



ACTEX ACADEMIC SERIES

*Models for  
Quantifying  
Risk*

Sixth Edition

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# GENERAL AND HISTORICAL PREFACE

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The analysis and management of financial risk is the fundamental subject matter of the discipline of actuarial science, and is therefore the basic work of the actuary. In order to manage financial risk, by use of insurance schemes or any other risk management technique, the actuary must first have a framework for quantifying the magnitude of the risk itself. This is achieved by using mathematical models that are appropriate for each particular type of risk under consideration. Since risk is, almost by definition, probabilistic, it follows that the appropriate models will also be probabilistic, or stochastic, in nature.

This textbook, appropriately entitled *Models for Quantifying Risk*, addresses the major types of financial risk analyzed by actuaries, and presents a variety of stochastic models for the actuary to use in undertaking this analysis. It is designed to be appropriate for a two-semester university course in basic actuarial science for third-year or fourth-year undergraduate students or entry-level graduate students. It is also intended to be an appropriate text for use by candidates in preparing for Exam MLC of the Society of Actuaries or Exam LC of the Casualty Actuarial Society.

One way to manage financial risk is to *insure* it, which basically means that a second party, generally an insurance company, is paid a fee to assume the risk from the party initially facing it. Historically the work of actuaries was largely confined to the management of risk within an insurance context, so much so, in fact, that actuaries were thought of as “insurance mathematicians” and actuarial science was thought of as “insurance math.” Although the insurance context remains a primary environment for the actuarial management of risk, it is by no means any longer the only one.

However, in recognition of the insurance context as the original setting for actuarial analysis and management of financial risk, we have chosen to make liberal use of insurance terminology and notation to describe many of the risk quantification models presented in this text. The reader should always keep in mind, however, that this frequent reference to an insurance context does not reduce the applicability of the models to risk management situations in which no use of insurance is involved.

The text is written in a manner that assumes each reader has a strong background in calculus, linear algebra, the theory of compound interest, and probability. (A familiarity with statistics is not presumed.)

*Models for Quantifying Risk* has appeared in five earlier editions. In each of those editions, important authorship contributions were made by Robin J. Cunningham, Ph.D., and Thomas N. Herzog, Ph.D., ASA. ACTEX Publications wishes to express its appreciation to these former co-authors for their lasting contributions to the text.

In addition to the former co-authors, many academic and industry actuaries contributed review services to the first five editions.

The original manuscript was thoroughly reviewed by Bryan V. Harsey, ASA, of Lebanon Valley College and by Esther Portnoy, FSA, of University of Illinois. Portions of the manuscript were also reviewed by Warren R. Luckner, FSA, and his graduate student Luis Gutierrez at University of Nebraska-Lincoln. Kristen S. Moore, ASA, used an earlier draft as a supplemental text in her courses at University of Michigan. Thorough reviews of the original edition were also conducted by James W. Daniel, ASA, of University of Texas, Professor Jacques Labelle, Ph.D., of Université du Québec à Montréal, and a committee appointed by the Society of Actuaries.

Special thanks goes to the students enrolled in Math 287-288 at University of Connecticut during the 2004-05 academic year, where the original text was classroom-tested, and to graduate student Xiumei Song, who developed the spreadsheet-based material presented in Appendix A.

A number of revisions in the Second Edition were also reviewed by Professors Daniel and Harsey; Third Edition revisions were reviewed by Professors Samuel A. Broverman, ASA (University of Toronto), Matthew J. Hassett, ASA (Arizona State University), and Warren R. Luckner, FSA (University of Nebraska-Lincoln). All of these academic colleagues made a number of useful comments that have contributed to an improved published text.

Three new applied topics were brought into the Fifth Edition, to meet changes made in the Exam MLC curriculum effective with the May 2012 exam administration. They were contributed by actuaries with considerable experience in their respective fields, and we wish to acknowledge their valuable contributions. They include Ronald Gebhardtshauer, FSA (Penn State University) for the pension material in Section 14.5, Ximing Yao, FSA (Hartford Life) for the universal life material in Chapter 16, and Chunhua (Amy) Meng, FSA (Yindga Taihe Life) for the material on variable annuities. (This topic has subsequently been removed from the text.)

The new material added to the Fifth Edition was also reviewed by Professor Luckner, as well as by Tracey J. Polsgrove, FSA (John Hancock USA), Link Richardson, FSA (American General Life), Arthur W. Anderson, ASA, EA (The Arthur W. Anderson Group), Cheryl Ann Breindel, FSA (Hartford Life), Douglas J. Jangraw, FSA (Massachusetts Mutual Life), Robert W. Beal, FSA (Milliman Portland), Andrew C. Boyer, FSA (Milliman Windsor), and Matthew Blanchette, FSA (Forethought Group).

# SIXTH EDITION PREFACE

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This latest edition of *Models for Quantifying Risk* has been revised from the prior edition by a new team of co-authors. There are three major areas of revision.

- (1) Early in 2013, the Society of Actuaries announced that Exam MLC would be changed from an all multiple choice exam to one that will be 40% multiple choice and 60% written answer, beginning with the April 2014 exam administration. Accordingly, we have revised our textbook by introducing a number of examples intended to introduce our readers to this new type of Exam MLC question.
- (2) Effective for the April 2014 exam, SOA has published an eight-page study note entitled “Notation and Terminology Used on Exam MLC.” The purpose of the study note is to inform exam candidates that some notation and terminology used on the exam could be different from that used in certain exam-preparation textbooks, particularly those written by authors oriented to actuarial theory and practice in countries outside of North America. *Our readers should be aware that the Sixth Edition of Models for Quantifying Risk uses notation and terminology that conforms totally to that to be used on the exam.* Exam candidates using this text will have no need to be concerned with the SOA study note.
- (3) The presentation of several important Exam MLC topics has been expanded and improved in the new edition. These include the topics of (a) universal life insurance, (b) multi-state model representation of various actuarial models, (c) Thiele’s differential equation for the fully continuous reserve, and its approximate solution via Euler’s method, and (d) profit analysis and testing, including the notion of the distribution of some of that profit back to the insureds as policyholder dividends under participating insurance contracts. Our expanded treatment of topic (d) has resulted in placing it in its own chapter (Chapter 17).

The current edition of *Models for Quantifying Risk* is organized into three sections.

The first, consisting of Chapters 1-4, presents a review of interest theory, probability, and Markov Chains in Chapters 1-3, respectively. The content of these chapters is very much needed as background to later material. They are included in the text for readers needing a comprehensive review of the topics. For those requiring an original textbook on any of these topics, we recommend either Broverman [5] or Kellison [15] for interest theory, Hassett and Stewart [12] for probability, and Ross [22] for Markov Chains. Chapter 4 presents a brief introduction to the life insurance industry and its products.

The second section, made up of Chapters 5-14, addresses the topic of survival-contingent payment models, traditionally referred to as *life contingencies*. The survival model is presented in Chapters 5 and 6, in both its parametric and tabular contexts. The standard set of single-life, single-decrement actuarial topics are then covered in Chapters 7-11, including contingent payment models (with emphasis on their standard life insurance applications), contingent annuities (life annuities), annual funding schemes (annual premiums), including their  $m^{\text{thly}}$  and continuous variations, and contingent contract reserves. Extensions to the multi-life cases of joint and last-survivor are presented in Chapter 12 and multiple-decrement models are covered in Chapters 13 and 14.

The third section, consisting of Chapters 15-17, contains three special topics. Chapter 15 deals with the topic of variable interest rates, Chapter 16 addresses the modern insurance product known as Universal Life, and Chapter 17 discusses the important topic of profit analysis and profit distribution to policyholders under participating insurance contracts.

The writing team would like to thank the folks at ACTEX Publications for their contributions to this edition. Gail A. Hall, FSA, served as the project editor, and reviewed a number of the expanded new edition topics. Marilyn J. Baleshiski and Garrett Doherty did the typesetting and graphic arts, and Jeff Melaragno designed the text's cover.

Xiaofeng (Felicia) Lai, a graduate student in the Actuarial Science Program at University of Connecticut, reviewed the entire Sixth Edition manuscript, working all of the new written-answer question examples, and made a number of valuable suggestions.

Finally, a very special acknowledgment is in order. When the Society of Actuaries published its textbook *Actuarial Mathematics* in the mid-1980s, Professor Geoffrey Crofts, FSA, then at University of Hartford, made the observation that the authors' use of the generic symbol  $Z$  as the present value random variable for *all* insurance models and the generic symbol  $Y$  as the present value random variable for *all* annuity models was confusing. He suggested that the present value random variable symbols be expanded to identify more characteristics of the models to which each related, following the principle that the present value random variable be notated in a manner consistent with the standard International Actuarial Notation used for its expected value. Thus one should use, for example,  $\bar{Z}_{x:\overline{n}|}$  in the case of the continuous endowment insurance model and  ${}_n|\ddot{Y}_x$  in the case of the  $n$ -year deferred annuity-due model, whose expected values are denoted  $\bar{A}_{x:\overline{n}|}$  and  ${}_n|\ddot{a}_x$ , respectively. Professor Crofts' notation has been adopted throughout our textbook, and we wish to thank him for suggesting this very useful idea to us.

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## SURVIVAL MODELS (CONTINUOUS PARAMETRIC CONTEXT)

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A *survival model* is simply a probability distribution for a particular type of random variable. Thus the general theory of probability, as reviewed in Chapter 2, is fully applicable here. However the particular history of the survival model random variable is such that specific terminology and notation has developed, particularly in an actuarial context. In this chapter (and the next) the reader will see this specialized terminology and notation, and recognize that it is *only* the terminology and notation that is new; the underlying probability theory is the same as that applying to any other continuous or discrete random variable and its distribution.

In actuarial science, the survival distribution is frequently summarized in tabular form, which is called a *life table*.<sup>1</sup> Because the life table form is so prevalent in actuarial work, we will devote a full chapter to it in this textbook (see Chapter 6).

### 5.1 THE AGE-AT-FAILURE RANDOM VARIABLE

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We begin our study of survival distributions by defining the generic concept of *failure*. In any situation involving a survival model, there will be a defined entity and an associated concept of *survival*, and hence of failure, of that entity.<sup>2</sup> Here are some examples of entities and their associated random variables.

- (1) The operating lifetime of a light bulb. The bulb is said to survive as long as it keeps burning, and fails at the instant it burns out.
- (2) The duration of labor/management harmony. The state of harmony continues to survive as long as regular work schedules are met, and fails at the time a strike is called. (Conversely, we could model the duration of a strike, where the strike survives until it is settled and workers return to the job. The settlement event constitutes the failure of the strike status.)
- (3) The lifetime of a new-born person. The person survives until death occurs, which constitutes the failure of the human entity. This will be the most common example considered in this text.

Let  $T_0$  denote the continuous random variable for the age of the entity at the instant it fails.

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<sup>1</sup> Alternatively, the tabular model is also called a *mortality table*.

