Policy Values

Lecture: Weeks 2-4
Chapter summary

- Insurance reserves (policy values)
  - what are they? how do we calculate them? why are they important?
- Reserves or policy values
  - benefit reserves (no expenses considered)
  - gross premium reserves (expenses accounted for)
  - prospective calculation of reserves (based on the future loss random variable)
  - retrospective calculation of reserves (not emphasized)
- Other topics to be covered (in separate slides)
  - analysis of profit or loss and analysis by source (mortality, interest, expenses)
  - asset shares
  - Thiele’s differential equation for reserve calculation
  - policy alterations
- Chapters 7 (Dickson, et al.)
Mortality assumptions

For illustration purposes, we may base our calculations on the following assumptions:

- Illustrative Life Table (ILT)
  - the (official) Life Table used for Exam MLC with $i = 6\%$

- Standard Ultimate Survival Model, pp. 583, 586-587
  - introduced in Section 4.3
  - Makeham’s law $\mu_x = A + Bc^x$, with $A = 0.00022$, $B = 2.7 \times 10^{-6}$ and $c = 1.124$, and interest rate $i = 5\%$

- Standard Select Survival Model, pp. 583, 584-585
  - introduced in Example 3.13
  - the ultimate part follows the same Makeham’s law as above; the select part follows
    \[
    \mu_{[x]+s} = 0.9^{2-s} \mu_{x+s}, \quad \text{for } 0 \leq s \leq 2,
    \]
    and interest rate $i = 5\%$
Insurance reserves (policy values)

- Money set aside to be able to cover insurer’s future financial obligations as promised through the insurance contract.
  - reserves show up as a liability item in the balance sheet;
  - increases in reserves are an expense item in the income statement.

- Reserve calculations may vary because of:
  - purpose of reserve valuation: statutory (solvency), GAAP (realistic, shareholders/investors), mergers/acquisitions
  - assumptions and basis (mortality, interest) - may be prescribed

- Actuary is responsible for preparing an Actuarial Opinion and Memorandum: that the company’s assets are sufficient to back reserves.

- Reserves are more often called provisions in Europe.
  - another term used is policy values
Why hold reserves?

- For several life insurance contracts:
  - the expected cost of paying the benefits generally increases over the contract term; but
  - the periodic premiums used to fund these benefits are level.

- The portion of the premiums not required to pay expected cost in the early years are therefore set aside (or provisioned) to fund the expected shortfall in the later years of the contract.

- Reserves also help reduce cost of benefits as they also earn interest while being set aside.

- Although reserves are usually held on a per-contract basis, it is still the overall responsibility of the actuary to ensure that in the aggregate, the company’s assets are enough to back these reserves.
The insurer’s future loss random variable

- At any future time $t \geq 0$, define the insurer’s (net) future loss random variable to be
  \[ L^n_t = PVFB_t - PVFP_t. \]

- For most types of policies, it is generally true that for $t \geq 0$, $L^n_t \geq 0$, i.e. $PVFB_t \geq PVFP_t$.

- If we include expenses, the insurer’s (gross) future loss random variable is said to be
  \[ L^g_t = PVFB_t + PVFE_t - PVFP_t. \]

- For our purposes, we define the expected value of this future loss random variable to be the reserve or policy value at time $t$:
  \[ tV^n = E[L^n_t] = E[PVFB_t] - E[PVFP_t] \]
  or in the case with expenses,
  \[ tV^g = E[L^g_t] = E[PVFB_t] + E[PVFE_t] - E[PVFP_t] \]
Some remarks I

- $tV^n$ and $tV^g$ are respectively called net premium reserve and gross premium reserve. The primary difference between the two is the consideration of expenses.

- For Exam MLC, the term benefit reserve is often the preferred terminology to refer to the net premium reserve (no expenses).

- So if no confusion arises, we will often drop $n$ and $g$ in the superscripts for either the future loss random variable $L_t$ or the reserve $tV$.

- Note that $E[L_t]$ is actually conditional on the survival of $(x)$ at time $t$. Because otherwise, there is no reason to hold reserves when policy has been paid out (or matured or voluntarily withdrawn).

- Reserves are indeed released from the balance sheet when policy is paid out (or matured or voluntarily withdrawn).
Some remarks II

- Technically speaking, \( tV \) is to be the (smallest) amount for which the insurer is required to hold to be able to cover future obligations.

