \operatorname{Var}(E[X \mid \Theta])$$

$$= E[E[X^2 \mid \Theta]] - E[E[X \mid \Theta]^2] + E[E[X \mid \Theta]^2] - E[E[X \mid \Theta]]^2$$

$$= E[X^2] - E[X]^2 = \operatorname{Var}(X)$$

## Example 7.1.2

Suppose that  $X \mid \Theta = \theta \sim \text{Exp}(\theta)$  and  $p_{\Theta}(\theta) = \frac{1}{3}$  for  $\theta = 1, 2, 3$ . Find the mean and variance of X.

#### Solution

The mean of *X* is

$$E[X] = EE[X \mid \Theta] = E[\Theta] = \frac{1}{3}(1+2+3) = 2.$$

The variance of *X* is

$$Var(X) = E[Var(X \mid \Theta)] + Var(E[X \mid \Theta])$$

$$= E[\Theta^{2}] + Var(\Theta) = 2E[\Theta^{2}] - E[\Theta]^{2}$$

$$= \frac{2}{3}(1 + 4 + 9) - 4 = \frac{28}{3} - \frac{12}{3} = \frac{16}{3}$$

## Example 7.1.3

Suppose that  $X \mid \Lambda = \lambda \sim \operatorname{Exp}(\lambda)$  and  $\Lambda \sim \operatorname{Gam}(\alpha, \theta)$  with mean  $\alpha\theta$  and variance  $\alpha\theta^2$ . Find the mean and variance of X.

#### Solution

The mean of *X* is

$$E[X] = EE[X \mid \Lambda] = E[\Lambda] = \alpha \theta.$$

The variance of *X* is

$$Var(X) = E[Var(X \mid \Lambda)] + Var(E[X \mid \Lambda])$$
$$= E[\Lambda^{2}] + Var(\Lambda) = 2 Var(\Lambda) + E[\Lambda]^{2}$$
$$= 2\alpha\theta^{2} + \alpha^{2}\theta^{2}.$$

# 7.2 Severity Distributions — Tail of Distributions

# Definition 29 (Tail)

The **tail** of a distribution (usually the right tail) is the portion of the distribution corresponding to large values of the random variable.

It is important that we understand large possible loss values as they have the greatest impact on the total losses that we may have to endure. In general, a loss rv is said to be **heavy-tailed** if it has a large probability to take large values.

Two measurements of tail weight:

- relative: comparing "sizes" of the tails of two distributions;
- absolute: classifying distributions as heavy or light-tailed.

The following is a set of criteria to measure or compare the heaviness of the tails of loss distributions:

- Existence of moments
- Limiting ratios
- Hazard rate function
- Mean excess loss function

# 7.2.1 Existence of Moments

Recall that the *k*th moment of a loss *X* is

$$E\left[X^k\right] = \int_0^\infty x^k f_X(x) \, dx.$$

Now if  $f_X$  takes on large values for large x, we may have  $E\left[X^k\right]$  blow up to infinity, and so it is desirable to find/use some distribution with a decaying probability function, one at which its rate of decay is faster than the growth of  $x^{-(k+1)}$ .

# 8 Lecture 8 Oct 02nd

# 8.1 Severity Distributions — Tail of Distributions (Continued)

# 8.1.1 Existence of Moments (Continued)

# Example 8.1.1

For a Pareto distribution, as  $x \to \infty$ , we have that  $f_X(x) \sim x^{-(\alpha+1)}$ , so its moments are finite if and only if  $k < \alpha$ .

We say that the Pareto distribution has a power tail.

# Example 8.1.2

Given the transformed Gamma distribution, with pdf

$$f_X(x) = \frac{\left(\frac{x}{\theta}\right)^{\alpha} e^{-\frac{x}{\theta}}}{x\Gamma(\alpha)}.$$

Now as  $x \to \infty$ , we have

$$f_X(x) \sim x^{\alpha-1} e^{-\frac{x}{\theta}}$$

We see that the exponential term decays faster than the rate of growth of  $x^{\alpha-1}$  for any  $\alpha>0$ . Thus all moments of the Gamma distribution exists.

We say that the Gamma distribution has a exponential tail.

# Exercise 8.1.1

The Normal distribution has an exponential tail.

We say that a distribution is a heavy-tailed distribution if its moments only exist up to some  $k \in \mathbb{N} \setminus \{0\}$ .

We say that a distribution is a light-tail distribution if its moments exist for all  $k \in \mathbb{N} \setminus \{0\}$ .

#### 66 Note

We may also use the mgf to determine if a distribution has a heavy or light tail; the inexistence of the kth moment implies the inexistence of the mgf, i.e. if the mgf does not exist, then the moments of the distribution is only finite up to some  $k \in \mathbb{N} \setminus \{0\}$ .

The actual definition, or should I say notion, of tail-heaviness comes from talking about the boundedness of the tail of the distribution, with reference to the exponential distribution. If a distribution has a tail that has greater value than the tail of the exponential distribution, then we say that the distribution has a heavy-tail.

# 8.1.1.1 Limiting Ratio: Survival Functions

# Definition 31 (Limiting Ratio)

The **limiting ratio** of **two survival functions** is used to compare the heaviness of tails of the two losses. Consider two losses X and Y, and consider the limit of the ratio

$$\lim_{x\to\infty}\frac{\bar{F}_X(x)}{\bar{F}_Y(x)}.$$

If the limit does not exist, we say that the comparison is inconclusive. Otherwise, we have 3 cases:

- If c = 0, then  $\overline{F}_X(x)$  decays faster than  $\overline{F}_Y(x)$  as  $x \to \infty$ , i.e. Y has a heavier tail than X;
- If  $0 < c < \infty$ , then  $\overline{F}_X(x)$  and  $\overline{F}_Y(x)$  decays at the smae rate, as  $x \to \infty$ , i.e. X and Y have similar tails;
- If  $c = \infty$ , then  $\overline{F}_X(x)$  decays slower than  $\overline{F}_Y(x)$  as  $x \to \infty$ , i.e. X has a heavier tail than Y;

where we let

$$c:=\lim_{x\to\infty}\frac{\overline{F}_X(x)}{\overline{F}_Y(x)}$$

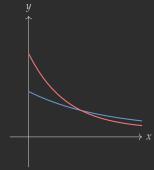


Figure 8.1: Limiting Ratio

#### 66 Note

Not all distributions have an explicit survival function, but they will always have a pdf/pmf. Fortunately, by L'Hôpital's Rule, the above definition can be applied to the pdfs of X and Y, i.e.

$$c = \lim_{x \to \infty} \frac{\overline{F}_X(x)}{\overline{F}_Y(x)} = \lim_{x \to \infty} \frac{-f_X(x)}{-f_Y(x)} = \lim_{x \to \infty} \frac{f_X(x)}{f_Y(x)}$$

#### Example 8.1.3

Show that the Pareto distribution has a heavier tail than the Gamma distribution using limiting ratio.

#### Solution

Let  $X \sim \text{Pareto}(\alpha, \theta)$  and  $Y \sim \text{Gam}(\tau, \lambda)$ . We have

$$c = \lim_{x \to \infty} \frac{f_X(x)}{f_Y(x)} = \lim_{x \to \infty} \frac{\frac{\alpha \theta^{\alpha}}{(x+\theta)^{\alpha+1}}}{\frac{x^{\tau-1}e^{-\frac{x}{\lambda}}}{\lambda^{\tau}\Gamma(\tau)}} = \alpha \theta^{\alpha} \lambda^{\tau} \Gamma(\tau) \lim_{x \to \infty} \frac{e^{\frac{x}{\lambda}}}{x^{\tau-1}(x+\theta)^{\alpha+1}}$$

Since the exponential term grows faster than the term in the denominator, we have  $c = \infty$ , i.e. X has a heavier tail than Y, as required.

# Example 8.1.4

For two losses *X* and *Y*, suppose that  $f_X(x) = \frac{2}{\pi(1+x^2)}$  and  $f_Y(x) =$  $\frac{1}{(1+x^2)}$  for x>0. Compare the tail heaviness of the two losses.

## Solution

Notice that

$$c = \lim_{x \to \infty} \frac{f_X(x)}{f_Y(y)} = \lim_{x \to \infty} = \frac{2}{\pi} < \infty,$$

i.e. *X* and *Y* have similar tails.

#### Hazard Rate 8.1.1.2

RECALL Definition 12. We had

$$h(x) = rac{f(x)}{\overline{F}(x)} = -rac{d}{dx} \ln \overline{F}(x),$$
 $h_X(x)\Delta x pprox P(X \le x + \Delta x \mid X > x)$ 

and the hazard rate function relates to the survival function as

$$\overline{F}(x) = e^{-\int_{-\infty}^{x} h(y) \, dy}.$$

Notice that

- if the hazard rate function is a **decreasing** function, that implies that the probability of the occurrence of  $X \le x + \Delta x$  decreases given X > x, as x increases, i.e. it is more likely that we have  $X > x + \Delta x \mid X > x$ . So X has a **heavy tail**.
- if the hazard rate function is a **increasing** function, that implies that the probability of the occurrence of  $X \le x + \Delta x$  increases given X > x, as x increases, i.e. it is less likely that  $X > x + \Delta x \mid X > x$ . So X has a **light tail**.

# Definition 32 (Decreasing and Increasing Failure Rates)

Let X be a loss with hazard rate function  $h_X$ . We say that<sup>1</sup>

- X or  $F_X$  has a decreasing failure rate (DFR) if  $h_X$  is decreasing;
- X or  $F_X$  has a increasing failure rate (IFR) if  $h_X$  is increasing.

¹ The following source claims that the failure rate and hazard rate are, in fact, not always interchangable terms: https://nomtbf.com/2013/11/ difference-hazard-failure-rate/. Perhaps this is worth looking into.

#### 66 Note

Consequently,

- Distributions that have a DFR are heavy-tailed;
- *Distributions that have an IFR are light-tailed.*

# • Proposition 10 (Exponential has Constant Hazard Rate)

The exponential distribution has a constant hazard rate.

#### Proof

The pdf and survival function of  $X \sim \text{Exp}(\lambda)$  is

$$f_X(x) = \lambda e^{-\lambda x}$$
 and  $\bar{F}_X(x) = e^{-\lambda x}$ ,

respectively. Thus the hazard rate of *X* is

$$h(x) = \frac{f_X(x)}{\overline{F}_X(x)} = \lambda,$$

which is a fixed value.

## 66 Note

We say that the exponential distribution is the only distribution which is said to have both DFR and IFR.2

<sup>2</sup> Why?

## Example 8.1.5

Let  $X \sim \operatorname{Pareto}(\alpha, \theta)$  with  $f_X(x) = \frac{\alpha \theta^{\alpha}}{(x+\theta)^{\alpha+1}}$  and  $\overline{F}_X(x) = \frac{\theta^{\alpha}}{(x+\theta)^{\alpha}}$ . Determine whether X has a DFR or IFR.