<sup>2</sup> Another term for failure is *decrement*. If an entity has a particular status, such as survival, then failure to retain that status is often described as being *decremented* from that status. This terminology is particularly useful in the context of multiple decrements, which we encounter in Chapters 13 and 14.

We assume that the entity exists at age 0, so the domain of the random variable  $T_0$  is  $T_0 > 0$ . We refer to  $T_0$  as the *age-at-failure* random variable. We will consider the terms “failure” and “death” to be synonymous, so we will also refer to  $T_0$  as the *age-at-death* random variable.<sup>3</sup>

It is easy to see that the numerical value of the age at failure is the same as the *length of time* that survival lasts until failure occurs, since the variable begins at age 0, so we can also refer to  $T_0$  as the *time-to-failure* random variable. (If failure occurs at exact age  $t$ , then  $t$  is also the time until failure occurs.)

Later (see Section 5.3) we will consider the case where the entity of interest is known to have survived to some age  $x > 0$ . Then the time-to-failure random variable, to be denoted by  $T_x$ , will not be identical to the age-at-failure random variable  $T_0$ , although they will be related to each other by  $T_0 = x + T_x$ . When dealing with this more general case we will do our thinking in terms of the time-to-failure random variable.

### 5.1.1 THE CUMULATIVE DISTRIBUTION FUNCTION OF $T_0$

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For the age-at-failure random variable  $T_0$ , we denote its CDF by

$$F_0(t) = Pr(T_0 \leq t), \quad (5.1)$$

for  $t \geq 0$ .<sup>4</sup> We have already noted, however, that  $T_0 = 0$  is not possible, so we will always consider that  $F_0(0) = 0$ . We observe that  $F_0(t)$  gives the probability that failure will occur prior to (or at) precise age  $t$  for our entity known to exist at age 0. In standard actuarial notation,<sup>5</sup> this probability is denoted by  ${}_tq_0$ , so we have

$${}_tq_0 = F_0(t) = Pr(T_0 \leq t). \quad (5.2)$$

### 5.1.2 THE SURVIVAL DISTRIBUTION FUNCTION OF $T_0$

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The *survival distribution function* (SDF) for the survival random variable  $T_0$  is denoted by  $S_0(t)$ , and is defined by

$$S_0(t) = 1 - F_0(t) = Pr(T_0 > t), \quad (5.3)$$

for  $t \geq 0$ . Since we take  $F_0(0) = 0$ , it follows that we will always take  $S_0(0) = 1$ . The SDF gives the probability that the age at failure exceeds  $t$ , which is the same as the probability that the entity known to exist at age 0 will survive to age  $t$ . Since the notion of infinite survival is unrealistic, we consider that

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<sup>3</sup> In practice, age-at-failure is often used for inanimate objects, such as light bulbs or labor strikes, and age-at-death is used for animate entities, such as laboratory animals or human persons under an insurance arrangement.

<sup>4</sup> In probability theory, it is customary to subscript the CDF symbol with the name of the random variable, which suggests the notation  $F_{T_0}(t)$  in this case. With the name of the random variable understood to be  $T_0$  in this section, we prefer the notation  $F_0(t)$  to avoid the awkwardness of subscripting a subscript.

<sup>5</sup> As stated in the Preface, this text uses Standard International Actuarial Notation whenever possible.



$$\lim_{t \rightarrow \infty} S_0(t) = 0 \quad (5.4a)$$

and

$$\lim_{t \rightarrow \infty} F_0(t) = 1. \quad (5.4b)$$

In actuarial notation, the probability represented by  $S_0(t)$  is denoted  ${}_t p_0$ , so we have

$${}_t p_0 = S_0(t) = Pr(T_0 > t). \quad (5.5)$$

In probability textbooks in general, the CDF is given greater emphasis than is the SDF. (Some textbooks do not even define the SDF at all.) But when we are dealing with an age-at-failure random variable, and its associated distribution, the SDF will receive greater attention.

### EXAMPLE 5.1

Use both the CDF and the SDF to express the probability that an entity known to exist at age 0 will fail between the ages of 10 and 20.

### SOLUTION

We seek the probability that  $T_0$  will take on a value between 10 and 20. In terms of the CDF we have

$$Pr(10 < T_0 \leq 20) = F_0(20) - F_0(10).$$

Since  $S_0(t) = 1 - F_0(t)$ , then we also have

$$Pr(10 < T_0 \leq 20) = S_0(10) - S_0(20). \quad \square$$

### 5.1.3 THE PROBABILITY DENSITY FUNCTION OF $T_0$

For a continuous random variable in general, the *probability density function* (PDF) is defined as the derivative of the CDF. Thus we have here

$$f_0(t) = \frac{d}{dt} F_0(t) = -\frac{d}{dt} S_0(t), \quad (5.6)$$

for  $t > 0$ . Consequently,

$$F_0(t) = \int_0^t f_0(y) dy \quad (5.7)$$

and

$$S_0(t) = \int_t^\infty f_0(y) dy. \quad (5.8)$$

Of course it must be true that

$$\int_0^{\infty} f_0(y) dy = 1. \quad (5.9)$$

Although we have given mathematical definitions of  $f_0(t)$ , it will be useful to describe  $f_0(t)$  more fully in the context of the age-at-failure random variable. Whereas  $F_0(t)$  and  $S_0(t)$  are probabilities that relate to certain *time intervals*,  $f_0(t)$  relates to a *point of time*, and is not a probability. It is the density of failure at age  $t$ , and is therefore an *instantaneous* measure, as opposed to an interval measure.

It is important to recognize that  $f_0(t)$  is the *unconditional* density of failure at age  $t$ . By this we mean that it is the density of failure at age  $t$  given *only* that the entity existed at  $t = 0$ . The concept of *conditional* density is presented in the next subsection.

#### 5.1.4 THE HAZARD RATE FUNCTION OF $T_0$

Recall that the PDF of  $T_0$ ,  $f_0(t)$ , is the *unconditional* density of failure at age  $t$ . We now define a *conditional* density of failure at age  $t$ , with such density conditional on survival to age  $t$ . This conditional instantaneous measure of failure at age  $t$ , given survival to age  $t$ , is called the *hazard rate* at age  $t$ , or the *hazard rate function* (HRF) when viewed as a function of  $t$ . (In some textbooks the hazard rate is called the *failure rate*.) It will be denoted by  $\lambda_0(t)$ .

In general, if a conditional measure is multiplied by the probability of obtaining the conditioning event, then the corresponding unconditional measure will result. Specifically,

$$\begin{aligned} & \text{(Conditional density of failure at age } t, \text{ given survival to age } t) \\ & \times \text{(Probability of survival to age } t) \\ & = \text{(Unconditional density of failure at age } t). \end{aligned}$$

Symbolically this states that

$$\lambda_0(t) \cdot S_0(t) = f_0(t), \quad (5.10)$$

or

$$\lambda_0(t) = \frac{f_0(t)}{S_0(t)}. \quad (5.11)$$

Equations (5.11) and (5.6) give formal definitions of the HRF and the PDF, respectively, of the age-at-failure random variable. Along with the definitions it is also important to have a clear understanding of the *conceptual meanings* of  $\lambda_0(t)$  and  $f_0(t)$ . They are both instantaneous measures of the density of failure at age  $t$ ; they differ from each other in that  $\lambda_0(t)$  is conditional on survival to age  $t$ , whereas  $f_0(t)$  is unconditional (i.e., given only existence at age 0).

In the actuarial context of survival models for animate objects, including human persons, failure means death, or mortality, and the hazard rate is normally called the *force of mortality*. We will discuss the actuarial context further in Section 5.1.6 and in Chapter 6.

Some important mathematical consequences follow directly from Equation (5.11). Since  $f_0(t) = -\frac{d}{dt}S_0(t)$ , it follows that

$$\lambda_0(t) = \frac{-\frac{d}{dt}S_0(t)}{S_0(t)} = -\frac{d}{dt} \ln S_0(t). \quad (5.12)$$

Integrating, we have

$$\int_0^t \lambda_0(y) dy = -\ln S_0(t), \quad (5.13)$$

or

$$S_0(t) = \exp\left[-\int_0^t \lambda_0(y) dy\right]. \quad (5.14)$$

The *cumulative hazard function* (CHF) is defined to be

$$A_0(t) = \int_0^t \lambda_0(y) dy = -\ln S_0(t), \quad (5.15)$$

so that

$$S_0(t) = e^{-A_0(t)}. \quad (5.16)$$

### EXAMPLE 5.2

An age-at-failure random variable has a distribution defined by

$$F_0(t) = 1 - .10(100-t)^{1/2},$$

for  $0 \leq t \leq 100$ . Find (a) the PDF and (b) the HRF for this random variable.

### SOLUTION

(a) The PDF is given by

$$f_0(t) = \frac{d}{dt}F_0(t) = -(0.10)(.50)(100-t)^{-1/2} \cdot (-1) = .05(100-t)^{-1/2}.$$

(b) The HRF is given by

$$\lambda_0(t) = \frac{f_0(t)}{S_0(t)} = \frac{.05(100-t)^{-1/2}}{.10(100-t)^{1/2}} = .50(100-t)^{-1}. \quad \square$$

### 5.1.5 THE MOMENTS OF THE AGE-AT-FAILURE RANDOM VARIABLE $T_0$

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The first moment, or expected value, of a continuous random variable defined on  $[0, \infty)$  is given by

$$E[T_0] = \int_0^{\infty} t \cdot f_0(t) dt, \quad (5.17)$$

if the integral exists, and otherwise the first moment is undefined. Integration by parts yields the alternative formula

$$E[T_0] = \int_0^{\infty} S_0(t) dt, \quad (5.18)$$

provided  $\lim_{t \rightarrow \infty} t \cdot S_0(t) = 0$ . Equation (5.18) is frequently used to find the first moment of an age-at-failure random variable.

The second moment of  $T_0$  is given by

$$E[T_0^2] = \int_0^{\infty} t^2 \cdot f_0(t) dt, \quad (5.19)$$

if the integral exists, so the variance of  $T_0$  can be found from

$$\text{Var}(T_0) = E[T_0^2] - \{E[T_0]\}^2. \quad (5.20)$$

Specific expressions can be developed for the moments of  $T_0$  for specific forms of  $f_0(t)$ . This will be pursued in the following section.

Another property of the age-at-failure random variable that is of interest is its *median* value. We recall that the median of a continuous random variable is the value for which there is a 50% chance that the random variable will exceed (and thus also not exceed) that value. Mathematically,  $y$  is the median of  $T_0$  if

$$\Pr(T_0 > y) = \Pr(T_0 \leq y) = \frac{1}{2}, \quad (5.21)$$

so that  $S_0(y) = F_0(y) = \frac{1}{2}$ .