- We can see this from the following equations (here, we consider expenses, but if we ignore expenses, the term with expenses will simply be zero - same principle will hold):

\[
tV = \text{APV}(FB_t) + \text{APV}(FE_t) - \text{APV}(FP_t)
\]

Rewriting this, we get

\[
\text{APV}(FB_t) + \text{APV}(FE_t) = \text{APV}(FP_t) + tV.
\]

- This equation tells us that the reserve \( tV \) is the balancing term in the equation to cover the deficiency of future premiums that arises at time \( t \) to cover future obligations (benefits plus expenses, if any).
A numerical illustration

Consider a whole life policy issued to a select age [40] with:

- $100 of death benefit payable at the moment of death;
- premiums are annual payable at the beginning of each year;
- mortality follows the Standard Select Survival Model with $i = 5\%$; and
- mortality between integral ages follows the Uniform Distribution of Death (UDD).

The first step in reserve calculation is to determine the annual premiums. Let $P$ be the annual premium in this case so that one can easily verify that

\[
P = 100 \times \frac{\bar{A}_{[40]}}{\bar{a}_{[40]}} = 100 \times \frac{i}{\delta} \frac{A_{[40]}}{\bar{a}_{[40]}}
\]

\[
= 100 \left( \frac{0.05}{\log(1.05)} \right) \left( \frac{0.1209733}{18.45956} \right) = 0.6715928.
\]
A numerical illustration - continued

The benefit reserve (or policy value) at the end of year 5 is given by

\[ 5V = \text{APV}(FB_5) - \text{APV}(FP_5) = 100 \times \left( \frac{\alpha}{\delta} \right)A_{45} - P \times \ddot{a}_{45} \]

\[ = 100 \times \left( \frac{0.05}{\log(1.05)} \right) (0.151609) - 0.6715928 \times 17.81621 \]

\[ = 3.571607 \]

Note that we have calculated the policy value above as the expectation of a future loss random variable. We can also view reserve in terms of the insurer’s account value after policies have been in force after 5 years (retrospectively).

Suppose that insurer issues \( N \) such similar but independent policies. What happens to the insurer’s account value after 5 years? [Done in lecture!]
Fully discrete reserves - whole life insurance

Consider the case of a fully discrete whole life insurance issued to a life \((x)\) where premium of \(P\) is paid at the beginning of each year and benefit of \(B\) is paid at the e.o.y. of death.

- The insurer’s **future loss random variable** at time \(k\) (or at age \(x + k\)) is
  \[
  L_k = Bv^{Kx+k+1} - P\ddot{a}_{Kx+k+1},
  \]
  for \(k = 0, 1, 2, \ldots\)

- Applying the equivalence principle by solving \(E[L_0] = 0\), it can be verified that
  \[
  P = B \times \frac{A_x}{\ddot{a}_x} = B \times P_x.
  \]

- The benefit reserve (or policy value) at time \(k\) can be expressed as
  \[
  kV = E[L_k] = B \times (A_{x+k} - P_x \ddot{a}_{x+k}).
  \]
The benefit reserve at time $k$ is indeed equal to the difference between

$$\text{APV}(\text{FB}_k) = B \times A_{x+k}$$

and

$$\text{APV}(\text{FP}_k) = B \times P_x \ddot{a}_{x+k}$$

Sometimes, the variance is a helpful statistic and one can easily derive the variance of $L_k$ with

$$\text{Var}[L_k] = \text{Var} \left[ B \cdot v^{K_{x+k+1}} \left( 1 + \frac{P_x}{d} \right) - B \cdot \frac{P_x}{d} \right]$$

$$= B^2 \times \left( 1 + \frac{P_x}{d} \right)^2 \left[ 2A_{x+k} - (A_{x+k})^2 \right].$$
Other special formulas

Note that it can be shown that other special formulas for the benefit premium reserves for the fully discrete whole life hold:

1. \( kV = 1 - d\overline{a}_{x+k} - \left( \frac{1}{\overline{a}_x} - d \right) \overline{a}_{x+k} = 1 - \frac{\overline{a}_{x+k}}{\overline{a}_x} \)

2. \( kV = 1 - \frac{P_x + d}{P_{x+k} + d} = \frac{P_{x+k} - P_x}{P_{x+k} + d} \)

3. \( kV = 1 - \frac{1 - A_{x+k}}{1 - A_x} = \frac{A_{x+k} - A_x}{1 - A_x} \)

Note that in these formulas we set \( B = 1 \). If the benefit amount \( B \) is not $1, then simply multiply these formulas with the corresponding benefit amount.
A numerical illustration

Consider a fully discrete whole life policy of $10,000 issued to a select age (40) with:

- mortality follows the Standard Ultimate Survival Model with \( i = 5\% \); and

One can verify that \( P = 65.58717 \) and the following table of benefit reserves:

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<th>( k )</th>
<th>( \ddot{a}_{40+k} )</th>
<th>( kV )</th>
<th>( k )</th>
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Endowment policy

To simplify the formula development, assume $B = 1$.