#### Solution

The hazard rate function of *X* is

$$h_X(x) = \frac{f_X(x)}{\overline{F}_X(x)} = \frac{\frac{\alpha \theta^{\alpha}}{(x+\theta)^{\alpha+1}}}{\frac{\theta^{\alpha}}{(x+\theta)^{\alpha}}} = \frac{\alpha}{x+\theta}.$$

It is clear that  $h_X$  is a decreasing function, and so  $X \sim \text{Pareto}(\alpha, \theta)$ has a DFR, i.e. it is heavy-tailed.

It is not always easy to get the survival function. The following is an alternative approach to finding out if the hazard rate function is increasing or decreasing.

#### • Proposition 11 (Ratio Comparison for DFR/IFR)

Let X be an rv, and<sup>3</sup>

$$s(x) = \frac{f_X(x+y)}{f_X(x)}.$$

- 1. If s(x) is increasing in x for every y, then X has a DFR;
- 2. If s(x) is decreasing in x for every y, then X has an IFR.

<sup>3</sup> Any bounds on 1/?

## Proof

We shall prove for one case as the other will follow analogously. Notice that

$$h_X(x) = \frac{f_X(x)}{\bar{F}_X(x)} = \frac{f_X(x)}{\int_x^{\infty} f_X(y) \, dy} = \frac{1}{\int_0^{\infty} \frac{f_X(x+y)}{f_X(x)} \, dy}$$

by a change of variable in the last equality. We notice that if  $\frac{f_X(x+y)}{f_X(x)}$  is increasing, then  $h_X(x)$  will be decreasing, and so X has a DFR.  $\square$ 

#### Example 8.1.6

Let  $X \sim \text{Gam}(\alpha, \theta)$  with  $\alpha > 1$ . Determine whether X is a DFR or IFR distribution.

## Solution

The cdf of *X* is

$$f_X(x) = \frac{x^{\alpha-1}e^{-\frac{x}{\theta}}}{\theta^{\alpha}\Gamma(\alpha)}.$$

The survival function of *X* is not explicit, and so we should use

• Proposition 11. We have

$$\frac{f_X(x+y)}{f_X(x)} = \frac{\frac{(x+y)^{\alpha-1}e^{-\frac{x+y}{\theta}}}{\theta^{\alpha}\Gamma(\alpha)}}{\frac{x^{\alpha-1}e^{-\frac{x}{\theta}}}{\theta^{\alpha}\Gamma(\alpha)}} = \left(\frac{x+y}{x}\right)^{\alpha-1}e^{-\frac{y}{\theta}} = \left(1+\frac{y}{x}\right)^{\alpha-1}e^{-\frac{y}{\theta}}.$$

To try to determine if it is increasing or decreasing, we calculate the second derivative of the ratio:

$$\frac{d}{dx}\left(1+\frac{y}{x}\right)^{\alpha-1}e^{-\frac{y}{\theta}} = y(\alpha-1)\left(1+\frac{y}{x}\right)^{\alpha-2}e^{-\frac{y}{\theta}}.$$

It is important to note that y is not completely free: it is bounded below by -x, as if y < -x, then x + y < 0, and f is undefined at these values. Also, if y = -x, then the ratio is simply a constant, and we cannot use f Proposition 11 to reach a conclusion. To be able to use f Proposition 11, we must have f Proposition 11, we must have f Proposition 12. In this case, it is clear that the ratio is increasing as f increases. Thus f has an IFR.

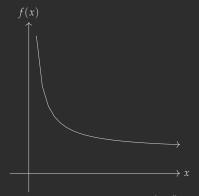


Figure 8.2: Graph of  $\left(1 + \frac{y}{x}\right)^{\alpha - 1} e^{-\frac{y}{\theta}}$  for y > -x and x > 0.

# 9 Lecture 9 Oct 11th

- 9.1 Severity Distributions Tail of Distributions (Continued 2)
- 9.1.1 Mean Excess Loss

# Definition 33 (Excess Loss Random Variable)

For a loss rv X, we define the excess loss rv as

$$T_d = X - d \mid X > d, \quad d > 0.$$

The survival function of  $T_d$  is

$$\begin{split} \bar{F}_{T_d}(x) &= P(T_d > x) = P(X - d > x \mid X > d) \\ &= \frac{P(X > x + d)}{P(X > d)} = \frac{\bar{F}_X(x + d)}{\bar{F}_X(d)}. \end{split}$$

As defined before in 🗗 Definition 22,

#### Definition (Mean Excess Loss)

The mean excess loss (or mean residual life) function is defined as

$$e_X(d) = E[T_d] = \int_0^\infty \bar{F}_{T_d}(x) \, dx = \frac{\int_0^\infty \bar{F}_X(x+d) \, dx}{\bar{F}_X(d)} = \frac{\int_d^\infty \bar{F}_X(y) \, dy}{\bar{F}_X(d)}$$

Essentially, the mean excess loss is the average payment in excess of the threshold *d*, given that the loss exceeds the threshold.

# Definition 34 (Increasing and Decreasing Mean Residual Lifetime)

Given a loss rv X,

- 1. we say X or  $F_X$  is an increasing mean residual lifetime (IMRL) if  $e_X(x)$  is increasing in x;
- 2. we say X or  $F_X$  is an decreasing mean residual lifetime (DMRL) if  $e_X(x)$  is decreasing in x.

## 66 Note

- IMRL distributions are heavy-tailed;
- DMRL distributions are light-tailed.

The reason of this claim should be rather clear from the context of  $e_X(x)$ : if  $e_X(x)$  is increasing with x, then we expect that the survival probability of  $T_d$  to be greater, and so the tail should be a heavy one. The following proposition clarifies this notion.

# • Proposition 12 (Relation between DFR/IFR and IMRL/DMRL)

A DFR rv is IMRL, and an IFR rv is a DMRL.

#### Proof

Suppose *X* has a DFR. The mean excess loss of *X* is

$$e_X(d) = \frac{\int_0^\infty \overline{F}_X(x+d) dx}{\overline{F}_X(d)} = \int_0^\infty \frac{\overline{F}_X(x+d)}{\overline{F}_X(d)} dx.$$

Note that by the relationship between the survival function and the hazard rate<sup>1</sup>,

$$\frac{\bar{F}_X(x+d)}{\bar{F}_X(d)} = \frac{e^{-\int_0^{x+d} h_X(y) \, dy}}{e^{-\int_0^d h_X(y) \, dy}} = e^{-\int_d^{x+d} h_X(y) \, dy} = e^{-\int_0^x h_X(z+d) \, dz}.$$

Since X has a DFR,  $h_X$  is decreasing, and thus  $\frac{\overline{F}_X(x+d)}{\overline{F}_X(d)}$  is increasing. Thus  $e_X(d)$  is increasing and so X is a IMRL, as required. THe argument is similar for IFL being a DMRL.

<sup>&</sup>lt;sup>1</sup> We use the hazard rate here because it is provided by the assumption.

Let  $X \sim \text{Wei}(\theta, \tau)$ . Determine whether X is DMRL or IMRL.

#### Solution

Since

$$f_X(x) = \frac{\tau x^{\tau - 1} e^{-\left(\frac{x}{\theta}\right)^{\tau}}}{\theta^{\tau}}$$

and from an earlier example, we have

$$\bar{F}_X(x) = e^{-\left(\frac{x}{\theta}\right)^{\tau}}$$

Then the hazard rate is

$$h_X(x) = \frac{f_X(x)}{\overline{F}_X(x)} = \frac{\tau}{\theta^{\tau}} x^{\tau - 1}.$$

Now if  $\tau \geq 1$ , then  $h_X(x)$  is an increasing function, and so X has an IFR, i.e. X is a DMRL. if  $0 < \tau \le 1$ , then  $h_X(x)$  is a decreasing function, and so *X* has a DFR, i.e. *X* is an IMRL.

#### Example 9.1.2

Consider a loss X with  $f_X(x) = (1 + 2x^2)e^{-2x}$  for x > 0.

- 1. Determine  $h_X(x)$ .
- 2. Determine  $e_X(x)$ .
- 3. Find  $\lim_{x \to \infty} h_X(x)$  and  $\lim_{x \to \infty} e_X(x)$ .
- 4. Show that *X* is DMRL but not IFR.

## Solution

Since both  $h_X(x)$  and  $e_X(x)$  require the survival function, we shall first derive that. Observe that<sup>2</sup>

$$\begin{split} \bar{F}_X(x) &= \int_x^\infty (1 + 2y^2) e^{-2y} \, dy = \frac{1}{2} e^{-2x} + 2 \left[ \int_x^\infty y^2 e^{-2y} \, dy \right] \\ &= \frac{1}{2} e^{-2x} + 2 \left[ -\frac{1}{2} y^2 e^{-2y} \Big|_x^\infty + \int_x^\infty y e^{-2y} \, dy \right] \\ &= \frac{1}{2} e^{-2x} + x^2 e^{-2x} + 2 \left[ -\frac{1}{2} y e^{-2y} \Big|_x^\infty + \frac{1}{2} \int_x^\infty e^{-2y} \, dy \right] \\ &= \frac{1}{2} e^{-2x} + x^2 e^{-2x} + x e^{-2x} + \frac{1}{2} e^{-2x} \\ &= (x^2 + x + 1) e^{-2x}. \end{split}$$

<sup>&</sup>lt;sup>2</sup> It is highly recommended that one gets really used to using integration by parts, to the point that you do not have to repeatedly write down what the uand dv are explicitly every time.