### 5.1.6 ACTUARIAL SURVIVAL MODELS

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When the age-at-failure random variable is considered in an actuarial context, special symbols are used for some of the concepts defined in this section. The hazard rate, now called the force of mortality, is denoted by  $\mu_t$ , rather than  $\lambda_0(t)$ . Thus we have

$$\mu_t = \frac{-\frac{d}{dt} S_0(t)}{S_0(t)} = -\frac{d}{dt} \ln S_0(t). \quad (5.22)$$

It is customary to denote the first moment of  $T_0$  by  ${}^{\circ}e_0$ . Thus we have

$${}^{\circ}e_0 = E[T_0] = \int_0^{\infty} t \cdot f_0(t) dt. \quad (5.23)$$

Since  ${}^{\circ}e_0$  is the unconditional expected value of  $T_0$ , given only alive at  $t=0$ , it is called the *complete expectation of life at birth*.<sup>6</sup>

We recognize that the moments of  $T_0$  given above are all unconditional. Conditional moments, and other conditional measures, are defined in Section 5.3, and the standard actuarial notation for them is reviewed in Chapter 6.

### EXAMPLE 5.3

For the distribution of Example 5.2, find (a)  $E[T_0]$  and (b) the median of the distribution.

#### SOLUTION

(a) The expected value is given by Equation (5.18) as

$$\begin{aligned} E[T_0] &= \int_0^{100} .10(100-t)^{1/2} dt \\ &= -\left(\frac{2}{3}\right)(.10)(100-t)^{3/2} \Big|_0^{100} = \left(\frac{2}{3}\right)(.10)(100)^{3/2} = \frac{200}{3}. \end{aligned}$$

(b) The median is the value of  $y$  satisfying  $S_0(y) = .10(100-y)^{1/2} = .50$ , which solves for  $y = 75$ . □

## 5.2 EXAMPLES OF PARAMETRIC SURVIVAL MODELS

In this section we explore several non-negative continuous probability distributions that are candidates for serving as survival models. In practice, some distributions fit better than others to the empirical evidence of the shape of a survival distribution, so we will comment on each distribution we present regarding its suitability as a survival model.

### 5.2.1 THE UNIFORM DISTRIBUTION

The continuous uniform distribution, defined in Section 2.3.1, is a simple two-parameter distribution with a constant PDF. The parameters of the distribution are the limits of the interval

<sup>6</sup> The significance of the adjective “complete” will become clearer when we consider an alternative measure of the expectation of life in Sections 5.3.6 and 6.3.4.

on the real number axis over which it is defined, and its PDF is the reciprocal of that interval length. Thus if a generic random variable  $X$  is defined over the interval  $[a, b]$ , then  $f_X(x) = \frac{1}{b-a}$ , for  $a \leq x \leq b$ , and  $f_X(x) = 0$  elsewhere.

For the special case of the age-at-failure random variable,  $a = 0$  so  $b$  is the length of the interval, as well as the greatest value of  $t$  for which  $f_0(t) > 0$ . When the uniform distribution is used as a survival model, the Greek  $\omega$  is frequently used for this parameter (which then represents the maximum survival age), so the distribution is defined by

$$f_0(t) = \frac{1}{\omega}, \quad (5.24)$$

for  $0 < t \leq \omega$ . The following properties of the uniform distribution easily follow, and should be verified by the reader:

$$F_0(t) = \int_0^t f_0(y) dy = \frac{t}{\omega} \quad (5.25)$$

$$S_0(t) = 1 - F_0(t) = \int_t^\omega f_0(y) dy = \frac{\omega - t}{\omega} \quad (5.26)$$

$$\lambda_0(t) = \frac{f_0(t)}{S_0(t)} = \frac{1}{\omega - t} \quad (5.27)$$

$$E[T_0] = \int_0^\omega t \cdot f_0(t) dt = \frac{\omega}{2} \quad (5.28)$$

$$Var(T_0) = E[T_0^2] - \{E[T_0]\}^2 = \frac{\omega^2}{12} \quad (5.29)$$

The uniform distribution, as a survival model, is not appropriate over a broad range of age, at least as a model for *human* survival. It is of historical interest, however, to note that it was the first continuous probability distribution to be suggested for that purpose, in 1724, by Abraham de Moivre. As a result, actuarial literature and exams often refer to the uniform distribution as “de Moivre’s law.”

The major use of this distribution is over short ranges of time (or age). We will explore this use of the uniform distribution quite thoroughly in Section 6.5.1.

### 5.2.2 THE EXPONENTIAL DISTRIBUTION

This very popular one-parameter distribution (see Section 2.3.3) is defined by its SDF to be

$$S_0(t) = e^{-\lambda t}, \quad (5.30)$$

for  $t > 0$  and  $\lambda > 0$ . It then follows that the PDF is

$$f_0(t) = -\frac{d}{dt} S_0(t) = \lambda \cdot e^{-\lambda t}, \quad (5.31)$$

so that the HRF is

$$\lambda_0(t) = \frac{f_0(t)}{S_0(t)} = \lambda, \quad (5.32)$$

a constant. In the actuarial context, where the hazard rate is generally called the force of mortality, the exponential distribution is referred to as the *constant force distribution*.

The exponential distribution, with its property of a constant hazard rate, is frequently used in reliability engineering as a survival model for inanimate objects such as machine parts. Like the uniform distribution, however, it is not appropriate as a model for human survival over a broad range, but might be used over short intervals, such as one year, due to its mathematical simplicity. This will be explored in Section 6.5.2.

### 5.2.3 THE GOMPERTZ DISTRIBUTION

This distribution was suggested as a model for human survival by Gompertz [9] in 1825. The distribution is usually defined by its force of mortality as

$$\mu_t = Bc^t, \quad (5.33)$$

for  $t > 0$ ,  $B > 0$ , and  $c > 1$ . Then the SDF is given by

$$S_0(t) = \exp\left[-\int_0^t Bc^y dy\right] = \exp\left[\frac{B}{\ln c}(1-c^t)\right]. \quad (5.34)$$

The PDF is given by  $\mu_t \cdot S_0(t)$ , and is clearly not a very convenient mathematical form. A closed-form expression for the mean of the distribution,  $E[T_0]$ , does not exist, but the mean can be approximated by numerical integration with a large finite upper limit replacing the actual upper limit of infinity.

### 5.2.4 THE MAKEHAM DISTRIBUTION

In 1860 Makeham [19] modified the Gompertz distribution by taking the force of mortality to be

$$\mu_t = A + Bc^t, \quad (5.35)$$

for  $t > 0$ ,  $B > 0$ ,  $c > 1$ , and  $A > -B$ . Makeham was suggesting that part of the hazard at any age is independent of the age itself, due, for example, to the risk of accident, so a constant was added to the Gompertz force of mortality.

The SDF for this distribution is given by

$$S_0(t) = \exp\left[-\int_0^t (A+Bc^y) dy\right] = \exp\left[\frac{B}{\ln c}(1-c^t) - At\right]. \quad (5.36)$$

Again it is clear that the PDF for this distribution is not mathematically tractable. As with the Gompertz distribution, there is no closed-form expression for  $E[T_0]$ , although it can also be approximated by numerical integration.<sup>7</sup>

### 5.2.5 SUMMARY OF PARAMETRIC SURVIVAL MODELS

We have briefly explored four distributions here: two (uniform and exponential) which are mathematically simple, and two (Gompertz and Makeham) which are not. For many illustrations, where we wish to avoid mathematical complexity, we will use the uniform or the exponential for illustrative purposes only, not necessarily suggesting that they are applicable in practice. The exponential distribution has been applied in many situations not involving healthy human lives, and has been widely used in those situations.

## 5.3 THE TIME-TO-FAILURE RANDOM VARIABLE

In Section 5.1 we defined a continuous random variable, denoted  $T_0$ , which measured the length of time from age 0 until failure occurs. Now we turn to the case where our entity of interest is known to have survived to age  $x$ , where  $x > 0$ , and we wish to consider the random variable for the *additional* time that the entity might survive beyond age  $x$ . We denote this random variable by  $T_x$ , and note that its domain is  $T_x > 0$ . We define the random variable  $T_x$  to be the *time-to-failure* random variable for an entity known to be alive (i.e., known to have not yet failed) at age  $x$ . We will use the notation  $(x)$  to denote the entity known to be alive at age  $x$ .<sup>8</sup>

If  $T_x$  is the random time-to-failure for an entity alive at age  $x$ , it follows that the age-at-failure will be  $T_x$  more than age  $x$ , so we have the relationship  $T_0 = x + T_x$  between our two basic random variables. This is illustrated in the following figure.

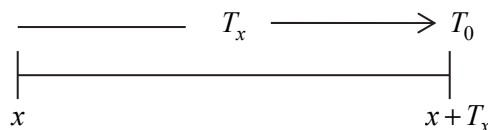


FIGURE 5.1

Rather than develop separate distributions for  $T_x$  for each different value of  $x$ , we will simply calculate probability values for  $T_x$  from the distribution of  $T_0$ . (An exception to this will be explored in Section 5.4.)

<sup>7</sup> A generalization of the Makeham distribution is presented in Exercise 5-10.

<sup>8</sup> The time until failure of  $(x)$  can also be called the future lifetime of  $(x)$ , so  $T_x$  is therefore often called the *future lifetime* random variable for the entity  $(x)$ .



# CHAPTER SIX

## THE LIFE TABLE (DISCRETE TABULAR CONTEXT)

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In this chapter we describe the nature of the traditional life table, showing that it can have all the properties of the survival models described in Chapter 5. When a survival model is presented in the life table format, it is customary to use notation and terminology which differ somewhat from that presented in Chapter 5. A major objective of this chapter will be to show clearly the correspondence between notation used in the probability model and that used in the life table model.

The reader should realize that life tables were developed by actuaries independently from (and a century earlier than) the development of the statistical theory of survival models as probability distributions<sup>1</sup>. For this reason, traditional life table notation and terminology will not tend to reveal the stochastic nature of the model as clearly as is done by the probability model in Chapter 5. By showing the correspondence of the life table symbols to those of the probability model, we intend to correct this.

### 6.1 DEFINITION OF THE LIFE TABLE

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The life table can be defined as a table of numerical values of  $S_0(x)$  for certain values of  $x$  (which we now prefer to use instead of  $t$ ). Table 6.1 illustrates such a table.

TABLE 6.1

$x$	0	1	2	3	4	...	109	110
$S_0(x)$	1.00000	.97408	.97259	.97160	.97082	...	.00001	.00000

Typically a complete life table shows values of  $S_0(x)$  for all integral values of  $x$ ,  $x=0,1,\dots$ . Since  $S_0(x)$  is represented by these values, it is clear that a practical upper limit on  $x$  must be adopted beyond which values of  $S_0(x)$  are taken to be zero. Traditionally,  $\omega$  is used for the smallest value of  $x$  for which  $S_0(x)=0$ . Then  $S_0(\omega-1)>0$ , but  $S_0(\omega)=0$ . In Table 6.1,  $\omega=110$ .

From Table 6.1, we can calculate the conditional probabilities represented by  ${}_n p_x$  and  ${}_n q_x$  for integral  $x$  and  $n$ . However, these are the *only* functions that can be determined from the tabular model. Functions such as  $f_0(x)$ ,  $\lambda_0(x)$ , and  ${}_x e_x$  cannot be determined from the tabular model unless we expand the model by adopting assumed values for  $S_0(x)$  between adjacent integers. We will pursue this in Section 6.6.

