



International Association for the
Study of Insurance Economics

Études et Dossiers

Extract from

Études et Dossiers No. 317

**2nd International Longevity Risk and
Capital Market Solutions Symposium**

24 April 2006, Chicago

August 2006

Working Paper Series of
The Geneva Association

© Association Internationale pour l'Etude de l'Economie de l'Assurance

The Geneva Association Working Paper Series “Études et Dossiers” appear at irregular intervals about 10 - 12 times per year. Distribution is limited.

The “Études et Dossiers” are the working paper series of The Geneva Association. These documents present intermediary or final results of conference proceedings, special reports and research done by The Geneva Association. As they contain work in progress or summaries of conference presentations, the material must not be cited without the express consent of the author in question.

Layout & Distribution: Valeria Kozakova

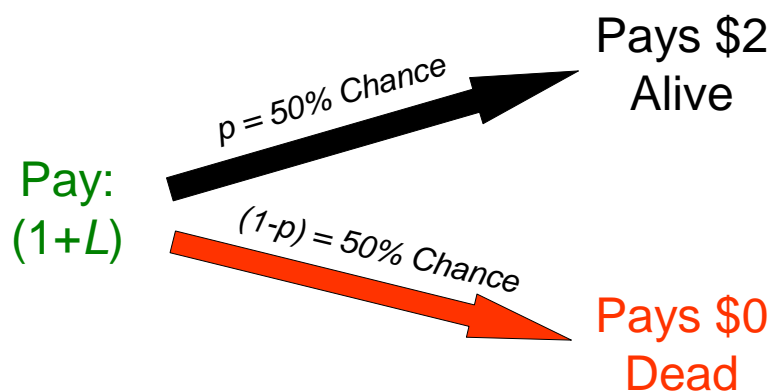
Killing the Law of Large Numbers: Financial Valuation of Mortality Risk via the Instantaneous Sharpe Ratio

Moshe A. Milevsky

Outline & Agenda

- Basic review of how the LLN breaks down under aggregate mortality risk and why this impacts risk management.
- Discuss the existing academic literature.
- Introduce our Sharpe Ratio based approach for pricing longevity-linked instruments in discrete time.
- Brief overview of how to model this in continuous-time...(time permitting)

Longevity Insurance Payoff:



Longevity Risk Symposium
24 April 2006, Chicago

Back to Classical Basics:

$$w_i = \begin{cases} 2 & \text{Pr}=(p) \\ 0 & \text{Pr}=(1-p) \end{cases}$$

$$E[w_i] = 2p$$

$$\begin{aligned} \text{var}[w_i] &= p(2-2p)^2 + (1-p)(0-2p)^2 \\ &= 4p(1-p) \end{aligned}$$

Longevity Risk Symposium
24 April 2006, Chicago

Back to Classical Basics:

$$w_i = \begin{cases} 2 & \text{Pr} = 0.5 \\ 0 & \text{Pr} = 0.5 \end{cases}$$

$$E[w_i] = 1$$

$$\text{var}[w_i] = 1$$

$$SD[w_i] = 1$$

Longevity Risk Symposium
24 April 2006, Chicago

Adding-up the longevity bets:
What is total payout when selling N policies?

$$W = \sum_{i=1}^N w_i$$

Term is larger when
risks are dependent

$$E[W] = E\left[\sum_{i=1}^N w_i\right] = N2p$$

$$\text{var}[W] = \text{var}\left[\sum_{i=1}^N w_i\right] = N4p(1-p)$$

Longevity Risk Symposium
24 April 2006, Chicago

Refresher: Law of Large Numbers: Under i.i.d. payouts...

$$\lim_{N \rightarrow \infty} \frac{1}{N} \sum_{i=1}^N w_i \rightarrow E[w_i]$$

Within the context of insurance this implies that eventually there is no uncertainty (i.e. risk) in what you will be paying out per policy and the payout risk is not compensated in equilibrium. In the language of portfolio theory, it is diversifiable.

*Longevity Risk Symposium
24 April 2006, Chicago*

The idiosyncratic **Risk** which is the total standard deviation per policy, goes to zero...

$$\frac{1}{N} SD[W] = \frac{2\sqrt{p(1-p)}}{\sqrt{N}} \rightarrow 0$$

You expect each policy to generate a payout of \$1 with zero uncertainty (risk), as long as you sell enough policies.