1. It is clear that

$$h_X(x) = \frac{1 + 2x^2}{1 + x + x^2}$$

2. By its definition, we have that

$$e_X(x) = rac{\int_x^\infty \overline{F}_X(y) \, dy}{\overline{F}_X(x)},$$

and so we need to solve for the integral in the numerator. Using pieces from our derivation of  $\bar{F}_X(x)$ , we obtain

$$\begin{split} & \int_{x}^{\infty} (1+y+y^{2})e^{-2y} \, dy \\ & = \frac{1}{2}e^{-2x} + \frac{1}{2}xe^{-2x} + \frac{1}{4}e^{-2x} + \frac{1}{2}x^{2}e^{-2x} + \frac{1}{2}xe^{-2x} + \frac{1}{4}e^{-2x} \\ & = \left(1 + x + \frac{1}{2}x^{2}\right)e^{-2x}. \end{split}$$

Thus

$$e_X(x) = \frac{1+x+\frac{1}{2}x^2}{1+x+x^2}.$$

3. The answers are straightforward<sup>3</sup>

$$\lim_{x \to \infty} h_X(x) = \lim_{x \to \infty} \frac{\frac{1}{x^2} + 2}{1 + \frac{1}{x} + \frac{1}{x^2}} = 2$$

$$\lim_{x \to \infty} e_X(x) = \lim_{x \to \infty} \frac{\frac{1}{x^2} + \frac{1}{x} + \frac{1}{2}}{\frac{1}{x^2} + \frac{1}{x} + 1} = \frac{1}{2}$$

4. First, observe that

$$e'_X(x) = \frac{(1+x)\left(1+x+x^2\right) - (1+2x)\left(1+x+\frac{1}{2}x^2\right)}{(1+x+x^2)}$$
$$= -\frac{x+\frac{1}{2}x^2}{(1+x+x^2)^2},$$

and we see that  $e_X'(x) < 0$  for x > 0. Thus X has a DMRL. For  $h_X(x)$ ,

$$h'_X(x) = \frac{4x(1+x+x^2) - (1+2x)(1+2x^2)}{(1+x+x^2)^2}$$
$$= \frac{2x^2 + 2x - 1}{x^4 + 2x^3 + 3x^3 + 2x + 1}.$$

It may appear as if  $h_X'(x)$  is positive, seeing that  $x^4$  should domi-

<sup>3</sup> Find out why did we calculate these values.

nate. However, notice that the discriminant is positive:4

$$2^2 - 4(2)(-1) = 12 > 0$$
,

and so the numerator has a root, i.e. there are critical points on  $h_X(x)$ . In fact, equating the said numerator to 0, we can obtain that  $x = -\frac{1}{2} + \sqrt{\frac{3}{4}}$  (the other case is ruled out as x > 0). Since  $h'_X(x)$  looks as if it is increasing, let's try out some values of x for  $0 < x < \sqrt{\frac{3}{4} - \frac{1}{2}}$ . In particular, notice that

$$h_X\left(\frac{1}{10}\right) = \frac{102}{111} \approx 0.9198$$
 $h_X\left(\frac{1}{5}\right) = \frac{27}{31} \approx 0.8710$ 

but  $\frac{1}{10} < \frac{1}{5}$ , and so we notice that *X* is not IFR.

<sup>4</sup> Lecture notes simply threw the values 1 and  $\frac{1}{2}$  for x almost out of nowhere. While the result seems harmless, firstly,  $x \neq 0$ , since x > 0. In fact, since the critical point is  $\sqrt{\frac{3}{4}} - \frac{1}{2} \approx 0.366$ ,  $\frac{1}{2}$ is a value that comes after the critical point, so we would not have been able to verify without trying and failing numerous times, especially since the critical point is an irrational value.

Here, we are smart and equipped with the knowledge that by solving the first derivative for *x* by equating to 0 allows us to find these critical points, which is indicative of a change from positive to negative, or vice versa, slope

# 10 Lecture 10 Oct 16th

# 10.1 Severity Distributions — Policy Adjustments (Continued)

Insurance policies contain various **adjustments** to soften the amount that insurers have to pay, to minimize moral hazards, and for various other reasons. In this section, we shall introduce some common policy adjustments.

In the following definitions, suppose that *X* is our ground-up loss rv, and *H* a function incurred by the adjustment.

# Definition 35 (Policy Limit)

A fixed level u > 0 is called a **policy limit** if, provided that there are no other adjustments, the insurer shall pay<sup>1</sup>

$$H(X) = \min\{X, u\} := X \wedge u = \begin{cases} X & X \leq u \\ u & X \geq u \end{cases}.$$

#### 66 Note

- A policy limit protects the insurer from overly large losses.
- This is noteworthy: in practice, a policy limit may refer to the maximum amount paid by the insurer, but in this course, it is the maximum loss coverred by the insurer.

¹ Now that this definition uses the symbol ∧ for denoting a policy limit, I shall refrain from using the same symbol in proofs, unless if the context is clear.

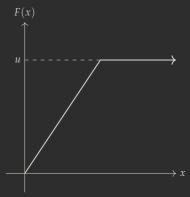


Figure 10.1: Typical graph of a policy limit, without other adjustments.

A fixed level d > 0 is called an **ordinary deductible** if, given that there are no other adjustments, the insurer pays

$$Y = H(X) = (X - d)_{+} = X \lor d = \begin{cases} 0 & X < d \\ X - d & X \ge d \end{cases}$$

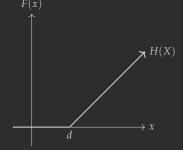


Figure 10.2: Graph of a policy with ordinary deductible without any other adjustments.

# 66 Note

- For any given loss, the first d dollars falls on the insured.
- It is a protection against frequent small claims.

# Definition 37 (Franchise Deductible)

A fixed level d > 0 is called a **Franchise Deductible** if, given that there are no other adjustments, the insurer pays

$$H(X) = X \cdot \mathbb{1}_{\{X > d\}} = \begin{cases} 0 & X \le d \\ X & X > d \end{cases}$$
$$= (X - d)\mathbb{1}_{\{X > d\}} + d \cdot \mathbb{1}_{\{X > d\}}$$
$$= (X - d)_{+} + d \cdot \mathbb{1}_{\{X > d\}}$$

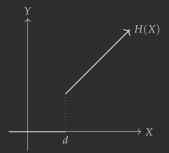


Figure 10.3: Graph of a policy with Franchise deductible without any other adjustments.

#### 66 Note

- This differs from the ordinary deductible in that twhen the loss exceeds d, the deductible is waived and the full loss is paid by the insurer.
- We are not concerned with whether the payment goes out or not at X = d in this course.<sup>2</sup>

<sup>2</sup> In the event that a problem of such a nature comes out in either exercises or exams, the point will be explicitly stated.

#### Remark

This is not a good adjustment as it is prone to moral hazard.

Definition 38 (Coinsurance)

A fixed rate  $\alpha \in [0,1]$  is called a **coinsurance factor** if, given that there are no other adjustments, the insurer pays

$$H(X) = \alpha X$$
.

For any given loss, the insurer pays a proportion  $100\alpha\%$  of the loss amount the remaining  $100(1-\alpha)\%$  falls on the insured.

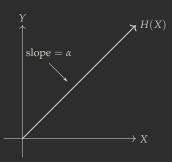


Figure 10.4: Graph of a policy with coinsurance without any other adjustments

# 10.1.1 Application Order for Multiple Adjustments

IF AN INSURANCE POLICY has more than one adjustment, we assume the adjustments in the following order:

- Policy limit (if any)
- Policy/ordinary deductible (if any)
- Coninsurance (if any)

#### 66 Note

- These transformations are not necessarily commutative, so the order must be obeyed.
- This ordering is optimal, i.e. it covers for all possible combinations, i.e. any other ways of adjustment can be expressed in this form.<sup>3</sup>
- If d is a deductible and u the policy limit, we must have that d < u, since if u < d, then the insurer will only pay the maximum amount u if the loss exceeds d, which is absurd. Therefore, for all of the cases that we shall consider, we will always assume, and safely so, that d < u.

<sup>3</sup> Claimed by lecturer. Require example.

Applying the ordering, we have

$$X \to X \land u \to [(X \land u) - d]_+ \to \alpha[(X \land u) - d]_+$$

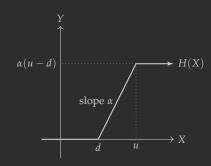


Figure 10.5: Graph of  $H(X) = \alpha[(X \wedge u) - d]_{+}$ .

and so

$$H(X) = \alpha[(X \wedge u) - d]_{+} = \begin{cases} 0 & X < d \\ \alpha(X - d) & d \le X < u \\ \alpha(u - d) & X \ge u \end{cases}$$

For the case of applying Franchise deductible instead of ordinary deductible, we have

$$X \to X \wedge u \to (X \wedge u) \mathbb{1}_{\{X > d\}} \to \alpha(X \wedge u) \cdot \mathbb{1}_{\{X > d\}}$$

Notice that  $X \wedge u \to (X \wedge u) \mathbb{1}_{\{X > d\}}$ , since  $X \wedge u > d$  is simply X > d as u > d by assumption. We have that for the case where we consider the Franchise deductible instead of an ordinary deductible,

$$H(X) = \alpha(X \wedge u) \cdot \mathbb{1}_{\{X > d\}} = \begin{cases} 0 & X < d \\ \alpha X & d \le X < u \\ \alpha u & X \ge u \end{cases}$$

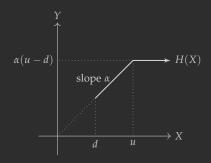


Figure 10.6: Graph of  $H(X) = \alpha(X \land u) \cdot \mathbb{1}_{\{X > d\}}$ .

# 10.1.2 🛊 Reporting Methods

When we consider the amount paid by the insurer, we typically consider (and distinguish) between two types of reporting methods.

- Loss basis:  $Y_L$  = amount paid per loss
- **Payment basis**:  $Y_P$  = amount paid per payment

It is sensible that

$$Y_P = Y_L \mid Y_L > 0. {(10.1)}$$

The above relationship shows that we can retrieve  $Y_P$  from  $Y_L$ , i.e.  $Y_L$  holds more information than  $Y_P$ . This makes sense; a loss may occur, but the insurer may not have to pay for the loss. For example, if the incurred loss is below a given deductible level.

#### 10.1.2.1 Loss Basis

- Each loss is recorded, i.e. each loss has an entry, even if the amount paid is 0.
- For a policy limit u, ordinary deductible d with  $d < u^4$ , and

<sup>&</sup>lt;sup>4</sup> It would be silly if d > u.

$$Y_L = \alpha[(X \wedge u) - d]_+.$$

• For a policy with limit u, Franchise deductible d with d < u, and coinsurance factor  $\alpha$ , we have

$$Y_L = \alpha(X \wedge u) \mathbb{1}_{\{X > d\}}.$$

• Note that in the presence of a deductible *d*, it is **usually the case** that *Y*<sub>L</sub> has a probability mass at 0, i.e.

$$P(Y_L = 0) = P(X \le d) = F_X(d) > 0.$$

In this case,  $Y_P > 0$  almost surely.

# 10.1.2.2 Payment Basis

- Only non-zero payments of the insurer are included, and so not every loss will have an entry. Here, we see that Y<sub>P</sub> leaves that information behind.<sup>5</sup>
- $Y_P$  does not have a probability mass at 0 (Why?), i.e.

$$P(Y_P=0)=0,$$

or equivalently,

$$Y_{P} > 0$$

## **Example 10.1.1**

Let X be the ground-up loss rv and assume that there is an ordinary deductible of 5 applied to the loss. The following table is a typical example illustrating how  $Y_L$  and  $Y_P$  works.

X	3	2	5	7	9	10
$Y_L$	О	o NA	О	2	4	5
$Y_P$	NA	NA	NA	2	4	5

Table 10.1: Example illustrating the relationship between  $Y_P$  and  $Y_L$ .

<sup>&</sup>lt;sup>5</sup> It is still useful to reporting purely on the financial effects of the claims.