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<sup>1</sup> The first modern life table, called the Breslau Table, dates from 1693 and is attributed to Edmund Halley [10] of Halley's Comet fame.

**EXAMPLE 6.1**

From Table 6.1, calculate (a) the probability that a life age 0 will fail before age 3; (b) the probability that a life age 1 will survive to age 4.

**SOLUTION**

(a) This is given directly by  $F_0(3) = 1 - S_0(3) = .02840$ .

(b) This conditional probability is given by  ${}_3p_1 = \frac{S_0(4)}{S_0(1)} = .99665$ . □

**6.2 THE TRADITIONAL FORM OF THE LIFE TABLE**

The tabular survival model was developed by the early actuaries many years ago. The history of this model is reported throughout actuarial literature, and a brief summary of this history is presented by Dobson [9].

Traditionally, the tabular survival model differs from Table 6.1 in two respects. Rather than presenting decimal values of  $S_0(x)$ , it is usual to multiply these values by, say, 100,000, and thereby present the  $S_0(x)$  values as integers. Secondly, since these integers are not probabilities (which  $S_0(x)$  values are), the column heading is changed from  $S_0(x)$  to  $l_x$ , where  $l$  stands for *number living*, or *number of lives*. In this way the tabular survival model became known as the *life table*.

Since  $S_0(0) = 1$ , then  $l_0$  is the same as the constant multiple which transforms all  $S_0(x)$  into  $l_x$ . This constant is called the *radix* of the table. Formally,

$$l_x = l_0 \cdot S_0(x). \quad (6.1)$$

Using a radix of 100,000, we transform Table 6.1 into Table 6.1a.

**TABLE 6.1a**

$x$	0	1	2	3	4	...	109	110
$l_x$	100,000	97,408	97,259	97,160	97,082	...	1	0

The basic advantage of the traditional form of the life table is its susceptibility to interpretation. If we view  $l_0 = 100,000$  as a hypothetical cohort group of newborn lives, or other new entities such as lightbulbs, electronic devices, or laboratory animals, then each value of  $l_x$  represents the survivors of that group to age  $x$ , according to the model. This is a convenient, deterministic, interpretation of the model. Of course, since  $l_x = l_0 \cdot S_0(x)$ , and  $S_0(x)$  is a probability, then  $l_x$  is really the *expected number* of survivors to age  $x$  out of an original group of  $l_0$  new entities. This connection between  $S_0(x)$  and  $l_x$  is also given in Chapter 1 of Jordan [14].

Although the basic representation of the tabular survival model is in terms of the values of  $l_x$ , it is customary for the table to also show the value of several other functions derived from  $l_x$ . We define

$$d_x = l_x - l_{x+1}, \quad (6.2)$$

or, more generally,

$${}_n d_x = l_x - l_{x+n}. \quad (6.3)$$

Since  $l_x$  represents the size of the cohort at age  $x$ , and  $l_{x+n}$  is the number of them still surviving at age  $x+n$ , then clearly  ${}_n d_x$  gives the number who fail (or die) between ages  $x$  and  $x+n$ . (This portrayal of number dying explains the frequent historical reference to these models as *mortality tables*.) Furthermore,

$$q_x = \frac{d_x}{l_x}, \quad (6.4)$$

or, more generally,

$${}_n q_x = \frac{{}_n d_x}{l_x} \quad (6.5)$$

gives the conditional probability of failure, given alive at age  $x$ . Finally, we have

$${}_n p_x = 1 - {}_n q_x = \frac{l_x - {}_n d_x}{l_x} = \frac{l_{x+n}}{l_x} \quad (6.6)$$

as the conditional probability of surviving to age  $x+n$ , given alive at age  $x$ . With  $n=1$ , we have the special case

$$p_x = \frac{l_{x+1}}{l_x}. \quad (6.7)$$

Recall that the conditional probabilities  ${}_n p_x$  and  ${}_n q_x$  were defined in Section 5.3 in terms of  $S_0(x)$ . The consistency of those definitions with the ones presented in this section is easily seen since  $l_x$  is simply  $l_0 \cdot S_0(x)$ . We redefined  ${}_n p_x$  and  ${}_n q_x$  in terms of  $l_x$  here simply to complete our description of the life table form of the survival model.

### EXAMPLE 6.2

From Table 6.1a, find (a) the number who fail between ages 2 and 4; (b) the probability that a life age 1 will survive to age 4.

**SOLUTION**

(a) This is given by  ${}_2d_2 = l_2 - l_4 = 177$ .

(b) This is given by  ${}_3p_1 = \frac{l_4}{l_1} = .99665$ . (Compare with part (b) of Example 6.1.)  $\square$

### 6.3 OTHER FUNCTIONS DERIVED FROM $l_x$

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Although a life table only presents values of  $l_x$  for certain (say, integral) values of  $x$ , we wish to adopt the view that the  $l_x$  function which produces these values is a continuous and differentiable function. In other words, we assume that a continuous and differentiable  $l_x$  function *exists*, but only certain values of it are presented in the survival model. The reason we make this assumption is that there are several other important functions that can be derived from  $l_x$  if  $l_x$  is continuous and differentiable.

If values of  $l_x$  are known only at integral  $x$ , the question of how to *evaluate* these additional functions then arises, and the usual way to accomplish this evaluation is to make an assumption about the form of  $l_x$  between adjacent integral values of  $x$ .

In this section we will derive these several new functions from  $l_x$  symbolically, assuming  $l_x$  to be continuous and differentiable. In Section 6.6 we will discuss three common distribution assumptions, and show how they allow us to evaluate the functions of this section from a table of  $l_x$  values at integral  $x$  only. We will also interpret these distribution assumptions in terms of both  $l_x$  and  $S_0(x)$ .

#### 6.3.1 THE FORCE OF FAILURE

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The derivative of  $l_x$  can be interpreted as the absolute instantaneous annual rate of change of  $l_x$ . Since  $l_x$  represents the number of survivors at age  $x$ , then the derivative, which is the annual rate at which  $l_x$  is changing, gives the annual rate at which failures are occurring at age  $x$ . This derivative is negative since  $l_x$  is a decreasing function. To obtain the absolute magnitude of this instantaneous rate of failure, we will use the negative of the derivative. Finally, since the magnitude of the derivative depends on the size of  $l_x$  itself, we obtain the *relative instantaneous rate of failure* by dividing the negative derivative of  $l_x$  by  $l_x$  itself. Thus we have

$$\mu_x = \frac{-\frac{d}{dx}l_x}{l_x}, \quad (6.8)$$

which we call the *force of failure* (or *force of mortality*) at age  $x$ . Since  $l_x = l_0 \cdot S_0(x)$ , we see that Equation (6.8) is the same as

$$\lambda(x) = \frac{-\frac{d}{dx}S_0(x)}{S_0(x)} = \frac{f_0(x)}{S_0(x)}. \quad (6.9)$$

Thus the hazard rate and the force of failure are identical.

If we multiply both sides of Equation (5.14) by  $l_0$  and substitute  $\mu_y$  for  $\lambda_0(y)$ , we obtain

$$l_x = l_0 \cdot S_0(x) = l_0 \cdot \exp\left[-\int_0^x \mu_y dy\right]. \quad (6.10)$$

In the life table context,  $S_0(x) = {}_x p_0 = \exp[-\int_0^x \mu_y dy]$  can be interpreted as a decremental factor that reduces the initial cohort of size  $l_0$  to size  $l_x$  at age  $x$ .

By a simple variable change we can write Equation (6.8) as

$$\mu_{x+t} = \frac{-\frac{d}{dt}l_{x+t}}{l_{x+t}}, \quad (6.8a)$$

a form in which the force of failure will frequently be expressed.

### EXAMPLE 6.3

Show that the force of failure,  $\mu_x$ , is the limiting value of the probability of failure over an interval divided by the interval length (in years), as the interval length approaches zero.

#### SOLUTION

Consider first a one-year interval, with  $q_x = \frac{d_x}{l_x}$ . Then consider a half-year interval with  $\frac{1/2 q_x}{1/2} = \frac{l_x - l_{x+1/2}}{1/2 \cdot l_x}$ . Now, in general, consider  $\frac{\Delta x q_x}{\Delta x} = \frac{l_x - l_{x+\Delta x}}{\Delta x \cdot l_x}$ , and show that  $\lim_{\Delta x \rightarrow 0} \frac{\Delta x q_x}{\Delta x} = \mu_x$ . We have

$$\lim_{\Delta x \rightarrow 0} \left[ \frac{l_x - l_{x+\Delta x}}{\Delta x \cdot l_x} \right] = \frac{1}{l_x} \cdot \lim_{\Delta x \rightarrow 0} \left[ \frac{l_x - l_{x+\Delta x}}{\Delta x} \right] = \frac{1}{l_x} \left[ -\frac{d}{dx} l_x \right] = \mu_x,$$

by Equation (6.8). □

### 6.3.2 THE PROBABILITY DENSITY FUNCTION OF $T_0$

With the force of failure, which is the same as the hazard rate, now defined, the next function to develop from  $l_x$  is the PDF of the age-at-failure random variable  $T_0$  (Remember that we wish to show that the life table is a representation of the distribution of this random variable.)

From Equation (5.10) we have  $f_0(x) = \lambda_0(x) \cdot S_0(x)$ . In the life table context,  $\lambda_0(x) = \mu_x$  and  $S_0(x) = \frac{l_x}{l_0}$ . Thus we have, for  $x \geq 0$ ,

$$f_0(x) = \mu_x \left( \frac{l_x}{l_0} \right) = {}_x p_0 \mu_x. \quad (6.11)$$

Also, from Equation (6.8),  $\frac{d}{dx} l_x = -l_x \mu_x$ . Dividing both sides by  $l_0$  gives

$$\frac{d}{dx} {}_x p_0 = -{}_x p_0 \mu_x. \quad (6.12)$$

#### EXAMPLE 6.4

Show that  $\int_0^\infty f_0(x) dx = 1$ .

#### SOLUTION

Since  $f_0(x) = {}_x p_0 \mu_x$ , we have  $\int_0^\infty {}_x p_0 \mu_x dx = -{}_x p_0 \Big|_0^\infty$ , from Equation (6.12). Thus we have  ${}_0 p_0 - \infty p_0 = 1$ , since  ${}_0 p_0 = 1$  and  $\infty p_0 = 0$ .  $\square$

With the PDF in hand, we can now find  $E[T_0]$ , which we recall is denoted by  ${}^0 e_0$ . (Throughout this and the following section, all expectations are assumed to exist.) We have

$${}^0 e_0 = E[T_0] = \int_0^\infty x \cdot f_0(x) dx = \int_0^\infty x \cdot {}_x p_0 \mu_x dx. \quad (6.13)$$

Integration by parts produces the alternative formula

$${}^0 e_0 = E[T_0] = \int_0^\infty {}_x p_0 dx = \frac{1}{l_0} \cdot \int_0^\infty l_x dx. \quad (6.14)$$

The second moment of  $T_0$  is found from

$$E[T_0^2] = \int_0^\infty x^2 \cdot {}_x p_0 \mu_x dx. \quad (6.15a)$$

Integration by parts produces

$$E[T_0^2] = 2 \int_0^\infty x \cdot {}_x p_0 dx = \frac{2}{l_0} \cdot \int_0^\infty x \cdot l_x dx. \quad (6.15b)$$

Then the variance of  $T_0$  is given by

$$\text{Var}(T_0) = E[T_0^2] - \{E[T_0]\}^2 = \frac{2}{l_0} \cdot \int_0^\infty x \cdot l_x \, dx - \left( \frac{1}{l_0} \cdot \int_0^\infty l_x \, dx \right)^2. \quad (6.16)$$

### 6.3.3 CONDITIONAL PROBABILITIES AND DENSITIES

We have already discussed the conditional probabilities  ${}_n p_x$  and  ${}_n q_x$  in terms of both  $S_0(x)$  and  $l_x$ .