*Longevity Risk Symposium
24 April 2006, Chicago*

...I can also use the Central Limit Theorem (CLT) to compute probabilities

$$\Pr[W \leq C] = \Pr\left[\frac{W - E[W]}{SD[W]} \leq \frac{C - E[W]}{SD[W]}\right]$$

$$\approx \Pr\left[Z \leq \frac{C - 2Np}{\sqrt{4Np(1-p)}}\right]$$

Or I can go thru the brute-force way using the Binomial distribution.
More on this later...

Longevity Risk Symposium
24 April 2006, Chicago

Numerical Example: Sell 10,000 Longevity Insurance Policies

Total Payout Outside the Range of:	Event Probability:
(\$5,000 -- \$15,000)	0.000%
(\$7,500 -- \$12,500)	0.000%
(\$9,000 -- \$11,000)	0.000%
(\$9,500 -- \$10,500)	0.000%
(\$9,700 -- \$10,300)	0.271%

Note: Standard deviation of payout
is only \$100, since $p = 0.5$.

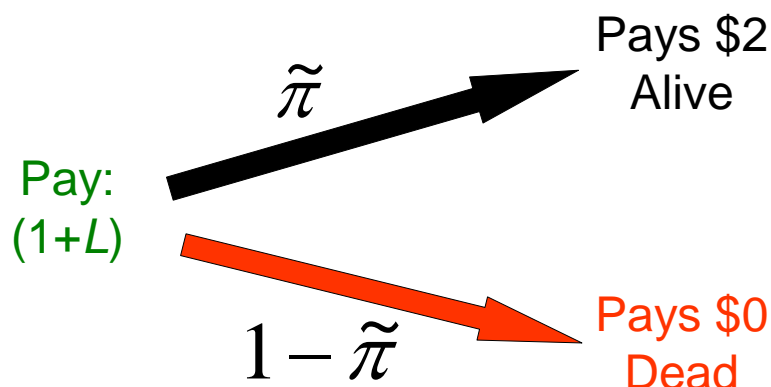
Longevity Risk Symposium
24 April 2006, Chicago

What happens under stochastic hazard parameters...

- The first (classical) example assumed we know the parameter value p with perfect certainty.
- What if we are unsure of p ? Are we entitled to simply compute the expectation $E[p]$ and use that estimate for pricing & risk management formulas?
- **No!**
- In fact, the total payout distribution becomes a mixture of Binomials, the Law of Large Numbers (LLN) -- invoked for pricing insurance -- breaks down and some risk can never be eliminated.

Longevity Risk Symposium
24 April 2006, Chicago

Longevity Insurance Payoff: Stochastic Hazard Parameters



Longevity Risk Symposium
24 April 2006, Chicago

Modern Basics (II): Stochastic Hazard Parameters

$$w_i^* = \begin{cases} 2 & \text{Pr} = \tilde{\pi} \\ 0 & \text{Pr} = 1 - \tilde{\pi} \end{cases}$$

$$\tilde{\pi} = \begin{cases} \pi_1 & \text{Pr} = (p_1) \\ \pi_2 & \text{Pr} = (p_2) \end{cases}$$

$$E[\tilde{\pi}] = \pi_1 p_1 + \pi_2 p_2$$

Longevity Risk Symposium
24 April 2006, Chicago

Modern Basics (II): Example Stochastic Hazard Parameters

$$w_i^* = \begin{cases} 2 & \text{Pr} = \tilde{\pi} \\ 0 & \text{Pr} = 1 - \tilde{\pi} \end{cases}$$

$$\tilde{\pi} = \begin{cases} \pi_1 = 0.6 & \text{Pr} = 0.5 \\ 1 - \pi_1 = 0.4 & \text{Pr} = 0.5 \end{cases}$$

$$E[\tilde{\pi}] = 0.5 \quad \rightarrow \text{Which was the assumed survival probability in the traditional case}$$