# 11 Lecture 11 Oct 18th

# **11.1** Severity Distribution — Policy Adjustments (Continued 2)

# **11.1.1** Distribution & Moments of $Y_P$ and $Y_L$

It suffices for us to closely study  $Y_L$  due to the following proposition:

# • Proposition 13 ( $Y_P$ is completely determined by $Y_L$ )

The survival function and moments of  $Y_P$  are given by

$$ar{F}_{Y_P}(y) = egin{cases} rac{1}{ar{F}_{Y_L}(y)} & y < 0 \ rac{ar{F}_{Y_L}(0)}{ar{F}_{Y_L}(0)} & y \geq 0 \end{cases}$$

and

$$E\left[Y_P^k\right] = \frac{E\left[Y_L^k\right]}{\bar{F}_{Y_L}(0)}, \quad k = 1, 2, \dots$$

## Proof

Using the definition of a survival function, we have

$$\bar{F}_{Y_P}(x) = P(Y_P > x) = P(Y_L > x \mid Y_L > 0) = \begin{cases} 1 & x < 0 \\ \frac{\bar{F}_{Y_L}(x)}{\bar{F}_{Y_L}(0)} & x \ge 0 \end{cases}.$$

Consequently,

$$e\left[Y_P^k\right] = k \int_0^\infty x^{k-1} \overline{F}_{Y_P}(x) \, dx = k \int_0^\infty x^{k-1} \frac{\overline{F}_{Y_L}(x)}{\overline{F}_{Y_L}(0)} \, dx = \frac{E\left[Y_L^k\right]}{\overline{F}_{Y_L}(0)}.$$

#### 66 Note

• Proposition 13 tells us that it suffices to discover the distribution of  $Y_L$ , since it completely determines  $Y_P$ ,

#### Remark

- If there is a deductible d>0, then the distributions of  $Y_P$  and  $Y_L$  are usually different.
- If  $Y_L$  has no mass point at 0, i.e.  $\bar{F}_{Y_L}(0) = 1$ , then  $Y_P$  nand  $Y_L$  have the same distribution.

<sup>1</sup> This depends on the distribution of X and  $Y_L$ .

# 11.1.2 Some Important Identities

The following proposition is important for us to venture forward.

# **♦** Proposition 14 (★★ Expected Value of the Policy Adjustments)

Consider a non-negative rv X and d > 0. Then

1. We have

$$E[X] = E[[X - d]_{+}] + E[X \wedge d].$$

2. For k = 1, 2, ...,

$$E\left[X^{k}\right] = \int_{0}^{\infty} x^{k-1} \bar{F}_{X}(x) \, dx.$$

3. For k = 1, 2, ...,

$$E\left[(X\wedge d)^k\right] = \int_0^d k x^{k-1} \bar{F}_X(x)\,dx.$$

4. For k = 1, 2, ...,

$$E\left[[X-d]_+^k\right] = \int_d^\infty k(x-d)^{k-1} \overline{F}_X(x) \, dx.$$

5. For  $k = 1, 2, ..., and \bar{F}_X(d) > 0$ ,

$$E\left[(X-d)^k\mid X>d\right] = \frac{E\left[[X-d]_+^k\right]}{\bar{F}_X(d)} = \frac{\int_d^\infty k(x-d)^{k-1}\bar{F}_X(x)\,dx}{\bar{F}_X(d)}.$$

$$e_X(d) = E[X - d \mid X > d] = \frac{\int_d^\infty \overline{F}_X(x) dx}{\overline{F}_X(d)}.$$

## Proof

1. For this identity, notice that

$$[X-d]_+ + (X \wedge d) = egin{cases} 0+X & X \leq d \ X-d+d & X>d \end{cases} = X.$$

The result follows from linearity of *E*.

2. We have proved this earlier on, but it shall be re-proved for exercise, variety, and ease of reference.<sup>2</sup>

$$E\left[X^{k}\right] = \int_{0}^{\infty} x^{k} f_{X}(x) dx = \int_{0}^{\infty} x^{k} \frac{d}{dx} F_{X}(x) dx$$

$$= \int_{0}^{\infty} x^{k} dF_{X}(x) = \int_{0}^{\infty} x^{k} d(1 - \overline{F}_{X}(x))$$

$$= -\int_{0}^{\infty} x^{k} d\overline{F}_{X}(x)$$

$$= -x^{k} \overline{F}_{X}(x) \Big|_{0}^{\infty} + k \int_{0}^{\infty} x^{k-1} \overline{F}_{X}(x) dx \quad \therefore \text{ IBP}$$

$$= k \int_{0}^{\infty} x^{k-1} \overline{F}_{X}(x) dx,$$

under the assumption that  $\overline{F}_X(x)$  decays faster than  $x^k$  3.

3. Using a similar argument as in the earlier part of the last proof, and by the Law of the Unconscious Statistician, we can arrive at

$$E\left[(X\wedge u)^k\right] = -\int_0^\infty (x\wedge u)^k \, d\overline{F}_X(x).$$

To proceed, use integration by parts as follows<sup>4</sup>:

$$u = (x \wedge u)^k$$
  $v = \overline{F}_X(x)$   
 $du = d(x \wedge u)^k$   $dv = d\overline{F}_X(x)$ 

We get

$$E\left[(X\wedge u)^k\right] = -(x\wedge u)^k \overline{F}_X(x)\Big|_0^\infty + \int_0^\infty \overline{F}_X(x)\,d(x\wedge u)^k,$$

- <sup>2</sup> Important: There are two rules that you must use, and it does not depend on any of your existing knowledge as an undergrad whatsoever.
- (a) Notice that  $\frac{d}{dx}F_X(x) = f_X(x) \implies -d\overline{F}_X(x) = f_X(x) dx$ ;
- (b) While using integration by parts, let  $dv = d\bar{F}_X(x)$  so that  $v = \bar{F}_X(x)$ . Forget any one of these are prepare to be screwed over.
- <sup>3</sup> How unlikely is this, I do not know.

<sup>4</sup> This is hopeless. If you can't remember this, or somehow make some sense of this monster (without going through a few lectures on Lesbesgue or Riemann-Stieljes integration), you're screwed.

and  $(x \wedge u)^k \overline{F}_X(x)\Big|_0^\infty = 0$ . Next, it is a "fact" that

$$d(x \wedge u)^k = \begin{cases} kx^{k-1} dx & x < u \\ 0 & x \ge u \end{cases}$$

<sup>5</sup>Since x > u gives us a 0 term, we are left with

$$E\left[(X\wedge u)^k\right] = \int_0^u kx^{k-1}\bar{F}_X(x)\,dx.$$

4. Using the Law of the Unconscious Statistician and Item 2, we have

$$E\left[[X-d]_{+}^{k}\right] = k \int_{0}^{\infty} (x-d)_{+}^{k} \bar{F}_{X}(x) \, dx = k \int_{d}^{\infty} (x-d)^{k} \bar{F}_{X}(x) \, dx.$$

5. Notice once and for all that

$$\begin{split} E\left[(X-d)^k \mid X > d\right] &= \frac{E\left[(X-d)^k \mathbb{1}_{\{X > d\}}\right]}{\bar{F}_X(d)} \\ &= \frac{E\left[[X-d]_+^k\right]}{\bar{F}_X(d)} = \frac{\int_d^\infty k(x-d)^k \bar{F}_X(x) \, dx}{\bar{F}_X(d)}. \end{split}$$

<sup>5</sup> This is yet another monstrosity that makes no sense whatsoever for one that has only taken basic Calculus classes and introductory Analysis. **Remember this "fact"** or **get screwed over**. The only "sense" that I can come up with right now is to consider the cases of when x < u and when  $x \ge u$ , and determine what  $x \land u$  should be in these cases, and provide some baseless rationalization.

# Example 11.1.1

Consider a ground-up loss X with pdf

$$f_X(x) = 0.0005, \quad 0 \le x \le 20.$$

Solve for

- 1.  $\bar{F}_X(x)$ ;
- 2.  $E[X \wedge 10]$  and  $E[X \wedge 25]$ ;
- 3.  $Var(X \wedge 10)$ ;
- 4.  $E[[X-10]_+];$
- 5.  $E[[X-10]_{+}^{2}]$ ; and
- 6.  $e_X(10)$ .

# Solution

1. We have

$$F_X(x) = \int_0^x 0.005y \, dy = 0.0025x^2$$

and so

$$ar{F}_X(x) = egin{cases} 1 & x < 0 \ 1 - 0.0025x^2 & 0 \le x \le 20 \ 0 & x > 20 \end{cases}$$

2. Using our identities,

$$E[X \wedge 10] = \int_0^{10} \overline{F}_X(x) \, dx = 10 - \frac{5}{6000} (10)^3 = \frac{55}{6},$$

and

$$E[X \wedge 25] = \int_0^{20} \overline{F}_X(x) \, dx = 25 - \frac{5}{6000} (25)^3 = \frac{40}{3}.$$

3. To get  $Var(X \wedge 10)$ , we first need the 2nd moment of  $X \wedge 10$ :

$$E\left[(X \wedge 10)^2\right] = 2\int_0^{10} x\overline{F}_X(x) \, dx = 2\left[\frac{1}{2}x^2 - \frac{5}{8000}x^4\right]_0^{10}$$
$$= 100 - \frac{25}{2} = \frac{175}{2}.$$

Thus

$$Var(X \wedge 10) = \frac{175}{2} - \left(\frac{55}{6}\right)^2 = \frac{125}{36}.$$

4. We have that

$$E[[X-10]_{+}] = \int_{10}^{20} 1 - \frac{1}{400} x^{2} dx$$
$$= 10 - \frac{1}{1200} (8000 - 1000) = \frac{25}{6}.$$

5. We have that

$$E\left[[X-10]_{+}^{2}\right] = 2\int_{10}^{20} (x-10) \left(1 - \frac{1}{400}x^{2}\right) dx$$

$$= 2\int_{10}^{20} \left(-10 + x + \frac{1}{40}x^{2} - \frac{1}{400}x^{3}\right) dx$$

$$= 2\left[-100 + \frac{300}{2} + \frac{7000}{120} - \frac{150000}{1600}\right]$$

$$= \frac{175}{6}$$

6. We have

$$e_X(10) = \frac{\int_{10}^{20} \left(1 - \frac{1}{400}x^2\right) dx}{1 - \frac{1}{400}(10)^2} = \frac{10 - \frac{7000}{1200}}{\frac{3}{4}} = \frac{50}{9}$$

# **11.1.2.1** Application of **♦** Proposition 14

Policy Limit If a policy limit u is the only adjustment in a contract, then

$$Y_L = X \wedge u$$
 and  $Y_P = X \wedge u \mid X > 0$ .

Since in most cases X > 0, we have that  $\overline{F}_X(0) = 1$ , and so  $Y_L = Y_P = X \wedge u$ .