Another conditional probability of some interest is denoted by  ${}_{n|m} q_x$ . It represents the probability that an entity known to be alive at age  $x$  will fail between ages  $x+n$  and  $x+n+m$ . In terms of the probability notation of Chapter 5,  ${}_{n|m} q_x = \text{Pr}[(x+n) < T_0 \leq (x+n+m) | T_0 > x]$ . This can also be expressed as the probability that an entity age  $x$  will survive  $n$  years, but then fail within the next  $m$  years. This way of stating the probability suggests that we can write

$${}_{n|m} q_x = {}_n p_x \cdot {}_m q_{x+n}. \quad (6.17)$$

Here  ${}_m q_{x+n}$  is the conditional probability of failing between ages  $x+n$  and  $x+n+m$ , given alive at age  $x+n$ . In turn,  ${}_n p_x$  is the conditional probability of surviving to age  $x+n$ , given alive at age  $x$ . Their product gives the probability of failing between ages  $x+n$  and  $x+n+m$ , given alive at age  $x$ . In terms of  $l_x$ , we have, from Equations (6.6) and (6.5),

$${}_{n|m} q_x = \frac{l_{x+n}}{l_x} \cdot \frac{{}_m d_{x+n}}{l_{x+n}} = \frac{{}_m d_{x+n}}{l_x}. \quad (6.18a)$$

When  $m=1$  we use the notation

$${}_n | q_x = \frac{d_{x+n}}{l_x}. \quad (6.18b)$$

Recall that  ${}_n | q_x$  was defined in Section 5.3.6 as  $\text{Pr}(K_x = n)$  or  $\text{Pr}(K_x^* = n+1)$ , the probability that an entity alive at age  $x$  would fail in the  $(n+1)^{\text{st}}$  year.

#### EXAMPLE 6.5

Show that  ${}_{n|m} q_x = {}_n p_x - {}_{n+m} p_x$ , and give an interpretation of this result.

#### SOLUTION

Since, from Equation (6.3),  ${}_m d_{x+n} = l_{x+n} - l_{x+n+m}$ , then Equation (6.18a) becomes  ${}_{n|m} q_x = \frac{l_{x+n} - l_{x+n+m}}{l_x} = {}_n p_x - {}_{n+m} p_x$ . Since  ${}_n p_x$  is the probability of surviving to age  $x+n$ , we

can think of it as containing the probability of surviving to any age beyond  $x+n$ . If we remove from  ${}_n p_x$  the probability of surviving to  $x+n+m$ , which is  ${}_{n+m} p_x$ , we have the probability of surviving to  $x+n$ , but not to  $x+n+m$ , which is  ${}_{n|m} q_x$ .  $\square$

Next we wish to explore the conditional PDF for death at age  $y$ , given alive at age  $x$ , where  $y > x$ . From Equation (5.44) we know this conditional PDF is  $f_0(y | T_0 > x) = \frac{f_0(y)}{S_0(x)}$ . Now from Equation (6.11) we have  $f_0(y) = \frac{1}{l_0} \cdot l_y \mu_y$ , and from Equation (6.1) we have  $S_0(x) = \frac{l_x}{l_0}$ . Thus

$$f_0(y | T_0 > x) = \frac{l_y \mu_y}{l_x} = {}_{y-x} p_x \mu_y. \quad (6.19a)$$

Letting  $t = y - x$ , so  $y = x + t$ , we have

$$f_0(x+t | T_0 > x) = {}_t p_x \mu_{x+t}, \quad (6.19b)$$

the conditional PDF of the random variable for the length of future lifetime of an entity alive at age  $x$ . This conditional PDF is a very useful function for developing other results.

If both numerator and denominator on the right side of Equation (6.8a) are divided by  $l_x$ , we obtain

$$\mu_{x+t} = \frac{-\frac{d}{dt} {}_t p_x}{{}_t p_x}, \quad (6.20)$$

which is equivalent to

$$\frac{d}{dt} {}_t p_x = -{}_t p_x \mu_{x+t}. \quad (6.21)$$

The expected future lifetime of an entity alive at age  $x$  is given by

$$e_x^0 = E[T_x] = \int_0^\infty t \cdot {}_t p_x \mu_{x+t} dt = \int_0^\infty {}_t p_x dt, \quad (6.22)$$

by evaluating the first integral using integration by parts. The second moment of  $T_x$  is

$$E[T_x^2] = \int_0^\infty t^2 \cdot {}_t p_x \mu_{x+t} dt = 2 \int_0^\infty t \cdot {}_t p_x dt, \quad (6.23)$$

again by using integration by parts on the first integral, so its variance is

$$\text{Var}(T_x) = E[T_x^2] - \{E[T_x]\}^2 = 2 \int_0^\infty t \cdot {}_t p_x dt - \left( \int_0^\infty {}_t p_x dt \right)^2. \quad (6.24)$$



# CHAPTER FIFTEEN

## MODELS WITH VARIABLE INTEREST RATES

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Thus far in the text, when calculating the actuarial present value (APV) for contingent payment models, including insurance products, we have treated time until failure and mode of failure as random variables. But we have always assumed that a single interest rate was valid throughout the life of the model, however long that might be. It can be risky to assume that interest rates will remain constant at today's rates. Indeed some insurance companies around the world have experienced severe losses as a result of pricing products at interest rates that proved to be too optimistic.

In this chapter we address contingent payment models using interest rates that vary with time. Sections 15.1 and 15.2 address models with deterministic contingent payment amounts evaluated using non-deterministic interest rates. The term structure of interest rates and implied forward rates of interest are introduced in Sections 15.3 and 15.4.

The treatment of topics in Chapter 15 follows a heuristic approach. To simplify the discussion in Sections 15.1 and 15.2, we make the assumption that the market consists only of *one-period securities*. For our discussion of interest rates, the only securities available for investment are one-period bonds that pay a single coupon plus principal at the end of the period. This assumption enables us to introduce features of interest rate variability without having to deal with issues such as a term structure or partial-period payments. In addition, there is no distinction (in the absence of default) between the interest rate of a bond and the rate of return on that bond. In Sections 15.3 and 15.4 we broaden the discussion to include multi-period bonds, including those with partial-period payments (coupons). This will enable us to develop the term structure of spot interest rates along with implied forward rates of interest.

### 15.1 ACTUARIAL PRESENT VALUES USING VARIABLE INTEREST RATES

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Interest rates in the United States have varied substantially over time. Table 15.1 shows sample one-year U.S. Treasury interest rates between 1962 and 2009.<sup>1</sup> This table gives a good indication of just how variable interest rates can be over time. In this section, we discuss one method for incorporating this variability into calculating the actuarial present value for contingent payment models. This method involves the construction of *interest rate scenarios* for the future. An interest rate scenario is a possible future path for interest rates. For example, Table 15.2 shows three illustrative interest rate scenarios for one-year interest rates in the first five years of a contingent contract. Each row represents a different scenario for the one-year interest rate in each year over the next five years. The pre-subscript  $j$  on the interest rate symbol

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<sup>1</sup> Source: [www.ustreas.gov](http://www.ustreas.gov).

indicates the scenario from which that rate was taken. For example,  ${}_3i_3 = .04$  means that the interest rate in the third interest rate scenario in the third year is 4%.

TABLE 15.1

Year	Rate	Year	Rate	Year	Rate
1962	3.10%	1978	8.34%	1994	5.32%
1963	3.36	1979	10.65	1995	5.94
1964	3.85	1980	12.00	1996	5.52
1965	4.15	1981	14.80	1997	5.63
1966	5.20	1982	12.27	1998	5.05
1967	4.88	1983	9.58	1999	5.08
1968	5.69	1984	10.91	2000	6.11
1969	7.12	1985	8.42	2001	3.49
1970	6.90	1986	6.45	2002	2.00
1971	4.89	1987	6.77	2003	1.24
1972	4.95	1988	7.65	2004	1.31
1973	7.32	1989	8.53	2005	2.79
1974	8.20	1990	7.89	2006	4.38
1975	6.78	1991	5.86	2007	5.00
1976	5.88	1992	3.89	2008	3.17
1977	6.08	1993	3.43	2009	0.40

TABLE 15.2

Scenario $j$	${}_j i_1$	${}_j i_2$	${}_j i_3$	${}_j i_4$	${}_j i_5$
1	6%	7%	8%	9%	10%
2	6	6	6	6	6
3	6	5	4	3	2

**EXAMPLE 15.1**

For each of the three interest rate scenarios in Table 15.2, find the actuarial present value of a five-year pure endowment issued at age  $x = 65$  for amount \$1000. The mortality rates for each year of age are  $q_{65} = .03$ ,  $q_{66} = .04$ ,  $q_{67} = .05$ ,  $q_{68} = .06$ , and  $q_{69} = .07$ .

**SOLUTION**

In each scenario, the APV is

$$1000 {}_5E_{65} = 1000({}_j v^5 \cdot {}_5p_{65}),$$

where  ${}_jv^5$  represents five years of discounting at interest rates given by Scenario  $j$ . Regardless of the chosen scenario,

$${}_5p_{65} = (.97)(.96)(.95)(.94)(.93) = .7734.$$

We can find  ${}_1v^5$ , for example, as

$${}_1v^5 = \left(\frac{1}{1.06}\right)\left(\frac{1}{1.07}\right)\left(\frac{1}{1.08}\right)\left(\frac{1}{1.09}\right)\left(\frac{1}{1.10}\right) = .6809,$$

so the APV under Scenario 1 is  $(1000)(.7734)(.6809) = 526.61$ . Under Scenarios 2 and 3 the APV's are 577.93 and 635.97, respectively. (The reader is asked to verify these results in Exercise 15-1.) □

We can imagine that an insurer who has priced a pure endowment contract assuming level interest rates of 6% (Scenario 2) will be unhappy if it chooses to invest the net single premium in one-year bonds, and the interest rates then emerge similarly to Scenario 3.<sup>2</sup>

**EXAMPLE 15.2**

Using the same mortality and interest assumptions as in Example 15.1, find the actuarial present value for a five-year term insurance of unit amount issued at age  $x = 65$ , with benefit paid at the end of the year of failure. Find a separate APV for each of the three scenarios.