- The future loss random variable at time $k \leq n$ (or at age $x + k$) is

$$L_k = v^{\min(K_x + k + 1, n - k)} - P_x:n \ddot{a}^{\min(K_x + k + 1, n - k)}.$$  

for $k = 0, 1, \ldots, n$. Loss is zero for $k > n$.

- The benefit reserve at time $k$ is

$$kV = A_{x+k:n-k} - P_x:n \ddot{a}_{x+k:n-k}.$$  

- The variance of $L_k$ is

$$\text{Var}[L_k] = \left(1 + \frac{P_x:n}{d}\right)^2 \left[2A_{x+k:n-k} - (A_{x+k:n-k})^2\right].$$
Published SOA question #77

You are given:

- \( P_x = 0.090 \)
- The benefit reserve at the end of year \( n \) for a fully discrete whole life insurance of $1 on \((x)\) is 0.563.
- \( P_{x:1}^{\frac{1}{n}} = 0.00864 \)

Calculate \( P_{x:1}^{\frac{1}{n}} \).
Illustrative example 1

For a special fully discrete whole life insurance on (50), you are given:

- The death benefit is $50,000 for the first 15 years and reduces to $10,000 thereafter.

- The annual benefit premium is $5P$ for the first 15 years and reduces to $P$ thereafter.

- Mortality follows the Illustrative Life Table.

- $i = 6\%$

Calculate the following:

1. the value of $P$;
2. the benefit reserve at the end of 10 years; and
3. the benefit reserve at the end of 20 years.
Recursive formulas

To motivate development of recursive formulas, consider a fully discrete whole life insurance of $B to $(x)$. It can be shown (done in lecture) that:

$$k + 1 V = \frac{(k V + P)(1 + i) - B q_{x+k}}{1 - q_{x+k}},$$

with $k = 1, 2, \ldots$ and $0 V = 0$. One can verify the following calculations of the successive reserves for $B = 10,000$. See slides page 13.

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Gross premium reserve calculation

Consider a fully discrete whole life policy of $10,000 issued to a select age (40) with:

- mortality follows the Standard Ultimate Survival Model with $i = 5\%$; and

Suppose expenses consist of: (a) $5$ per $1,000$ of death benefit in the first year and (b) $2$ per $1,000$ of death benefit in subsequent years.

It can be shown that the gross annual premium, $G$, is

$$ G = \frac{10000A_{40} + 30 + 20\ddot{a}_{40}}{\ddot{a}_{40}} $$

$$ = \frac{10000(0.1210592) + 30 + 20(18.45776)}{18.45776} $$

$$ = 87.21251. $$
To calculate gross premium reserves, use recursive formulas with \( V_0 = 0 \):

\[
V_1 = \frac{(V_0 + G - 50)(1.05) - 10000q_{40}}{1 - q_{40}}, \quad \text{and}
\]

\[
k+1 V_k = \frac{(k V_k + G - 20)(1.05) - 10000q_{40+k}}{1 - q_{40+k}}, \quad \text{for } k = 1, 2, \ldots
\]

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<tr>
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<th>( kV )</th>
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Compare these values with the benefit reserves. What do you observe?
Recursive formulas: net vs gross premium reserves

Figure: Comparison between benefit reserve and gross premium reserve
A generalization of recursive relations

The reserve in the next period $t + 1$ can be shown to be

$$
_{t+1}V = \frac{(tV + G_t - e_t)(1 + i_t) - (B_{t+1} + E_{t+1})q_{x+t}}{1 - q_{x+t}}.
$$

Intuitively, we have:

- accumulate previous reserves plus premium (less expenses) with interest;
- deduct death benefits (plus any claims-related expenses) to be paid at the end of the year; and
- divide the reserves by the proportion of survivors.
Valuation between policy years

Sometimes we may want to compute reserves between policy years $k$ and $k + 1$, say at $k + h$ for some $0 < h < 1$.

One may use the recursive formula but with caution:

- timing of the premium payments and expenses (if any)
- timing of the payment of the death benefit

Consider the whole life policy considered in slides page 8.

The reserve at time $k + h$ can be derived (assuming UDD between integral ages):

$$ k + h V = \frac{(kV + P)(1 + i)^h - B \cdot \int_0^h (1 + i)^{h-s}sp[x] + k\mu[x] + k + sds}{1 - \int_0^h sp[x] + k\mu[x] + k + sds} $$

$$ = \frac{(kV + P)(1 + i)^h - B \cdot \frac{e^{\delta h} - 1}{\delta} \cdot q[x] + k}{1 - h \cdot q[x] + k} $$
Figure: An illustration of the value of (benefit) reserves between policy years
Illustrative example 2

For a special single premium 20-year term insurance on (70):

- The death benefit, payable at the end of the year of death, is equal to 1000 plus the benefit reserve.