• The survival function is

$$\bar{F}_{Y_P}(y) = \bar{F}_{Y_L}(y) = P(X \land u > y) = \begin{cases} 1 & y < 0 \\ \bar{F}_X(y) & 0 \le y < u \\ 0 & y \ge u \end{cases}$$

• The expected value is

$$E[Y_P] = E[Y_L] = E[X \wedge u] = \int_0^u \overline{F}_X(x) dx.$$

• The second moment is

$$E\left[Y_P^2\right] = E\left[Y_L^2\right] = E\left[(X \wedge u)^2\right] = 2\int_0^u x\overline{F}_X(x) dx$$

*Ordinary Deductible* If an ordinary deductible *d* is the only adjustmnet in a contract, then

$$Y_L = [X - d]_+ = (X - d) \mathbb{1}_{\{X > d\}}$$

and

$$Y_P = [X-d]_+ \mid [X-d]_+ > 0 = (X-d)\mathbb{1}_{\{X>d\}} \mid X>d = X-d \mid X>d$$

In most cases, since  $\bar{F}_X(d) = P(X > d) < 1$  as it is  $P(X < d) \neq 0$ , the distribution of  $Y_L$  and  $Y_P$  differs.

$$\bar{F}_{Y_L}(y) = P([X-d]_+ > y) = \begin{cases} 1 & y < 0 \\ \bar{F}_X(y+d) & y \ge 0 \end{cases}$$

and

$$ar{F}_{Y_P}(y) = rac{ar{F}_{Y_L}(y)}{ar{F}_{Y_L}(0)} = egin{cases} 1 & y < 0 \ rac{ar{F}_X(d+y)}{ar{F}_X(d)} & y \geq 0 \end{cases}$$

for  $Y_L$  and  $Y_P$  respectively.

• The mean is

$$E[Y_L] = E[[X - d]_+] = \int_d^{\infty} \bar{F}_X(x) dx$$

and

$$E[Y_P] = E[X - d \mid X > d] = \frac{E[(X - d)\mathbb{1}_{\{X > d\}}]}{\overline{F}_X(d)} = \frac{\int_d^\infty \overline{F}_X(x) dx}{\overline{F}_X(d)}$$

for  $Y_L$  and  $Y_P$  respectively.

• The second moment is

$$E\left[Y_L^2\right] = E\left[[X - d]_+^2\right] = 2\int_d^\infty x \overline{F}_X(x) \, dx$$

and

$$E\left[Y_P^2\right] = \frac{E\left[Y_L^2\right]}{\overline{F}_{Y_L}(0)} = \frac{2\int_d^\infty x \overline{F}_X(x) \, dx}{\overline{F}_X(d)}$$

for  $Y_L$  and  $Y_P$  respectively.

# 12 Lecture 12 Oct 23rd

### **12.1** Severity Distribution — Policy Adjustments (Continued 3)

12.1.1 Some Important Identities (Continued)

### **12.1.1.1** Application of **6** Proposition 14 (Continued)

*Policy Limit* + *Ordinary Deductible* If there is a policy limit u and an ordinary deductible d with u > d, then

$$Y_{L} = [(X \wedge u) - d]_{+} = \begin{cases} 0 & X < d \\ X - d & d \le X < u \\ u - d & X \ge u \end{cases}$$

and so its survival function is1

$$\begin{split} \bar{F}_{Y_L}(y) &= P(Y_L > y) = P([(X \land u) - d]_+ > y) \\ &= P(\max\{0, (X \land u) - d\} > y) \\ &= \begin{cases} 1 & y < 0 \\ P((X \land u) - d > y) & y \ge 0 \end{cases} \\ &= \begin{cases} 1 & y < 0 \\ P(X > y + d) & 0 \le y < u - d \\ P(u > y + d) & y \ge u - d \end{cases} \\ &= \begin{cases} 1 & y < 0 \\ \bar{F}_X(y + d) & 0 \le y < u - d \\ 0 & y \ge u - d \end{cases} \end{split}$$

<sup>&</sup>lt;sup>1</sup> Important: Pay attention to the notion here: we are using the actual definition of a deductible to arrive at an explicit solution.

Consequently, its moments are

$$\begin{split} E\left[Y_L^k\right] &= \int_0^\infty k y^{k-1} \bar{F}_{Y_L}(y) \, dy \\ &= \int_0^{u-d} k y^{k-1} \bar{F}_X(y+d) \, dy \\ &= \int_d^u k (y-d)^{k-1} \bar{F}_X(y) \, dy \end{split}$$

For  $Y_P$ , we have

$$Y_P = Y_L \mid Y_L > 0 = [(X \wedge u) - d]_+ \mid [(X \wedge u) - d]_+ > 0$$
  
=  $(X \wedge u) - d \mid X > d$ .

Thus by 6 Proposition 13,

$$ar{F}_{Y_P}(y) = egin{cases} 1 & y < 0 \ rac{ar{F}_{Y_L}(y)}{ar{F}_{Y_L}(0)} & 0 \leq y < u - d \ 0 & y \geq u - d \end{cases}$$

Using the same proposition, the moments of  $Y_P$  are

$$E\left[Y_P^k\right] = \frac{E\left[Y_L^k\right]}{\overline{F}_X(d)} = \frac{\int_d^u k(y-d)^{k-1} \overline{F}_X(y) \, dy}{\overline{F}_X(d)}.$$

*Franchise Deductible* Given a Franchise Deductible d > 0, we have

$$Y_L = X \cdot \mathbb{1}_{\{X > d\}}$$
.

Its survival function is

$$\begin{split} \overline{F}_{Y_L}(y) &= P(X \cdot \mathbbm{1}_{\{X > d\}} > y) = \begin{cases} 1 & y < 0 \\ P(X \cdot \mathbbm{1}_{\{X > d\}} > y) & y \geq 0 \end{cases} \\ &= \begin{cases} 1 & y < 0 \\ \overline{F}_X(d) & 0 \leq y < d \\ \overline{F}_X(y) & y \geq d \end{cases} \end{split}$$

For the case when  $0 \le y < d$ , it is clear that in order for  $X \cdot \mathbb{1}_{\{X > d\}} >$ y, we first need X > d. Now the moments of  $Y_L$  are

$$\begin{split} E\left[Y_L^k\right] &= \int_0^\infty k y^{k-1} \bar{F}_{Y_L}(y) \, dy \\ &= \bar{F}_X(d) \int_0^d k y^{k-1} \, dy + \int_d^\infty k y^{k-1} \bar{F}_X(y) \, dy \\ &= d^k \bar{F}_X(d) + \int_d^\infty k y^{k-1} \bar{F}_X(y) \, dy. \end{split}$$

Now observe that

$$Y_P = Y_L \mid Y_L > 0 = X \cdot \mathbb{1}_{\{X > d\}} \mid X \cdot \mathbb{1}_{\{X > d\}} > 0 = X \mid X > d$$

Again, using 6 Proposition 13,

$$\bar{F}_{Y_P}(y) = \frac{\bar{F}_{Y_L}(y)}{\bar{F}_{Y_L}(0)} = \begin{cases} 1 & y < d \\ \frac{\bar{F}_X(y)}{\bar{F}_X(d)} & y \ge d \end{cases}$$

and its moments are

$$E\left[Y_P^k\right] = \frac{E\left[Y_L^k\right]}{\bar{F}_X(d)} = \frac{d^k \bar{F}_X(d) + \int_d^\infty ky^{k-1} \bar{F}_X(y) \, dy}{\bar{F}_X(d)}$$
$$= d^k + \frac{\int_d^\infty ky^{k-1} \bar{F}_X(y) \, dy}{\bar{F}_X(d)}.$$

Coinsurance Let  $\hat{Y}_L$  be the amount to-be-paid per loss without coinsurance. Let  $\alpha \in (0,1)$  be a coinsurance factor. Applying coinsurance for adjustment, we have that

$$Y_L = \alpha \hat{Y_L}$$
.

The survival function of  $Y_L$  is

$$\bar{F}_{Y_L}(y) = P\left(\alpha \hat{Y_L} > y\right) = P\left(\hat{Y_L} > \frac{y}{\alpha}\right) = \begin{cases} 1 & y < 0\\ \bar{F}_{\hat{Y_L}}\left(\frac{y}{\alpha}\right) & y \ge 0 \end{cases}$$

and its moments are

$$E\left[Y_L^k\right] = E\left[\alpha^k \hat{Y_L}^k\right] = \alpha^k E\left[\hat{Y_L}^k\right].$$

Then for  $Y_P$ , we have that its survival function is

$$ar{F}_{Y_P}(y) = rac{ar{F}_{Y_L}(y)}{ar{F}_{Y_L}(0)} = rac{ar{F}_{\hat{Y_L}}\left(rac{y}{lpha}
ight)}{ar{F}_{\hat{Y_L}}(0)}, \quad y \geq 0,$$

and its moments

$$E\left[Y_{P}^{k}\right] = \frac{E\left[Y_{L}^{k}\right]}{\bar{F}_{\hat{Y}_{I}}\left(0\right)} = \frac{\alpha^{k}E\left[\hat{Y}_{L}^{k}\right]}{\bar{F}_{\hat{Y}_{I}}\left(0\right)}.$$

### Example 12.1.1

The cdf of a ground-up loss X is given by

$$F_X(x) = 1 - \left(1 - \frac{x}{800}\right)^2, \quad 0 \le x \le 800.$$

Assuming a policy limit of 600, an ordinary deductible of 200, and a coinsurance facotr of 0.8, determine the cdf of  $Y_L$  and the expected amount paid per loss  $E[Y_L]$ .

### Solution

We are given

$$Y_L = 0.8[(X \wedge 600) - 200]_+.$$

The survival function of  $Y_L$  is

$$\begin{split} \overline{F}_{Y_L}(y) &= P\left(\max\{0, (X \land 600) - 200\} > \frac{y}{0.8}\right) \\ &= \begin{cases} 1 & y < 0 \\ P\left(X \land 600 > \frac{5y}{4} + 200\right) & y \ge 0 \end{cases} \\ &= \begin{cases} 1 & y < 0 \\ P\left(X > \frac{5y}{4} + 200\right) & 0 \le y < 0.8(600 - 200) = 320 \\ 0 & y \ge 320 \end{cases} \\ &= \begin{cases} 1 & y < 0 \\ \overline{F}_X\left(\frac{5y}{4} + 200\right) & 0 \le y < 320 \\ 0 & y \ge 320 \end{cases} \end{split}$$

Thus the cdf of  $Y_L$  is

$$ar{F}_{Y_L}(y) = egin{cases} 0 & y < 0 \\ 1 - ar{F}_X \left( rac{5y}{4} + 200 
ight) & 0 \leq y < 320 \ 1 & y \geq 320 \end{cases}.$$

The expected amount paid per loss is

$$E[Y_L] = 0.8 \int_{200}^{600} \left(1 - \frac{x}{800}\right)^2 dx = \frac{260}{3}$$

### Example 12.1.2

Consider a ground-up loss *X* with a Franchise deductible *d*. You are given that

- 15% of the losses are below the Franchise deductible *d*,
- the mean excess loss  $e_X(d) = 50$ ,
- the expected amount paid per loss is 51.

Determine the value of d.