**SOLUTION**

We adapt Equation (7.8) to find the actuarial present value for the five-year term insurance under Scenario  $j$ , and we denote this APV by  ${}_jA_{65:\overline{5}|}^1$ .

**TABLE 15.3**

$t$	Year $t$ Rate	${}_1v^t$	${}_{t-1}q_{65}$	${}_1v^t \cdot {}_{t-1}q_{65}$
1	.06	.9434	.0300	.0283
2	.07	.8817	.0388	.0342
3	.08	.8164	.0466	.0380
4	.09	.7490	.0531	.0398
5	.10	.6809	.0582	.0396
${}_1A_{65:\overline{5} }^1$				<b>.1799</b>

<sup>2</sup> In practice, the situation is more complicated than that presented here, because the insurer will generally try to invest in securities with a maturity similar to that of the product from which the net single premium arose. In this case the insurer will only have to worry about current interest rates for bond cash flows requiring reinvestment. However, for some very long-term contracts such as whole life contingent annuities, whole life insurance, or long term care insurance, this problem can be serious.

The results of the calculation for Scenario 1 are shown in Table 15.3 in spreadsheet form. Note how the term  $v^k$  in Equation (7.8), which assumes a constant interest rate, is generalized to  ${}_j v^k = \prod_{t=1}^k (1 + {}_j i_t)^{-1}$  in the case of the  $j^{\text{th}}$  variable interest rate scenario. The APV under Scenario 1 is  ${}_1 A_{65:\overline{5}|}^1 = .1799$ . (The reader should repeat the steps depicted in Table 15.3 under Scenarios 2 and 3 to verify that  ${}_2 A_{65:\overline{5}|}^1 = .1875$  and  ${}_3 A_{65:\overline{5}|}^1 = .1958$ .) Note that the APV is higher for the lower interest rate scenarios.  $\square$

## 15.2 DETERMINISTIC INTEREST RATE SCENARIOS

Interest rate scenarios used in actuarial analysis are of two distinct types. *Deterministic scenarios*, described in this section, are determined *a priori* and are often used to “stress” a product’s profitability in the event future interest rates are unfavorable. Scenarios of this type are sometimes prescribed by regulatory agencies to provide a test of sensitivity to interest rates that is common across products and companies. *Stochastic scenarios* are scenarios that are created using a stochastic interest rate simulator based on an assumed probability distribution for future interest rates.

We address the deterministic scenarios in this section by studying a sample regulatory policy designed to test the interest sensitivity of insurance products. If a product “fails” the interest sensitivity test, the company selling the product must hold additional capital as contingent funds for adverse changes in interest rates. Although the example here is fictional, similar deterministic scenarios are performed in some jurisdictions as part of cash flow testing of products for interest sensitivity.

### EXAMPLE 15.3

An annuity company sells the following two products:

- (a) A five-year annual payment temporary immediate annuity
- (b) A five-year pure endowment

The national regulatory authority requires the following two-step interest rate test in order to determine if the annuity company must hold additional capital:

- (1) The net single premium (NSP) for each product is calculated under three deterministic interest rate scenarios:
  - (i) Rates remain level at the current rate.
  - (ii) Rates rise 1% per year until they reach twice the current rate, and then remain level in succeeding years.
  - (iii) Rates fall 1% per year until they reach one-half the current rate, and then remain level in succeeding years.

- (2) If the NSP under the falling interest rate scenario is 5% or more above the NSP in the level rate case, the company must hold additional capital.

If the probability of death in any given year remains constant at  $q_x = .02$  and the current interest rate is 6%, determine whether this annuity company must hold additional capital for either product.

**SOLUTION**

- (a) For the five-year temporary immediate annuity, we first calculate the NSP (or APV) in the level rate case, using Equation (8.21). We obtain

$${}_l a_{x:\overline{5}|} = \sum_{t=1}^5 {}_l v^t \cdot {}_t p_x = \sum_{t=1}^5 \left(\frac{1}{1.06}\right)^t \cdot (.98)^t = 3.9756,$$

where the pre-subscript  $l$  denotes the level interest rate case. For the falling interest rate case, denoted by the pre-subscript  $f$ , the NSP is given by

$${}_f a_{x:\overline{5}|} = \sum_{t=1}^5 {}_f v^t \cdot {}_t p_x = \sum_{t=1}^5 {}_f v^t \cdot (.98)^t.$$

The calculation is summarized in Table 15.4 below. The reader should repeat the steps depicted in Table 15.4 to calculate the APV under the rising interest rate scenario, obtaining the value  ${}_r a_{x:\overline{5}|} = 3.8461$  (see Exercise 15-3(a)). Since the falling interest rate scenario does not produce an APV more than 5% greater than under the level rate case, the annuity company does not need to hold additional reserves for its five-year temporary immediate annuity product.

**TABLE 15.4**

$t$	Year $t$ Rate	${}_f v^t$	${}_t p_x$	${}_f v^t \cdot {}_t p_x$
1	.06	.9434	.9800	.9245
2	.05	.8985	.9604	.8629
3	.04	.8639	.9412	.8131
4	.03	.8388	.9224	.7737
5	.03	.8143	.9039	.7360
${}_f a_{x:\overline{5} }$				<b>4.1102</b>

- (b) For the five-year pure endowment, we again calculate first the APV in the level interest case, obtaining

$${}_l A_{x:\overline{5}|}^1 = {}_l v^5 \cdot {}_5 p_x = \left(\frac{1}{1.06}\right)^5 \cdot (.98)^5 = .6755.$$

Under the falling interest rate scenario, we have  ${}_f v^5 = .8143$  (from Table 15.4) along with the value  ${}_5 p_x = (.98)^5 = .9039$ , so the APV for the five-year pure endowment is  $(.8143)(.9039) = .7361$ . The ratio of the falling rate APV to the level rate APV is  $\frac{.7361}{.6755} = 1.0897$ .

Since the falling rate APV is more than 5% above the level rate APV, the annuity company is required to hold additional capital for each five-year pure endowment product that it sells. □

### 15.3 SPOT INTEREST RATES AND THE TERM STRUCTURE OF INTEREST RATES

We now drop the assumption made in Sections 15.1 and 15.2 that the market consists only of one-period securities, and move to a more realistic set of investment products. We assume that it is possible to buy interest-bearing securities of varying maturities. Also, we assume that some of these interest-bearing securities make periodic interest payments every six months and make an interest and principal payment at maturity. For the sake of simplicity, we assume that all of these securities are risk-free (i.e., they are certain to pay interest and principal with no chance of default), and we refer to all of them as *bonds*. Bonds with periodic interest payments are called *coupon bonds* whereas bonds with no periodic payments and a single payment at maturity are called *zero-coupon bonds*. There is a large market in United States Treasury securities fitting these descriptions.

Table 15.5 shows available interest rates for coupon-bearing treasury securities of varying maturities on a particular date.<sup>3</sup>

TABLE 15.5

Maturity (in years)	Nominal Annual Yield for Coupon-bearing Bonds ( $i^{(2)}$ )
0.5	2.44%
1.0	2.60
1.5	2.76
2.0	2.93

This table suggests that on the day in question, we could expect to purchase a treasury security with a maturity of six months at a yield of 2.44%.<sup>4</sup> In other words, for an investment of \$1000, we would expect to receive \$1012.20 in six months. Note that the coupon payment, made in addition to the principal, is half the stated yield. A one-year bond purchased the same day would pay \$13 in six months and \$1013 at the end of one year.

<sup>3</sup> Source: Daily Treasury Yield Curve Rates at [www.ustreas.gov](http://www.ustreas.gov); 1.5 year yield is interpolated.

<sup>4</sup> In reality, such a security with exact yield and maturity dates may not be available on that day.

Similarly, a two-year bond would entitle the purchaser to three semi-annual payments of \$14.65 and a final payment of \$1014.65.

The first important feature of this table is that bonds with differing maturities offer differing rates of interest. The extra yield for longer-term bonds reflects the loss of liquidity that investors suffer by committing their money for a longer period of time, and can be thought of as a type of *liquidity premium*. Differences in yield also reflect market expectations for what the future short-term rates of interest will be. On occasion, expectations for lower short-term rates in the future will offset the liquidity premium and longer maturities will have lower yields than shorter maturities.

A second important feature of the table is that there is an implied set of zero-coupon bond interest rates for each maturity listed in the table, which can be derived from the coupon-bearing bond yields using a method called *bootstrapping*. First, the zero-coupon bond yield for a maturity of six-months must equal that of the coupon-bearing bond, since both consists of only a single payment at that maturity. Therefore the nominal annual yield, convertible semiannually, for a six-month zero-coupon bond, denoted  $z_{0.5}$ , is  $z_{0.5} = 2.440\%$ , or 1.220% as an effective semiannual rate.

To calculate the yield for a zero-coupon bond which matures in one year, we use the six-month zero-coupon rate to value the six-month coupon payment and the original price of the bond to determine the implied one-year zero-coupon rate. For example, the one-year bond described above pays \$13 in six months and \$1013 in one year for the price of \$1000. Therefore the implied one-year zero-coupon yield, denoted  $z_{1.0}$ , must satisfy

$$1000 = \frac{13}{1.01220} + \frac{1013}{\left(1 + \frac{z_{1.0}}{2}\right)^2},$$

where .01220 is effective semiannual and  $z_{1.0}$  is nominal annual, convertible semiannually. From this we obtain  $z_{1.0} = 2.601\%$ . Similarly,  $z_{1.5}$  must satisfy

$$1000 = \frac{13.80}{1.01220} + \frac{13.80}{\left(1 + \frac{.02601}{2}\right)^2} + \frac{1013.80}{\left(1 + \frac{z_{1.5}}{2}\right)^3}.$$

(The reader should note that the one-year zero-coupon rate was used for that maturity, rather than the one-year coupon-bearing rate.) From this we obtain  $z_{1.5} = 2.763\%$ . Finally, using

$$1000 = \frac{14.65}{1.01220} + \frac{14.65}{\left(1 + \frac{.02601}{2}\right)^2} + \frac{14.65}{\left(1 + \frac{.02763}{2}\right)^3} + \frac{1014.65}{\left(1 + \frac{z_{2.0}}{2}\right)^4},$$

we determine that  $z_{2.0} = 2.936\%$ . In summary, the bootstrap method produces the results shown in Table 15.6.

TABLE 15.6

Maturity (in years)	Nominal Annual Yield for Coupon-bearing Bonds	Nominal Annual Yield for Zero-coupon Bonds
0.5	2.44%	2.440%
1.0	2.60	2.601
1.5	2.76	2.763
2.0	2.93	2.936

Regarding Table 15.6, the dependence of available yields on years to maturity is referred to as the *term structure of interest rates*. The associated zero-coupon bond rates are often referred to as *spot rates*. Once a set of spot rates has been obtained, it is easy to value any set of cash flows, whether or not those cash flows are uniform.