Longevity Risk Symposium
24 April 2006, Chicago

Adding-up the Longevity bets...
under Stochastic Hazard Parameters

$$W^* = \sum_{i=1}^N w_i^*$$

$$E[W^*] = E\left[\sum_{i=1}^N w_i^*\right] = N2E[\tilde{\pi}]$$

Longevity Risk Symposium
24 April 2006, Chicago

Adding-up the Longevity bets...
under Stochastic Hazard Parameters

$$W^* = \sum_{i=1}^N w_i^*$$

$$E[W^*] = E\left[\sum_{i=1}^N w_i^*\right] = N2E[\tilde{\pi}]$$

$$\text{var}[W^*] = E[\text{var}[W^* | \pi]] + \text{var}[E[W^* | \pi]]$$

Longevity Risk Symposium
24 April 2006, Chicago

Decomposing the Payout Variance

$$E[\text{var}[W^* | \pi]] = 4N\pi_1(1 - \pi_1)$$

$$\text{var}[E[W^* | \pi]] = 4N^2 p_1(1 - p_1)(2\pi_1 - 1)^2$$

**The total (payout) variance is the sum of these two components.
Note that the second portion would be zero under the classical approach.**

Longevity Risk Symposium
24 April 2006, Chicago

Decomposing the Payout Variance: A Numerical Example

$$\begin{aligned} E[\text{var}[W^* | \pi]] &= 4N(0.6)(0.4) \\ &= 0.96N \end{aligned}$$

$$\begin{aligned} \text{var}[E[W^* | \pi]] &= 4N^2(0.5)(0.5)(0.2)^2 \\ &= 0.04N^2 \end{aligned}$$

$$\text{var}[W^*] = 0.96N + 0.04N^2$$

Notice that when $N = 1$, the variance equals \$1 which is the same as classical case. A single policy is not riskier!
But, when N gets large we have a problem...

Longevity Risk Symposium
24 April 2006, Chicago

In this case the **Risk** per policy does **not go** to zero which is our main problem and motivation...

$$\lim_{N \rightarrow \infty} \frac{1}{N} SD[W^*] \rightarrow 2(2\pi_1 - 1)\sqrt{p_1(1 - p_1)} \neq 0$$

When $\pi_1 = 0.5$, which implies no parameter uncertainty, the expression does go to zero. The same idea applies when p_1 or p_2 equal zero. The classical model is a special case.

Longevity Risk Symposium
24 April 2006, Chicago

How Fast Does Risk Decline? Total Standard Deviation per Policy

Number of Policies Sold: N	Deterministic Hazard Parameter p = 0.5	Stochastic Hazard Parameter E[π] = 0.5
1	\$1.000	\$1.000
2	\$0.707	\$0.721
5	\$0.447	\$0.482
100	\$0.100	\$0.223
1000	\$0.032	\$0.202
10,000	\$0.010	\$0.200
<i>Infinity</i>	\$0.000	\$0.200

$\pi = 0.6$ or 0.4 with even odds

Longevity Risk Symposium
24 April 2006, Chicago

The Mixture of Binomial Distributions: Another way to get the same results

$$\Pr[W \leq 2k] = \sum_{i=0}^k B(i | N, p)$$

$$\Pr[W^* \leq 2k] =$$

$$\sum_{i=0}^k p_1 B(i | N, \pi_1) + (1 - p_1) B(i | N, 1 - \pi_1)$$

Where:

$$B(i | N, p) := \binom{N}{i} p^i (1 - p)^{N-i}$$

Longevity Risk Symposium
24 April 2006, Chicago

You sold 100 Longevity Insurance policies: Comparing the two cases:

Total Payout Larger Than:	$\Pr[W > C]$	$\Pr[W^* > C]$
	Diversifiable	Non-Diversifiable
\$102	0.382	0.483
\$110	0.136	0.411
\$120	0.018	0.231
\$130	0.001	0.065

Note: Survivor gets \$2
 $E[\pi] = (0.6)(0.5) + (0.4)(0.5) = p = 0.5$

Longevity Risk Symposium
24 April 2006, Chicago

A Quick Break: Review Previous & Current Literature...

- Lee & Carter (1992), Olivieri (2001)
- Milevsky & Promislow (2001), Dahl (2004), Biffis (2005), Schrager (2006), Ballotta & Haberman (2006), Biffis & Millossovich (2006).
- Denuit & Dhaene (2006).
- Cairns, Blake & Dowd (2005), Cox & Lin (2004), Webb & Friedberg (2006).

*Longevity Risk Symposium
24 April 2006, Chicago*

Refresher on the Sharpe Ratio:
Common financial language used in thinking about compensation for market risk.

$$\alpha := \frac{E[X] - R}{SD[X]}$$

$$E[X] = 0.11$$

$$R = 0.06$$

$$SD[X] = 0.20$$

$$\alpha = 0.25$$

Roughly in-line with historical returns for equity markets.