### Solution

We are given

$$Y_L = X \cdot \mathbb{1}_{\{X > d\}}$$
$$P(X < d) = 0.15$$

Thus P(X > d) = 0.85. We have

$$ar{F}_{Y_L}(y) = egin{cases} 1 & y < 0 \\ ar{F}_X(d) & 0 \leq y < d = \\ ar{F}_X(y) & y \geq d \end{cases} egin{cases} 1 & y < 0 \\ 0.85 & 0 \leq y < d \\ ar{F}_X(y) & y \geq d \end{cases}$$

We are given

$$50 = e_X(d) = \frac{\int_d^\infty \overline{F}_X(y) \, dy}{\overline{F}_X(d)},$$

and so

$$\int_{d}^{\infty} \bar{F}_X(y) \, dy = 50 * 0.85 = 42.5.$$

We are given

$$51 = E[Y_L] = \int_0^\infty \bar{F}_X(y) \, dy = d\bar{F}_X(d) + \int_d^\infty \bar{F}_X(y) \, dy$$
$$= 0.85d + 42.5.$$

Thus

$$d = \frac{8.5}{0.85} = 10.$$

# 13 Lecture 13 Oct 25th

### 13.1 Severity Distribution — Policy Adjustments (Continued 3)

By introducing policy adjustments, it is within our interest to determine if the introduced adjustments have helped to eliminate the expected proportion of loss.

### Definition 39 (Loss Elimination Ratio)

The **loss elimination ratio**, denoted as LER, is the ratio of which loss has been mitigated, or eliminated, as a result of policy adjustments, and it is given by

$$LER = \frac{E[X - Y_L]}{E[X]} = 1 - \frac{E[Y_L]}{E[X]},$$

where  $\frac{E[Y_L]}{E[X]}$  corresponds to the percentage of loss retained by the insurer.

### Example 13.1.1

For a policy that has only an ordinary deductible, i.e.  $Y_L = [X - d]_+$ , we have

LER = 
$$1 - \frac{E([X - d]_+)}{E[X]} = 1 - \frac{E[X] - E[X \wedge d]}{E[X]} = \frac{E[X \wedge d]}{E[X]}.$$

### Example 13.1.2

Consider a ground-up loss  $X \sim \text{Pareto}(\alpha, \theta)$  with  $\alpha = 2$  and  $\theta = 1000$ .

- 1. Calculate the LER if an ordinary deductible of 500 is applied.
- 2. What is the required value of *d* to eliminate 20% of the loss?

### Solution

1. Note that

$$\bar{F}_X(x) = \frac{\theta^{\alpha}}{(x+\theta)^{\alpha}}.$$

Now

$$E[X] = \int_0^\infty \bar{F}_X(x) \, dx = \theta^\alpha \int_0^\infty \frac{1}{(x+\theta)^\alpha} \, dx$$
$$= \frac{\theta^\alpha}{1-\alpha} \cdot \frac{1}{(x+\theta)^{\alpha-1}} \Big|_0^\infty = \frac{\theta}{\alpha-1}.$$

and

$$E[X \wedge d] = \int_0^d \bar{F}_X(x) \, dx = \frac{\theta^{\alpha}}{1 - \alpha} \cdot \frac{1}{(x + \theta)^{\alpha - 1}} \Big|_0^d$$
$$= \frac{\theta^{\alpha}}{1 - \alpha} \left( \frac{1}{(d + \theta)^{\alpha - 1}} - \frac{1}{\theta^{\alpha - 1}} \right)$$
$$= \frac{\theta}{\alpha - 1} \left( 1 - \left( \frac{\theta}{d + \theta} \right)^{\alpha - 1} \right).$$

Thus

LER = 
$$\frac{E[X \wedge d]}{E[X]} = \left(1 - \left(\frac{\theta}{d+\theta}\right)^{\alpha-1}\right) = \frac{1}{3}$$
.

In other words,  $\frac{1}{3}$  is mitigated by setting an ordinary deductible of 500.

2. In this case, let LER =  $0.2 = \frac{1}{5}$ . Then

$$\frac{1}{5} = 1 - \frac{1000}{d + 1000} \iff \frac{1000}{d + 1000} = \frac{4}{5} \iff d = 250$$

## 13.2 Frequency Distributions — Basic Frequency Distributions

Recall from our Collective Risk Model that

$$S = \sum_{i=1}^{N} X_i,$$

where

 $X_i \equiv \text{ size of the } i^{\text{th}}$  claim, modelled by severity distributions

 $N\equiv {
m a}$  nonnegative integer-valued rv that represents the number of claims, modelled by frequency distributions

### Definition 40 (Counting Distributions and RVs)

A nonnegative rv, usually represented by N, is called a counting rv and its distribution is called a counting distirbution.

#### 66 Note

For this section, the pgf is important.

*Importance of PGF* Given  $G(t) = E[t^N] = \sum_{k=0}^{\infty} t^K p_k$ , provided that the moments exist, we have

$$G^{(n)}(t) = \frac{d^n}{dt^n}G(t) \stackrel{(*)}{=} E\left[\prod_{i=1}^n (N-i+1)t^{N-n}\right]$$
$$= \sum_{k=0}^\infty \prod_{i=1}^n (k-i+1)t^{k-n}p_k$$
$$\stackrel{(**)}{=} \sum_{k=n}^\infty \prod_{i=1}^n (k-i+1)t^{k-n}p_k$$

where (\*) is because the moments exist, and (\*\*) is because for k = 0, 1, ..., n - 1, the product  $\prod_{i=1}^{n} (k - i + 1) = 0$ .

We can obtain the pmf of *N* from the pgf by

$$G^{(n)}(0) = \sum_{k=n}^{\infty} \prod_{i=1}^{n} (k-i+1)t^{k-n} p_k \Big|_{t=0}$$

$$= \prod_{i=1}^{n} (n-i+1)p_n = n! p_n$$
(13.1)

where we notice in Equation (13.1) that only the  $n^{th}$  term survives as

Factorial Moments<sup>1</sup> can be obtained by

$$G^{(n)}(1) = E\left[\prod_{i=1}^{n}(N-i+1)\right], \quad n = 1, 2, 3, \dots$$

In particular, we have that

$$G'(1) = E[N]$$
 and  $G''(1) = E[N(N-1)] = E(N^2) - E(N)$ 

and so

$$Var(N) = G''(1) + G'(1) - G'(1)^{2}.$$

Also for (\*): The derivation is

$$G_N^{(n)}(t) = \frac{d^n}{dt^n} G_N(t)$$

$$= \sum_{k=0}^{\infty} \frac{d^n}{dt^n} t^k p_k$$

$$= \sum_{k=0}^{\infty} k(k-1) \dots (k-n+1) t^{k-n} p_k$$

$$= E \left[ \prod_{k=1}^n (N-k+1) t^{N-n} \right]$$

#### Definition 41 (Factorial Moments from PGF)

We can obtain the factorial moments of an rv X from its pgf. In particular,

$$G^{(n)}(1) = E\left[\prod_{i=1}^{n}(X-i+1)\right]$$

where  $n \in \mathbb{N} \setminus \{0\}$ .

### 13.2.1 Frequency Distributions

### 13.2.1.1 Poisson Distribution

### Definition 42 (Poisson Distribution)

A counting rv N is said to have a **Poisson distribution** with parameter  $\lambda$ , and denote  $N \sim \text{Poi}(\lambda)$ , if it has the pmf

$$p_k = P(N = k) = \frac{e^{-\lambda} \lambda^k}{k!}, \quad k = 0, 1, 2, \dots$$

#### Remark

We can easily verify that the Poisson distribution is indeed a probability distribution, by noticing that

$$\sum_{k=0}^{\infty} p_k = \sum_{k=0}^{\infty} \frac{e^{-\lambda} \lambda^k}{k!} = e^{-\lambda} e^{\lambda} = 1$$

where we used the Taylor expansion  $e^x = \sum_{k=0}^{\infty} \frac{x^k}{k!}$ .

# • Proposition 15 (PGF, Mean, and Variance of Poisson Distribution)

*For*  $N \sim \text{Poi}(\lambda)$ *, its pgf is* 

$$G(t) = e^{\lambda(t-1)},$$

and its mean and variance are

$$E(N) = Var(N) = \lambda$$
.

### Proof

Notice that

$$G(t) = E\left[t^N\right] = \sum_{k=0}^{\infty} t^k p_k = \sum_{k=0}^{\infty} \frac{e^{-\lambda}(t\lambda)^k}{k!} = e^{-\lambda}e^{t\lambda} = e^{\lambda(t-1)}.$$

Thus

$$E[N] = G'(1) = \lambda \text{ and } G''(1) = \lambda^2,$$

and so

$$Var(N) = \lambda^2 + \lambda - \lambda^2 = \lambda.$$

### • Proposition 16 (Sum of Independent Poisson RVs)

If  $N_1, N_2, ..., N_m$  are independent Poisson rvs with parameters  $\lambda_1, \lambda_2, ..., \lambda_m$  respectively, then

$$N = \sum_{i=1}^{m} N_i \sim \operatorname{Poi}\left(\sum_{i=1}^{m} \lambda_i\right)$$

### Proof

Using the pgf method for N, we see that

$$G(t) = e\left[t^{N}\right] = E\left[t^{\sum_{i=1}^{m} N_{i}}\right] = \prod_{i=1}^{m} E\left[t^{N_{i}}\right]$$
$$= \prod_{i=1}^{m} e^{\lambda_{i}(t-1)} = e^{(t-1)\sum_{i=1}^{m} \lambda_{i}}$$

which is the pgf of Poi  $(\sum_{i=1}^{m} \lambda_i)$  as required.

# 14 Lecture 14 Oct 30th

- **14.1** Frequency Distribution Basic Frequency Distributions (Continued)
- **14.1.1** *Frequency Distributions (Continued)*
- 14.1.1.1 Poisson Distribution (Continued)

### • Proposition 17 (Splitting a Poisson Distribution)

Suppose that the total number of claim arrivals follows  $N \sim \text{Poi}(\lambda)$ . There are m distinct types of claims. Given a claim occurs, it is of type i with probability  $p_i$  such that

$$p_1 + \ldots + p_m = 1.$$

Then, for each fixed i=1,...,m, the number of claims of type  $i, N_i \sim Poi(\lambda p_i)$ . Furthermore,  $N_1, N_2,...,N_m$  are independent.

### 66 Note

The above proposition can be visualized using a tree.

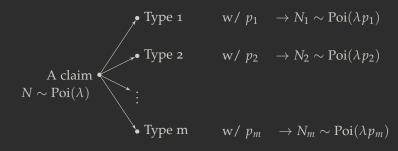


Figure 14.1: Visualization of Proposition 17

### Proof

We shall use **mathematical induction** on m, for the statement " $N_1, N_2, \ldots, N_m$  are independent".  $N_i \sim \text{Poi}(\lambda p_i)$  will follow from the induction step.

For m = 1, there is nothing to prove. It suffices to prove for m = 2, since we may think of the problem as

Case m=2 Suppose  $N=N_1+N_2\sim {\rm Poi}(\lambda)$ . To show that  $N_1$  and  $N_2$  are independent, a relation which we denote as  $N_1\bot N_2$ , we need to show

$$P(N_1 = k_1, N_2 = k_2) = P(N_1 = k_1)P(N_2 = k_2),$$
 (14.1)

which is a defining property of independence.