**EXAMPLE 15.4**

To finance the construction of an auditorium, a college has agreed to make the following payments at the following maturity times:

Payment	\$200,000	\$50,000	\$50,000	\$100,000
Maturity	Today	6 months	12 months	24 months

Using the term structure of interest rates in Table 15.6, calculate the net present value of these payments.

**SOLUTION**

We directly find

$$NPV = 200,000 + \frac{50,000}{1.01220} + \frac{50,000}{\left(1 + \frac{.02601}{2}\right)^2} + \frac{100,000}{\left(1 + \frac{.02936}{2}\right)^4} = 392,459.12. \quad \square$$

**EXAMPLE 15.5**

A client age 60 purchases a five-year term life insurance policy that will pay \$1,000,000 at the end of the year of death. The client will fund the policy with level annual premiums, and the insurance company has the ability to lock in appropriate forward rates of interest on those premiums. Using the information in Table 15.7, calculate the net level annual premium for the policy.

TABLE 15.7

Maturity (in years)	Annual Yield for Zero-coupon Bonds	$x$	$q_x$
1.0	3.0%	60	.02
2.0	4.0	61	.03
3.0	5.0	62	.04
4.0	6.0	63	.05
5.0	7.0	64	.06



**SOLUTION**

The most straightforward solution to this problem is to calculate the APV of the premium payments and set it equal to the APV of the insurance death benefit, using the equivalence principle. For a level annual premium,  $P$ , the APV of premium is

$$P \cdot \ddot{a}_{60:\overline{5}|} = P(1 + v p_{60} + v^2 {}_2p_{60} + v^3 {}_3p_{60} + v^4 {}_4p_{60}),$$

where each  $v^t$  value is calculated using the  $t$ -year spot rate. Using this and the mortality rates shown above, we have

$$P \cdot \ddot{a}_{60:\overline{5}|} = P \left[ 1 + \frac{.98}{1.03} + \frac{(.98)(.97)}{(1.04)^2} + \frac{(.98)(.97)(.96)}{(1.05)^3} + \frac{(.98)(.97)(.96)(.95)}{(1.06)^4} \right].$$

From this we find the APV of the premiums to be  $4.3054P$ . The APV of the death benefit is

$$A_{60:\overline{5}|}^1 = v q_{60} + v^2 p_{60} \cdot q_{61} + v^3 {}_2p_{60} \cdot q_{62} + v^4 {}_3p_{60} \cdot q_{63} + v^5 {}_4p_{60} \cdot q_{64},$$

where, again, spot interest rates are used. (As an exercise, the reader should verify that  $A_{60:\overline{5}|}^1 = .1527$ .) Then the net level premium is

$$P = \frac{(1,000,000)(.1527)}{4.3054} = 35,467.09. \quad \square$$

## 15.4 FORWARD INTEREST RATES

For this section, we assume a financial environment in which investors can buy and sell zero-coupon bonds that pay interest at current spot rates in any dollar amount and with no transaction costs. In such an environment, current spot rates imply another set of interest rates that can be locked in today for future deposits. For example, suppose an investor simultaneously undertakes the following pair of transactions:

- Transaction A: Buy a \$1000 par value two-year zero-coupon bond paying 2.96% interest.
- Transaction B: Sell a \$1000 par value one-year zero-coupon bond paying 2.62% interest.

With this pair of transactions, the investor has a net cash flow of zero today. In one year he must pay principal and interest on the one-year bond, and in two years he will receive principal and interest on the two-year bond. The resulting net cash flows experienced by the investor are shown in Table 15.8.

TABLE 15.8

Time (in years)	Net Cash Flow
0	\$ 0.00
1	- 1026.20
2	1060.08

These are the same cash flows that would be experienced by an investor who agrees one year in advance to invest \$1026.20 in a zero-coupon bond at 3.30% interest (except for some small round-off error). Therefore by purchasing and selling securities of differing maturities today, an investor can “lock in” a return on an investment one or more periods from now. In the current example, we say that the 3.30% interest rate obtained for an investment one year from now is the *one-year forward one-year rate*, since the interest rate obtained is for an investment one year from now (i.e., one year forward) and is obtained for a one-year security. When a similar set of transactions is implemented to lock in a rate  $n$  years from now on a  $k$ -year zero coupon bond, the resulting rate is called the  *$n$ -year forward  $k$ -year rate*. We denote this rate by  $f_{n,k}$ .

**EXAMPLE 15.6**

Using the yields in Table 15.9, find all possible forward rates for forward securities with maturities of one, two, three, and four years.

TABLE 15.9

Maturity (in years)	Annual Yield for Zero-coupon Bonds
1.0	3.0%
2.0	4.0
3.0	5.0
4.0	6.0
5.0	7.0

**SOLUTION**

We show here the calculations for  $f_{1,4}$  and  $f_{2,2}$ . (Calculations for other forward rates are similar, and are left to the reader as Exercise 15-12.)  $f_{1,4}$  is the only forward four-year rate that can be calculated from the rates in the table. This rate is most easily calculated using the logic that an investor obtains the same total return *either* by buying a five-year zero-coupon bond, *or* by investing in a one-year bond and then investing the proceeds for four years at the one-year forward four-year rate. That is,

$$(1+z_5)^5 = (1+z_1)^1 \cdot (1+f_{1,4})^4. \quad (15.1)$$

In this case we have

$$(1.07)^5 = (1.03)^1 \cdot (1+f_{1,4})^4,$$

from which we find  $f_{1,4} = 8.024\%$ . Similarly,  $f_{2,2}$  must satisfy

$$(1+z_4)^4 = (1+z_2)^2 \cdot (1+f_{2,2})^2, \tag{15.2}$$

from which we find  $f_{2,2} = 8.038\%$ . All of the forward rates, rounded to four decimal places, are shown in Table 15.10. □

**TABLE 15.10**

$n$	$f_{n,1}$	$f_{n,2}$	$f_{n,3}$	$f_{n,4}$
1.0	5.01%	6.01%	7.02%	8.02%
2.0	7.03	8.04	9.05	–
3.0	9.06	10.07	–	–
4.0	11.10	–	–	–

**EXAMPLE 15.7**

A five-year pure endowment contract issued to a person age 60 is funded with level annual premiums and has a maturity benefit of \$10,000. Premiums are payable at the beginning of each year, and the benefit is payable at the end of the fifth year. Table 15.11 shows mortality rates for a 60-year-old and forward rates that are currently available. Use this information to calculate the net level annual premium for the pure endowment. Note that  $f_{0,5} = z_5$ .

**TABLE 15.11**

$y$	$f_{y,5-y}$	$x$	$q_x$
0	4.0%	60	.02
1	5.0	61	.03
2	6.0	62	.04
3	7.0	63	.05
4	8.0	64	.06

**SOLUTION**

Since we are given forward rates, it will be easiest to determine the level annual premium retrospectively. The premiums must accumulate with interest and survivorship to total \$10,000 at the end of the fifth year. That is,

$$10,000 = P \cdot \ddot{s}_{60:\overline{5}|} = P \left( \frac{1}{{}_5E_{60}} + \frac{1}{{}_4E_{61}} + \frac{1}{{}_3E_{62}} + \frac{1}{{}_2E_{63}} + \frac{1}{{}_1E_{64}} \right),$$

where, for example,

$${}_3E_{62} = \frac{{}_3P_{62}}{(1+f_{2,3})^3} = \frac{(.96)(.95)(.94)}{(1.06)^3} = .7198.$$

Similar calculations produce

$$10,000 = P \cdot \ddot{s}_{60:\overline{5}|} = P \left( \frac{1}{.6698} + \frac{1}{.6841} + \frac{1}{.7198} + \frac{1}{.7800} + \frac{1}{.8704} \right),$$

from which we find  $P = 1476.02$ .

Note that we could also have found the net level annual premium prospectively by first converting the forward rates to current spot rates. We first note that  $z_5 = f_{0,5} = 4.0\%$ . Then to calculate  $z_n$  for  $n < 5$ , we use the relationship

$$(1+z_n)^n \cdot (1+f_{n,5-n})^{5-n} = (1+z_5)^5. \quad (15.3)$$

The resulting spot rates, rounded to four decimal places, are shown in Table 15.12. (The reader should verify that they are correct.)

**TABLE 15.12**

$n$	$z_n$
1	0.094%
2	1.071
3	2.049
4	3.023
5	4.000

Then prospectively we have

$$10,000 {}_5E_{60} = P \cdot \ddot{a}_{60:\overline{5}|} = P(1 + v \cdot {}_1P_{60} + v^2 \cdot {}_2P_{60} + v^3 \cdot {}_3P_{60} + v^4 \cdot {}_4P_{60}).$$

The left side of this equation evaluates to

$$10,000v^5 \cdot {}_5P_{60} = \frac{(10,000)(.98)(.97)(.96)(.95)(.94)}{(1.04)^5} = 6698.13,$$

where the five-year spot rate has been used. For the right side of the equation, each  $v^n$  is calculated using the corresponding spot rate  $z_n$ . From this we find  $\ddot{a}_{60:\overline{5}|} = 4.53795$ , from which we again find

$$P = \frac{6698.13}{4.53795} = 1476.02. \quad \square$$

## 15.5 TRANSFERRING THE INTEREST RATE RISK

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The overriding theme of this text is that persons facing financial risks can be relieved of those risks by paying an insurer to assume them. From the insurer's perspective, there are three primary risks associated with a contract of life insurance, namely those of expenses, mortality, and interest.

The insurer charges for the expenses of doing business by increasing the net premiums to reach the contract premiums (or gross premiums), actually paid. If operational expenses turn out to be less than assumed in setting the contract premiums, the insurer makes a profit on the expense element. If the opposite turns out to be the case, then the insurer loses money on the expense element. Generally insurers are fairly good at charging for their expenses, so the *expense risk* is not very great.

For many years the view was held that the major risk to the insurer was the *mortality risk*. If failures occurred earlier than, or at greater rates than, as predicted by the underlying survival model, the insurer suffered losses on the mortality element under life insurance contracts. Under annuities, the opposite would be true; the insurer would suffer a loss if mortality was lighter (i.e., if annuitants lived longer) than as predicted by the survival model.

By assuming that the lifetimes of different policyholders are independent, the insurer can *diversify* the mortality risk over the collection of policyholders. Some will fail earlier and some later, so that the aggregate risk can be better predicted. In light of this, we refer to the mortality risk as a *diversifiable risk*. (This concept was illustrated in Section 9.3.)<sup>5</sup>

When the insurer selects an interest rate for the premium calculation, it is assuming that it will be able to earn that rate on its invested assets backing the insurance or annuity contracts. If it earns interest on its assets at a greater rate than that assumed, it makes a profit on the interest element. On the other hand, the insurer faces an *interest rate risk* that earned rates will fall below assumed rates and it will therefore suffer a loss on the interest element. This has been a problem for many insurers in recent years.

If an interest loss occurs, due to falling interest rates in the investment marketplace, it will occur on all contracts alike. For this reason we refer to the interest rate risk as a *non-diversifiable risk*.