*Longevity Risk Symposium
24 April 2006, Chicago*

Our contribution:

(Think about) pricing via the Sharpe Ratio

- How much would you charge for the longevity insurance policy if you wanted to be compensated for this (non diversifiable) risk in proportion to the Sharpe Ratio?
- As a crude example, if your standard deviation per policy is converging to \$0.20 and you demand a Sharpe Ratio of $\alpha = 0.25$, then you would charge a loading of $L = 5\%$ above the risk-free rate.
- Yes. This is just another premium principle.

Longevity Risk Symposium
24 April 2006, Chicago

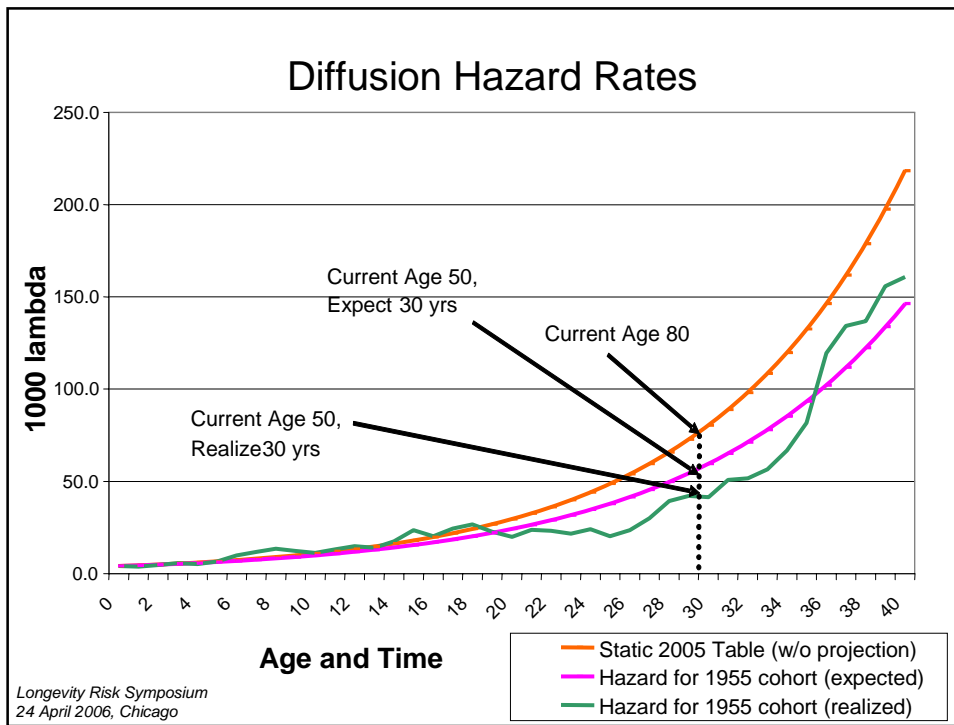
Ok. How does this model work in continuous time?

$$d\lambda_t = a(\lambda_t, t)dt + b(t)(\lambda_t - \underline{\lambda})dW_t^\lambda$$

$$dr_t = \mu(r_t, t)dt + \sigma(r_t, t)dW_t$$

The variable λ denotes the Instantaneous Force of Mortality (IFM) which is akin to the stochastic hazard parameter π in the discrete case. It is being driven by a Brownian motion (i.e. a random walk).

Longevity Risk Symposium
24 April 2006, Chicago



Financial Perspective on Mortality: Do Not Confuse The Two

$$E^Q[\lambda_t]$$

Financial Economic

$$E^P[\lambda_t]$$

Bio-statistical

Remember that if a mortality risk premium exists...

$$E^Q[\lambda_t] \neq E^P[\lambda_t]$$

Longevity Risk Symposium
24 April 2006, Chicago

One Possible Hazard Rate Process:
Milevsky & Promislow (2001)

$$\lambda_t = \lambda_0 \exp\{gt + \xi Y_t\}$$

$$dY_t = -\kappa Y_t + dB_t$$

Mean Reverting Brownian-driven Gompertz (MRBG) model.
Related to the Black-Derman-Toy Model for interest rates.