Firstly, note that if given sets  $A \subset B$ , we have

$$P(A) = P(A \cap B)$$
.

With that,

$$P(N_{1} = k_{1}, N_{2} = k_{2}) = P(N_{1} = k_{1}, N_{2} = k_{2}, N_{1} + N_{2} = k_{1} + k_{2})$$

$$= P(A \mid B)P(B)$$

$$= {\binom{k_{1} + k_{2}}{k_{1}}} p_{1}^{k_{1}} p_{2}^{k_{2}} \cdot \frac{e^{-\lambda} \lambda^{k_{1} + k_{2}}}{(k_{1} + k_{2})!}$$

$$= \frac{(k_{1} + k_{2})!}{k_{1}! k_{2}!} p_{1}^{k_{1}} p_{2}^{k_{2}} \cdot \frac{e^{-\lambda(1)} \lambda^{k_{1} + k_{2}}}{(k_{1} + k_{2})!}$$

$$= e^{-\lambda(p_{1} + p_{2})} \cdot \frac{(\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{(\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

$$= \frac{e^{-\lambda p_{1}} (\lambda p_{1})^{k_{1}}}{k_{1}!} \cdot \frac{e^{-\lambda p_{2}} (\lambda p_{2})^{k_{2}}}{k_{2}!}$$

Thus, the marginal distribution of  $N_1$ 

$$P(N_1 = k_1) = \sum_{k_2=0}^{\infty} P(N_1 = k_1, N_2 = k_2)$$

$$= \frac{e^{-\lambda p_1} (\lambda p_1)^{k_1}}{k_1!} e^{-\lambda p_2} \sum_{k_2=0}^{\infty} \frac{(\lambda p_2)^{k_2}}{k_2!}$$

$$= \frac{e^{-\lambda p_1} (\lambda p_1)^{k_1}}{k_1!} e^{-\lambda p_2} e^{\lambda p_2}$$

$$= \frac{e^{-\lambda p_1} (\lambda p_1)^{k_1}}{k_1!}$$

which is the pmf of  $Poi(\lambda p_1)$ . The marginal distribution of  $N_2$  is similar. It is clear from Equation (14.2) that we have Equation (14.1). The result then follows from induction.

### **Example 14.1.1**

The number of claims of a portfolio follows  $Poi(\lambda)$ . The severity of ground-up loss follows Unif(0, b). The insurer would like to impose an ordinary deductible d and a policy limit u such that

$$0 < d < u < b$$
.

What is the frequency distribution of **positive payments**?

### Solution

Let Type 1 be the case where X < d and Type 2 be X > d. Since the severity of the ground-up loss follows Unif(0,b), the probability of an occurrence of Type 2 is

$$1 - \frac{d}{h} = \frac{b - d}{h}.$$

By lacktriangleq Proposition 17, we have that the frequency distribution of positive payments, i.e. Type 2, follows Poi  $\left(\lambda \frac{b-d}{b}\right)$ .

### 14.1.1.2 Binomial Distribution

### Definition 43 (Binomial Distribution)

A counting rv N is said to have a **binomial distribution** with parameters  $q \in (0,1)$  and  $m \in \mathbb{N} \setminus \{0\}$ , written as  $N \sim \text{Bin}(q,m)$ , if it has the

pmf

$$p_k = P(N = k) = {m \choose k} q^k (1 - q)^{m-k}, \ k = 0, 1, 2, \dots$$

### Remark

It is easy to verify that this is a valid probability distribution, since

$$\sum_{k=0}^{m} {m \choose k} q^k (1-q)^{m-k} = (q+1-q)^m = 1^m = 1$$

by the binomial theorem.

### 66 Note

- When m = 1, the distribution is called a Bernoulli rv with mean q.
- The binomial distribution is a **bounded** rv, since it has a fixed number of trials.

### • Proposition 18 (PGF of Binomial Distribution)

Let  $N \sim \text{Bin}(q, m)$ . Its pgf is given by

$$G(t) = (1 - q + tq)^m.$$

Moreover, its mean and variance are

$$E[N] = mq$$
 and  $Var(N) = mq(1-q)$ 

respectively.

### Proof

We have

$$G(t) = \sum_{k=0}^{m} {m \choose k} (tq)^k (1-q)^{m-k} = (1-q+tq)^m$$

The mean is, therefore,

$$G'(1) = mq(1 - q + (1)q)^{m-1} = mq,$$

and its variance

$$Var(N) = G''(1) + G'(1) - G'(1)^{2}$$
$$= m(m-1)q^{2} + mq - m^{2}q^{2} = mq(1-q).$$

### • Proposition 19 (Sum of Independent Binomial RVs)

If  $N_1, \ldots, N_n$  are independent and  $N_i \sim \text{Bin}(q, m_i)$  for  $i = 1, \ldots, n$ , then

$$N = \sum_{i=1}^{n} N_i \sim \text{Bin}\left(q, \sum_{i=1}^{n} m_i\right).$$

### Proof

We shall use the pgf to prove this, instead of using the mgf (which is the common approach).

$$G_N(t) = E\left[t^N\right] = E\left[t^{\sum_{i=1}^n N_i}\right] \stackrel{(*)}{=} \prod_{i=1}^n E\left[t^{N_i}\right]$$
$$= \prod_{i=1}^n (1 - q + tq)^{m_i} = (1 - q + tq)^{\sum_{i=1}^n m_i}$$

Thus 
$$N = \sum_{i=1}^{n} N_i \sim \text{Bin}\left(q, \sum_{i=1}^{n} m_i\right).$$

### 66 Note

As a result of  $\bullet$  Proposition 19, if we have a sequence of Bernoulli trials, each with the same "success" probability q, call each of them  $I_i$ , then

$$N = \sum_{i=1}^{m} I_i \sim \text{Bin}(q, m)$$

Consequently, it becomes rather silly how easy it is we can get the mean

and variance of N:

$$E[N] = E\left[\sum_{i=1}^{m} I_i\right] = \sum_{i=1}^{m} E[I_i] = mq$$

$$Var(N) = Var\left(\sum_{i=1}^{m} I_i\right) = \sum_{i=1}^{m} Var(I_i) = mq(1-q)$$

# 15 Lecture 15 Nov 01st

- 15.1 Frequency Distribution Basic Frequency Distributions (Continued 2)
- 15.1.1 Frequency Distributions (Continued 2)
- 15.1.1.1 Negative Binomial Distribution

### Definition 44 (Negative Binomial Distribution)

A counting rv N is said to have a **negative binomial distribution** with parameters  $\beta > 0$  and r > 0, denoted  $N \sim NB(\beta, r)$ , if it has the pmf

$$p_k = P(N=k) = {k+r-1 \choose k} \left(\frac{1}{1+\beta}\right)^r \left(\frac{\beta}{1+\beta}\right)^k, k = 0, 1, 2, \dots$$

### Remark

*Note that* 

$$\binom{k+r-1}{k} = \frac{\Gamma(k+r)}{k!\Gamma(r)} = \frac{(k+r-1)!}{k!(r-1)!},$$

where the later equality follows if  $r \in \mathbb{N} \setminus \{0\}$ .

### 66 Note

• When r = 1, we can also write the pmf of  $NB(\beta, 1)$  as the pmf of the geometric distribution:

$$p_k = \frac{1}{1+\beta} \left( \frac{\beta}{1+\beta} \right)^k, k = 0, 1, 2, \dots$$

• To verify that the negative binomial distribution is a valid probability

distribution, we need the following identity:

$$(1-x)^{-r} = \sum_{k=0}^{\infty} {k+r-1 \choose k} x^k,$$

which is proven as follows:

### Exercise 15.1.1

Verify that the negative binomial distribution is a valid probability distribution.

### Proof

We shall use the **Taylor expansion** of  $(1-x)^{-r}$ .

$$(1-x)^{-r} = 1 + (-1)(-r)(1-x)^{-r-1} \Big|_{x=0} x$$

$$+ \frac{r}{2}(-1)(-r-2)(1-x)^{-r-2} \Big|_{x=0} x^2 + \dots$$

$$= 1 + rx + \frac{r(r+1)}{2}x^2 + \frac{r(r+1)(r+2)}{3!}x^3 + \dots$$

$$= \sum_{k=0}^{\infty} \frac{r(r+1)\dots(r+k-1)}{k!} x^k$$

$$= \sum_{k=0}^{\infty} {k+r-1 \choose k} x^k.$$

• The negative binomial distribution is an unbounded rv, and can take all natural numbers sans 0.

Interpretation Consider an experiment with independent trails, of which each has only two possible outcomes: success with probability  $\frac{1}{1+\beta}$ , and failure with probability  $1-\frac{1}{1+\beta}=\frac{\beta}{1+\beta}$ . Let N denote the number of failures until reaching the  $r^{\text{th}}$  success.

### • Proposition 20 (PGF of the Negative Binomial Distribution)

Let  $N \sim NB(\beta, r)$ . Its pgf is thus

$$G(t) = [1 - \beta(t-1)]^{-r}$$
.

Moreover, its mean and variance are

$$E[N] = r\beta$$
 and  $Var(N) = r\beta(1+\beta)$ ,

respectively.

### 66 Note

Note that the proof for getting the pgf is similar to how we can verify that N is a probability (same case as in earlier counting distributions).

### Proof

Using the Taylor Expansion  $(1-x)^{-r} = \sum_{k=0}^{\infty} {k+r-1 \choose k} x^k$ , we have

$$G(t) = \sum_{k=0}^{\infty} t^k p_k = \left(\frac{1}{1+\beta}\right)^r \sum_{k=0}^{\infty} {k+r-1 \choose k} \left(\frac{t\beta}{1+\beta}\right)^k$$
$$= \left(\frac{1}{1+\beta}\right)^r \left(1 - \frac{t\beta}{1+\beta}\right)^{-r} = [1 - \beta(t-1)]^{-r}.$$

Consequently, the mean is

$$E[N] = G'(1) = -r(-\beta) = r\beta$$

and variance is

$$Var(N) = G''(1) + G'(1) - G'(1)^{2}$$
$$= -r(-r - 1)\beta^{2} + r\beta - r^{2}\beta^{2} = r\beta(1 + \beta)$$

### Proposition 21 (Negative Binomial from Poisson Conditioned on Gamma)

Let  $N \mid \Lambda = \lambda \sim Poi(\lambda)$  and  $\Lambda \sim Gam(\alpha, \theta)$ . Then

$$N \sim NB(\theta, \alpha)$$
.

### 66 Note

We may also write  $N \mid \Lambda = \lambda \sim Poi(\lambda)$  as  $N \mid \Lambda \sim Poi(\Lambda)$ .

### Proof

We shall prove this statement by finding the pgf of N, which identifies the distribution. Note that

$$G_N(t) = E\left[t^N\right] \stackrel{\text{Proposition 9}}{=} E\left[E\left[t^N \mid \Lambda\right]\right] \stackrel{(*)}{=} E\left[e^{\Lambda(t-1)}\right],$$

where (\*) requires further clarification. Now since  $\Lambda \sim \text{Gam}(\alpha, \theta)$ , and  $M_{\Lambda}(t) = E\left[e^{t\Lambda}\right] = (1 - \theta t)^{-\alpha}$ , it follows that

$$G_N(t) = [1 - \theta(t-1)]^{-\alpha}.$$

Thus  $N \sim NB(\theta, \alpha)$ .