- $q_{70+k} = 0.03$, for $k = 0, 1, 2, \ldots$

- $i = 0.07$

Calculate the single benefit premium for this insurance.
Net amount at risk

- The difference $B_{t+1} + E_{t+1} - t+1V$ is called the net amount at risk.

- Sometimes called death strain at risk (DSAR) or sum at risk.

- The recursive formula can then alternatively be written as

$$
(tV + G_t - e_t)(1 + i_t) = t+1V + (B_{t+1} + E_{t+1} - t+1V)q_{x+t}
$$

where the term $(B_{t+1} + E_{t+1} - t+1V)q_{x+t}$ can then be called the expected net amount at risk.
Published SOA question #118

For a special fully discrete three-year term insurance on \((x)\):

- Level benefit premiums are paid at the beginning of each year.
- Benefit amounts with corresponding death probabilities are
  
  \[
  \begin{array}{ccc}
  k & b_{k+1} & q_{x+k} \\
  0 & 200,000 & 0.03 \\
  1 & 150,000 & 0.06 \\
  2 & 100,000 & 0.09 \\
  \end{array}
  \]

- \(i = 0.06\)

Calculate the initial benefit reserve for year 2.
SOA MLC Fall 2014 question #13

For a fully discrete whole life insurance of 100,000 on \((45)\), you are given:

- The gross premium reserve at duration 5 is 5500 and at duration 6 is 7100.
- \(q_{50} = 0.009\)
- \(i = 0.05\)
- Renewal expenses at the start of each year are 50 plus 4% of the gross premium.
- Claim expenses are 200.

Calculate the gross premium.
Fully continuous reserves - whole life

Consider now the case of a fully continuous whole life insurance with an annual premium rate of $\bar{P}(\bar{A}_x)$.

- The future loss random variable at time $t$ (or at age $x+t$):

$$L_t = v^{T_{x+t}} - \bar{P}(\bar{A}_x) \bar{a}_{T_{x+t}} = v^{T_{x+t}} \left[ 1 + \frac{\bar{P}(\bar{A}_x)}{\delta} \right] - \frac{\bar{P}(\bar{A}_x)}{\delta}.$$ 

- The benefit reserve at time $t$ is

$$tV = \mathbb{E}[L_t] = \bar{A}_{x+t} - \bar{P}(\bar{A}_x) \bar{a}_{x+t}.$$ 

- The variance of $L_t$ is

$$\text{Var}[L_t] = \left[ 1 + \frac{\bar{P}(\bar{A}_x)}{\delta} \right]^2 \left[ 2\bar{A}_{x+t} - (\bar{A}_{x+t})^2 \right].$$
Other formulas

Some continuous analogues of the discrete case:

1. \( tV = 1 - \frac{\overline{a}_{x+t}}{\overline{a}_x} \)

2. \( tV = \frac{\overline{P}(\overline{A}_{x+t}) - \overline{P}(\overline{A}_x)}{\overline{P}(\overline{A}_{x+t}) + \delta} \)

3. \( tV = \frac{\overline{A}_{x+t} - \overline{A}_x}{1 - \overline{A}_x} \)
Illustrative example 3

For a 10-year deferred whole life annuity of 1 on (35) payoffable continuously, you are given:

- Mortality follows deMoivre’s law with $\omega = 85$.
- Level benefit premiums are payable continuously for 10 years.
- $i = 0$

Calculate the benefit reserve at the end of five years.
Illustrative example 4 - modified SOA MLC Spring 2012

A special fully discrete 3-year endowment insurance on \((x)\) pays death benefits as follows:

<table>
<thead>
<tr>
<th>Year of Death</th>
<th>Death Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10,000</td>
</tr>
<tr>
<td>2</td>
<td>$20,000</td>
</tr>
<tr>
<td>3</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

You are given:

- The endowment benefit amount is $50,000.
- Annual benefit premiums increase at 10% per year, compounded annually.
- \(i = 0.05\)
- \(q_x = 0.08\) \(q_{x+1} = 0.10\) \(q_{x+2} = 0.12\)

Calculate the benefit reserve at the end of year 2.
### Other terminologies and notations used

<table>
<thead>
<tr>
<th>Expression</th>
<th>Other terms/symbols used</th>
</tr>
</thead>
<tbody>
<tr>
<td>reserves</td>
<td>policy values</td>
</tr>
<tr>
<td>future loss random variable</td>
<td>prospective loss</td>
</tr>
<tr>
<td>net amount at risk</td>
<td>death strain at risk (DSAR)</td>
</tr>
<tr>
<td></td>
<td>sum at risk</td>
</tr>
<tr>
<td>reserve at end of the year</td>
<td>terminal reserve</td>
</tr>
<tr>
<td>reserve at beginning of year plus applicable premium</td>
<td>initial reserve</td>
</tr>
</tbody>
</table>