Longevity Risk Symposium
24 April 2006, Chicago

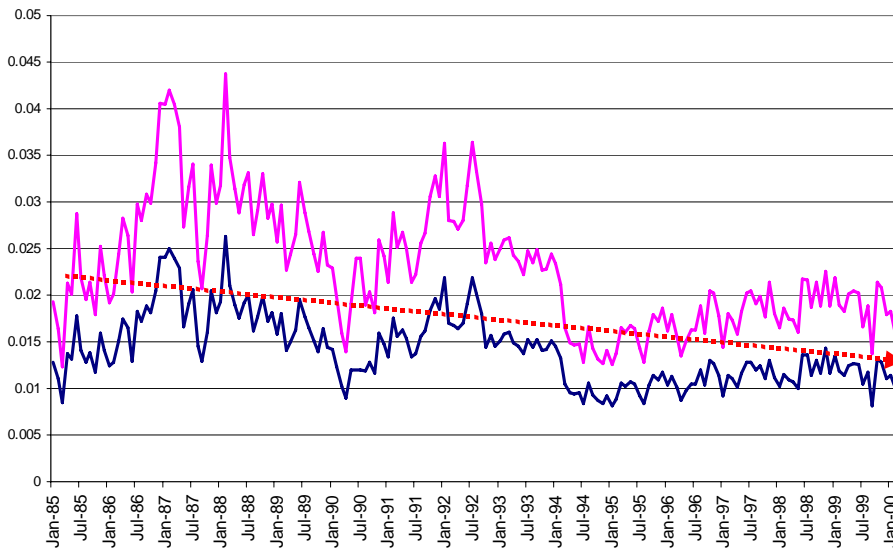
Calibrating Mortality Diffusions Using Annuity Payouts

Pc\Age	55	60	65	70	75	80
0	631	686	765	877	1039	1259
5	628	681	755	855	989	1146
10	620	666	726	799	879	940
15	607	644	687	729	764	774
20	591	618	643	662	673	665
25	573	589	601	608	610	N.A.

Source: CANNEX Financial 2002 (unisex)
Monthly income per \$100,000 premium

Longevity Risk Symposium
24 April 2006, Chicago

The Evolution of Implied Hazard Rates Age 65: 1985 - 2000



Longevity Risk Symposium
24 April 2006, Chicago

Back to our story: Hedging Portfolio for a Pure Endowment Policy

$$\Pi_t = -P(r_t, \lambda_t, t) + \pi_t F(r_t, t)$$

Sell the pure endowment (longevity insurance) for P and then hedge the risk using a portfolio of risk-free bonds denoted by F . In this set-up the variable π denotes the hedge ratio.

Longevity Risk Symposium
24 April 2006, Chicago

Local Standard Deviation (Instantaneous Sharpe Ratio) of the Hedging Portfolio

$$\begin{aligned} & \lim_{h \rightarrow 0} \sqrt{\frac{1}{h} \text{var}(\Pi_{t+h} | \mathcal{F}_t)} \\ &= \sqrt{b^2(t)(\lambda - \underline{\lambda})^2 P_\lambda^2(r, \lambda, t) + \lambda P^2(r, \lambda, t)} \end{aligned}$$

We value (price) the pure endowment by setting the drift of the hedging portfolio equal to the short rate r , times portfolio value plus α times the local standard deviation.

Longevity Risk Symposium
24 April 2006, Chicago

Value (price) of the claim solves:

$$P_t + \mu^{\theta} P_r + \frac{1}{2} \sigma^2 P_{rr} + a P_{\lambda} + \frac{1}{2} b^2 (\lambda - \underline{\lambda})^2 P_{\lambda\lambda} - (r + \lambda) P$$

$$= -\alpha \sqrt{b^2 (\lambda - \underline{\lambda})^2 P_{\lambda}^2 + \lambda P^2}$$

$$P(r, \lambda, T) = 1$$

Our paper proves that P satisfies a number of appealing properties:

- (1) It is sub-additive in the number of contracts sold.
- (2) The pricing survival probability is greater than the physical probability

Longevity Risk Symposium
24 April 2006, Chicago

Practical Conclusion

- Most researchers (and practitioners) now agree that there is a mortality risk premium.
- At a minimum this means we – as instructors -- should change the way we teach (life, annuity) insurance pricing to students.
- We also believe the concept of Sharpe Ratios can be helpful in understanding the risk & reward tradeoff, as well as linking these ideas to financial economics.
- Slides & updated paper at www.ifid.ca

Longevity Risk Symposium
24 April 2006, Chicago