### • Proposition 22 (Combining Negative Binomial Distributions)

If  $\{N_i\}_{i=1}^n$  is a sequence of independent rvs, and  $N_i \sim NB(\beta, r_i)$ . Then

$$N = \sum_{i=1}^{n} N_i \sim NB\left(\beta, \sum_{i=1}^{n} r_i\right).$$

### Proof

We shall, again, use the pgf. We have

$$G_N(t) = E\left[t^N\right] \stackrel{(*)}{=} \prod_{i=1}^n E\left[t^{N_i}\right] = \prod_{i=1}^n G_{N_i}(t)$$
  
=  $\prod_{i=1}^n [1 - \beta(t-1)]^{r_i} = [1 - \beta(t-1)]^{-\sum_{i=1}^n r_i},$ 

where (\*) is by independence of the rvs, and the last equality is thanks to  $\beta$  being fixed for all the rvs. This completes the proof.  $\Box$ 

### 15.1.2 (*a*, *b*, *n*) Classes

### 15.1.2.1 (*a*, *b*, 0) Class

### Definition 45 ((a, b, 0)) Class)

The (a, b, 0) class is a set of counting rvs with pmf  $p_k$  satisfying the recursive formula

$$\frac{p_k}{p_{k-1}} = a + \frac{b}{k}, \quad k \in \mathbb{N} \setminus \{0\}.$$

#### Remark

An (a, b, 0) distribution is determiend by the parameters a and b.

### 66 Note

Observe that

$$\frac{p_1}{p_0} = a + \frac{b}{1} \iff p_1 = p_0 \left( a + \frac{b}{1} \right)$$

$$\frac{p_2}{p_2} = a + \frac{b}{2} \iff p_2 = p_1 \left( a + \frac{b}{2} \right) = p_0 \left( a + \frac{b}{1} \right) \left( a + \frac{b}{2} \right)$$

$$\vdots$$

$$\frac{p_k}{p_{k-1}} = a + \frac{b}{k} \iff p_k = p_0 \prod_{i=1}^k \left( a + \frac{b}{i} \right).$$

Thus we see that each of the  $p_k$  is completely determined by  $p_0$ . In other words, for the distributions of this class, if we can find  $p_0$ , then we can get  $p_k$ , even if we do not know the actual parameters of the distribution.

In fact, we can solve for  $p_0$ , if we already know what a and b are: we need to solve for  $p_0$  in  $\sum_{k=0}^{\infty} p_k = 1$ . In particular, we need to solve for

$$p_0 \sum_{k=0}^{\infty} \prod_{i=1}^{k} \left( a + \frac{b}{i} \right) = 1.$$

Members of the (a, b, 0) class It can be shown<sup>1</sup> that the Poisson, Binomial, and Negative Binomial distributions are the only distributions that belong to this class. We have that

Distribution	а	b	$p_0$
$\operatorname{Poi}(\lambda)$	0	λ	$e^{-\lambda}$
Bin(q, m)	$-\frac{q}{1-q}$	$(m+1)\frac{q}{1-q}$	$(1-q)^m$
$NB(\beta, r)$	$\frac{\beta}{1+\beta}$	$(r-1)\frac{\beta}{1+\beta}$	$(1+\beta)^{-r}$

We shall prove for the case of  $Poi(\lambda)$ .

Table 15.1: The (a, b, 0) distributions

### Exercise 15.1.2

Find a, b and  $p_0$  for Bin(q, m) and  $NB(\beta, r)$ .

<sup>&</sup>lt;sup>1</sup> Perhaps this can be shown using Colloquia/Helsinki/Papers/S7\_13\_

### Proof

By the pmf of  $Poi(\lambda)$ , it is clear that

$$p_0 = \frac{e^{-\lambda}\lambda^0}{0!} = e^{-\lambda}.$$

Now, since

$$p_1 = \lambda e^{-\lambda}$$
  $p_2 = \frac{1}{2}\lambda^2 e^{-\lambda}$ 

we have the following system of equations:

$$\lambda = \frac{p_1}{p_0} = a + b$$

$$\frac{1}{2}\lambda = \frac{p_2}{p_1} = a + \frac{b}{2}$$

Thus  $b = \lambda$  and a = 0.

### **Example 15.1.1**

Assume that the number of claims in a portfolio N follows (-0.25, 2.75, 0) distribution. Calculate the probability that there is at least one claim.

### Solution

Using Table 15.1, we know that  $N \sim \text{Bin}(q, m)$ , where

$$-\frac{q}{1-q} = -0.25$$
 and  $(m+1)\frac{q}{1-q} = 2.75$ ,

which gives q = 0.2 and m = 10. Thus the desired probability is

$$P(N \ge 1) = 1 - P(N = 0) = 1 - (1 - 0.8)^{10} = 0.8926.$$

### A.1 Individual Risk Model: An Alternate View

This appendix serves to explain why our note of  $Z_i = I_i X_i$  is wrong with as mush rigour as we can go for now. There may be hand-wavy parts, but those will be indicated.

We mentioned, as shown by Klugman, Panjer and Willmot (2012)<sup>1</sup>, that for the Individual Risk Model, the aggregate claim is modeled by

$$S = \sum_{i=1}^{n} Z_i$$

where  $Z_i$  is a random variable for the potential loss of the  $i^{th}$  insurance policy, while n is fixed. It is claimed that we can also express each  $Z_i$  as

$$Z_i = I_i X_i$$

where  $I_i$  is an indicator function given by

$$I_i(x) = egin{cases} 1 & ext{if a claim occurs} \ 0 & ext{if there are no claims} \end{cases}$$
 ,

while  $X_i$  is the size of the claim(s) for the  $i^{th}$  policy provided that there is a claim.

ONE PROBLEM that arises is: are  $X_i$  and  $I_i$  independent? They should be if we wish to define  $Z_i$  in such a way. In fact, according to Klugman et al. in page 177,

Let 
$$X_j = I_j B_j$$
, where  $I_1, \ldots, I_n, B_1, \ldots, B_n$  are independent.

where  $X_j$  is our  $Z_i$ ,  $I_j$  is our  $I_i$ , and  $B_j$  is our  $X_i$ .

<sup>1</sup> Klugman, S. A., Panjer, H. H., and Willmot, G. E. (2012). Loss Models: From Data to Decisions. John Wiley & Sons, Inc., 4th edition

§  $Z_i$  is not well-defined Let us be explicit about the definitions of  $I_i$  and  $X_i$ ; we have

$$I_i = \mathbb{1}_{\{Z_i > 0\}}$$
$$X_i = Z_i \mid Z_i > 0$$

However, we observe that such a defintion of  $X_i$  is undefined on  $Z_i = 0$ . So the equation

$$Z_i = I_i X_i$$

is note well-defined.

§ Independence of  $I_i$  and  $X_i$  We cannot actually tell if  $I_i$  and  $X_i$  are independent from each other, as it is equivalent to comparing apples with oranges<sup>2</sup>. Recall from our earlier courses, in particular STAT<sub>330</sub>, of the following notion:

<sup>2</sup> In fact, I think this analogy fits our case perfectly so.

### Definition (Probability Space)

Let  $\Omega$  be a sample space, and  $\mathcal{F}$  a  $\sigma$ -algebra defined on  $\Omega^3$ . A **probability space** is the measurable space  $(\Omega, \mathcal{F})$  with a probability measure,  $f: \mathcal{F} \to [0,1]$ , defined on the space. We denote a probability space as  $(\Omega, \mathcal{F}, f)$ .

<sup>3</sup> Note that  $(\Omega, \mathcal{F})$  is called a **measurable space**.

As mentioned in an earlier  $\S$ ,  $X_i$  is not defined on  $Z_i = 0$ , while  $I_i$  is defined on  $Z_i = 0$ . So the sample space for  $X_i$  and  $I_i$  are not the same, and so their probability measures are not the same as well. Therefore, it is meaningless to ask if  $X_i$  and  $I_i$  are independent.

<sup>4</sup> This statement is hand-wavy.

Our best attempt at fixing this is probably the following: let

$$Z_i = \sum_{i=1}^{I_i} X_i,$$

which we can then have  $X_i$  to be independent from  $I_i$ . However, interestingly so, this is a similar approach to a Collective Risk Model.

### A.2 Coherent Risk Measure

An excerpt from Klugman et al. (2012) <sup>5</sup>:

The study of risk measures and their properties has been carried out by authors such as Wang. Specific desirable properties of risk measures were proposed as axioms in connection with risk pricing by Wang, Young, and Panjer and more generally in risk measurement by Artzer et al. The Artzner paper introduced the concept of coherence and is considered to be the groundbreaking paper in risk measurement.

Often, we use the function  $\rho(X)$  to denote risk measures. One may think of  $\rho(X)$  as the amount of assets required to protect against adverse outcomes of the risk X.

### Definition 46 (Coherent Risk Measure)

A coherent risk measure is a risk measure  $\rho(X)$  that has the following *four properties for any two loss rvs X and Y:* 

- 1. (Subadditivity)  $\rho(X+Y) \leq \rho(X) + \rho(Y)$ .
- 2. (Monotonicity) If  $X \leq Y$  for all possible outcomes, then  $\rho(X) \leq$  $\rho(Y)$ .
- 3. (Positive homogeneity)  $\forall c \in \mathbb{R}_{>0}$ ,  $\rho(cX) = c\rho(X)$ .
- 4. (Translation invariance)  $\forall c \in \mathbb{R}_{>0}$ ,  $\rho(X+c) = \rho(X) + c$

*Interpretation of the conditions* 

### Subadditivity

- the risk measure (and in return, the capital required to cover for it) for two risks combined will not be greater than for the risks to be treated separately;
- reflects the fact that there shuld be some diversification benefit from combining risks;
- this requirement is disputed: e.g. the merger of several small companies into a larger one exposes each of the small companies to the reputational risks of the others.

### Monotonicity

 if one risk always has greater losses than the other under all circumstances<sup>6</sup>, then the risk measure of the greater risk should always be greater than the other.

 $^{6}$  Probabilistically, this means P(X > Y) = 0

### • Positive homogeneity

- the risk measure is independent of the currency used to measure it;
- doubling the exposure to a particular risk requires double the capital, which is sensible as doubling provides no diversification.

### • Translation invariance

- there is no additional risk for an additional risk which has no additional uncertainty.

# Bibliography

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# List of Symbols and Abbreviations

crv continuous random variable

DFR Decreasing Failure Rate

drv discrete random variable

IFR Increasing Failure Rate

mgf moment generating function

pf probability function

pdf probability density functionpmf probability mass function

pgf probability generating function

rv random variable TVaR Tail-Value-at-Risk

VaR Value-at-Risk

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