Although the insurer cannot diversify the interest rate risk across the collection of policyholders, it is possible for the insurer to *transfer* part or all of that risk back to the insured. When this is done under a life insurance or annuity contract, we say that the policyholder is participating in the interest rate risk.<sup>6</sup>

In this text we explore how this is accomplished under variable or indexed universal life insurance contracts. (See Sections 16.2.1 and 16.2.3.) For annuity contracts, transferring all or part of the interest rate risk to the annuitant occurs under *variable annuity contracts*. Such contracts are not discussed in this text.

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<sup>5</sup> See Appendix C for a mathematical analysis of risk diversification.

<sup>6</sup> Another strategy available to an insurer to reduce interest rate risk is *hedging*.

## 15.6 EXERCISES

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### 15.1 Actuarial Present Values Using Variable Interest Rates

15-1 Complete Example 15.1 for Scenarios 2 and 3.

15-2 Complete Example 15.2 for Scenarios 2 and 3.

### 15.2 Deterministic Interest Rate Scenarios

15-3 (a) Complete part (a) of Example 15.3 for the rising interest rate scenario.

(b) Complete part (b) of Example 15.3 for the rising interest rate scenario.

15-4 A company sells insurance in a country where only one-year bonds are available as investments to back its business. Our task is to compare the interest sensitivity of the following three products in this environment.

- (i) A 5-year immediate annuity-certain, where payments are made regardless of survival status.
- (ii) A 5-year immediate life annuity.
- (iii) A single premium 5-year term insurance contract.

The applicable failure rates are  $q_x = .10$ ,  $q_{x+1} = .15$ ,  $q_{x+2} = .20$ ,  $q_{x+3} = .25$ , and  $q_{x+4} = .30$ .

(a) Assuming today's interest rate is 7%, calculate the actuarial present value for each of the three products using each of the following two interest rate scenarios:

- (1) Increasing: rates rise by 1% each year, but do not exceed 11% in any year.
- (2) Decreasing: rates fall by 1% each year, but do not fall below 3% in any year.

(b) Which of the products is least interest sensitive in this environment? Explain.

15-5 For the same country and interest scenarios as in Exercise 15-4, we wish to evaluate the following two similar products:

- (1) Single premium 10-year term insurance of face amount \$1000, with benefit paid at the end of the year of failure.
  - (2) Annual premium 10-year term insurance of face amount \$1000, with benefit paid at the end of the year of failure. The level annual premiums are paid at the beginning of each year.
- (a) For both products, assume  $q_x = .05$  for all years. Calculate the benefit premium for each product, assuming rates remain level over the life of the product.

- (b) Calculate the actuarial present value of the gain for each product under the increasing and decreasing scenarios. (Note that the premium was chosen so that the actuarial present value in each case is zero in the event of level rates.)
- (c) In terms of interest risk, which payment scheme appears less risky for the insurance company? Explain.

**15.3 Spot Interest Rates and the Term Structure of Interest Rates**

- 15-6 Verify that  $A_{60:\overline{5}|}^1 = .1527$  in Example 15.5.
- 15-7 Use the nominal annual coupon yields in the table below to calculate the corresponding zero-coupon yields of the same maturities. (In both cases the nominal annual yield rates are convertible semiannually.)

Maturity (in years)	Nominal Annual Yield for Coupon-bearing Bonds	Nominal Annual Yield for Zero-coupon Bonds
0.5	2.0%	
1.0	4.0	
1.5	6.0	
2.0	8.0	

- 15-8 Use the annual coupon yields in the table below to calculate the corresponding zero-coupon yields of the same maturities. (For this exercise, we assume annual-payment coupon bonds rather than semiannual-payment coupon bonds.) How does the solution compare to that of Exercise 15-7?

Maturity (in years)	Annual Yield for Coupon-bearing Bonds	Annual Yield for Zero-coupon Bonds
1	2.0%	
2	4.0	
3	6.0	
4	8.0	

- 15-9 Use the annual zero-coupon yields in the table below to calculate the corresponding yields for annual-payment coupon bonds of the same maturities. (We assume here that coupon bonds pay coupons annually rather than semiannually.)

Maturity (in years)	Annual Yield for Coupon-bearing Bonds	Annual Yield for Zero-coupon Bonds
1		2.0%
2		4.0
3		6.0
4		8.0

- 15-10 Assume the following zero-coupon rates and calculate the implied yields for coupon bonds with equivalent maturities. (In both cases the nominal annual yield rates are convertible semiannually.)

Maturity (in years)	Nominal Annual Yield for Coupon-bearing Bonds	Nominal Annual Yield for Zero-coupon Bonds
0.5		2.0%
1.0		4.0
1.5		6.0
2.0		8.0

- 15-11 The regents of Fantastic University provide a four-year scholarship for one incoming freshman who plans to major in actuarial science. Current tuition at Fantastic is \$26,000 per year and tuition is expected to increase 8% per year over the next four years. The first annual tuition payment is due today. Each year we assume a 25% chance that the scholarship recipient will change majors or drop out of school; either event cancels future scholarship payments. Using the table of yields from Exercise 15-9, calculate the actuarial present value of this scholarship.

#### 15.4 Forward Interest Rates

- 15-12 Complete Example 15.6 by verifying the  $f_{n,k}$  values shown in Table 15.10.
- 15-13 Verify the spot rate values shown in Table 15.12.
- 15-14 Using the  $n$ -year forward one-year rates in the following table, find all determinable spot rates.

$n$	$f_{n,1}$
0	4.0%
1	5.0
2	6.0
3	7.0
4	8.0

- 15-15 Using the  $n$ -year forward one-year rates from Exercise 15-14, find all available forward rates.
- 15-16 In connection with taking over a client's retirement account, the client agrees to invest \$300,000 of that account with your firm for three years, starting two years from now.
- (a) According to the interest rates in Exercise 15-15, what rate of interest can be locked in for the investment period?



(b) What spot-rate transactions should be entered into today in order to lock in the yield found in part (a)? Include the term and principal amount of the two transactions.

15-17 Due to the demise of a distant relative, you will receive \$25,000 in one year that you would like to invest at that time for two years.

(a) According to the rates in Exercise 15-15, what rate can be locked in for the investment period?

(b) What transactions should be entered into today in order to lock in the rate from part (a)? Include the terms and principal amounts of the two transactions.

15-18 Calculate all forward rates that can be inferred from the annual coupon-bearing bond yield rates in the following table.

<b>Maturity (in years)</b>	<b>Annual Yield Rates for Coupon-bearing Bonds</b>
1	2.0%
2	4.0
3	6.0
4	8.0

**15.5 Transferring the Interest Rate Risk**

15-19 Give examples of mortality risk that is not diversifiable.

15-20 Explain the differences in interest rate risk for whole life insurance versus term life insurance.

15-21 Why is interest rate risk considered a non-diversifiable risk? Give an example of the effects of interest rate risk.

$$(b) APV_{51}^{ER} = \sum_{y=61}^{64} \left[ 1 - .03 \left( 65 - y - \frac{1}{2} \right) \right] \cdot PAB_{y+1/2} \cdot v^{y+1/2-51} \cdot {}_{y-51}p_{51}^{(\tau)} \cdot q_y^{(r)} \cdot r \ddot{a}_{y+1/2}^{(12)},$$

where

$$PAB_{y+1/2} = .01 \left( y + \frac{1}{2} - 51 \right) (100,000) \cdot \frac{1}{3} \left( \frac{\frac{1}{2}S_{y-3} + S_{y-2} + S_{y-1} + \frac{1}{2}S_y}{S_{51}} \right)$$

$$(c) APV_{51}^W = \sum_{y=56}^{60} PAB_{y+1/2} \cdot v^{14} \cdot {}_{y-51}p_{51}^{(\tau)} \cdot q_y^{(w)} \cdot {}_{65-y-1/2}p_{y+1/2}^w \cdot r \ddot{a}_{65}^{(12)}$$

$$(d) APV_{51}^I = \sum_{y=56}^{64} PAB_{y+1/2} \cdot v^{y+1/2-51} \cdot {}_{y-51}p_{51}^{(\tau)} \cdot q_y^{(i)} \cdot i \ddot{a}_{y+1/2}^{(12)}$$

$$(e) APV_{51}^D = \sum_{y=61}^{64} .50 \left[ 1 - .03 \left( 65 - y - \frac{1}{2} \right) \right] \cdot PAB_{y+1/2} \cdot v^{y+1/2-51} \cdot {}_{y-51}p_{51}^{(\tau)} \cdot q_y^{(d)} \cdot r \ddot{a}_{y+1/2-3}^{(12)}$$

14-27 (a) 1860

(b) The APV for each benefit is calculated the same as in Exercise 14-25, except that  $PAB_{65}$  in part (a) and  $PAB_{y+1/2}$  in parts (b)-(e) are all replaced by the benefit accrual 1860. The unit credit normal cost is the sum of these five APVs.

(c) The APV for each benefit is calculated the same as in part (b), except that the 1860 benefit accrual is replaced by the 7500 accrued benefit. The accrued liability is the sum of these five APVs.

14-29 (a) -4362.80 (b) 28.25

**CHAPTER 15**

15-1 577.93; 635.97

15-2 .1875; .1958

15-3 (a) 3.8461

(b) .6155

15-4 (a)

Interest Rate Scenario	Annuity Certain	Life Annuity	Term Insurance
Increasing	3.97	2.53	.53
Decreasing	4.25	2.65	.57

(b) The life annuity

- 15-5 (a) 289.84; 46.73  
 (b) Increasing: 23.74; 6.10  
 Decreasing: -29.25; -7.96  
 (c) The annual premium product
- 15-7 2.0%; 4.020%; 6.082%; 8.211%
- 15-8 2.0%; 4.041%; 6.169%; 8.447%
- 15-9 2.0%; 3.960%; 5.844%; 7.615%
- 15-10 2.0%; 3.980%; 5.921%; 7.804%
- 15-11 74,020

15-14

$n$	1	2	3	4	5
$z_n$	4.000%	4.499%	4.997%	5.494%	5.991%

15-15

$n$	$f_{n,1}$	$f_{n,2}$	$f_{n,3}$	$f_{n,4}$	$f_{n,5}$
0	4.00%	4.499%	4.997%	5.494%	5.991%
1	5.00	5.499	5.997	6.494	--
2	6.00	6.499	6.997	--	--
3	7.00	7.499	--	--	--
4	8.00	--	--	--	--

- 15-16 (a) 6.997%
- (b) Sell a 2-year zero-coupon bond and buy a 5-year zero-coupon bond, each of face amount 274,724.24.
- 15-17 (a) 5.499%
- (b) Sell a 1-year zero-coupon bond and buy a 3-year zero-coupon bond, each of face amount 24,038.46.

15-18

$n$	$f_{n,1}$	$f_{n,2}$	$f_{n,3}$
1	6.12%	8.32%	10.685%
2	10.56	13.04	--
3	15.58	--	--

15-19, 15-20, 15-21 (See Solutions Manual.)

## CHAPTER 16

- 16-1 2,489.89; 2,479.75; 2,469.59