Model Uncertainty and its Impact on Solvency Measurement in Property-Liability Insurance

Hato Schmeiser, Caroline Siegel, Joël Wagner
1. Overview

2. Model Framework and Methodology

3. Numerical Results

4. Implications and Conclusion

"It's time we face reality, my friends. ... We're not exactly rocket scientists."
1. Overview

Background

- The recent financial crisis has shown that quantitative solvency models can give insurers, regulators, and policyholders a false sense of security
- Most solvency frameworks incorporate linear correlation but neglect non-linear dependencies and stochastic jumps and might perform rather poor in extreme scenarios
- "Model risk" should be analyzed in more details in order to understand the explanatory power of stochastic solvency models

Contribution

- Analysis of model risk in combination with parameter risk of solvency models for property-liability insurers
- Examination of the effects of introducing stochastic jumps, linear, or non-linear dependencies into a basic solvency model on capital requirements and shortfall risk measures
- Consideration of reducing the model uncertainty of solvency models by means of mandatory interim financial reports
2. Model Framework and Methodology

Aim

• Examination of the impact of changes to the specification of a solvency model on capital requirements, the shortfall probability and the expected policyholder deficit of a property-liability insurer

• Estimation of the derivations in capital requirements, shortfall probabilities and expected policyholder deficit when using a standard solvency model (Swiss Solvency Test SST and Solvency II) in the case the real world behaves differently (we refer to these derivations as "model risk")

Related Literature

• Literature regarding parameter risk (risk of errors in the parameter estimation within a specific model framework)

• Model risk (in general more important than parameter risk)

Concept

• One a) standard model framework in the sense of the SST / Solvency II is defined and its explanatory power is analyzed if b) the underlying stochastic process or c) the dependency structure differs from what had been assumed in a)
2. Model Framework and Methodology

Model setting (I)

a) Basic setting

- Standard solvency model as it might be specified by a European regulatory authority
- Usage of independent Brownian motions for the modeling of two asset classes and liabilities
- Calculation of capital requirements as required by the proposed Solvency II framework and the Swiss Solvency Test

\[ A_t = A_{1,t} + A_{2,t} . \]

\[ dA_{i,t} = \mu_{A_i} A_{i,t} dt + \sigma_{A_i} A_{i,t} dW_{A_i,t} . \]

\[ dL_t = \mu_L L_t dt + \sigma_L L_t dW_{L,t} . \]

\[ A_{i,t} = A_{i,0} \cdot \exp \left( \left( \mu_{A_i} - \sigma_{A_i}^2 / 2 \right) t + \sigma_{A_i} W_{A_i,t} \right) . \]

\[ L_t = L_0 \cdot \exp \left( \left( \mu_L - \sigma_L^2 / 2 \right) t + \sigma_L W_{L,t} \right) . \]

- One year horizon \( t = 0, 1 \); assets \( A_{i,t} \) are divided in a high-risk \((i = 1)\) and a low-risk investment \((i = 2)\)
2. Model Framework and Methodology

Model setting (II)

- Available economic capital AEC and solvency capital SC

\[ AEC_t = A_t - L_t, \]
\[ AEC_{t-1} = A_{t-1} - L_{t-1} \geq SC_t. \]

- Solvency II requirement (value at risk approach with confidence level \( \alpha \)VaR = 0.5%) and SST approach (tail value at risk approach with confidence level \( \alpha \)TVaR = 1%)

\[ X_t = AEC_t/(1 + r_f) - AEC_{t-1}. \]
\[ SC_t^{VaR} = -\text{VaR}_{\alpha_{VaR}}(X_t). \]
\[ SC_t^{TVaR} = \text{TVaR}_{\alpha_{TVaR}} - \mathbb{E}(X_t \mid X_t \leq \text{VaR}_{\alpha_{TVaR}}). \]

- Risk measurers

\[ SP_t = P(\ A_t < L_t), \]
\[ EPD_t = \mathbb{E}(\max(L_t - A_t, 0))/(1 + r_f). \]
2. Model Framework and Methodology

Model setting (III)

b) Uncertainty in modeling the development of assets and liabilities
   • Introduction of stochastic jumps into the liability process (cf. Merton 1976)

c) Uncertainty in modeling dependencies
   • Linear dependencies (pairwise linear correlation measured with Pearson's correlation coefficient)
     \[ dW_{A1,t}^P dW_{A2,t}^P = \rho(A_{1,t}, A_{2,t})dt, \]
     \[ dW_{A1,t}^P dW_{L,t}^P = \rho(A_{1,t}, L_t)dt, \]
     \[ dW_{A2,t}^P dW_{L,t}^P = \rho(A_{2,t}, L_t)dt. \]
   • Non-linear dependencies (three-dimensional non-exchangeable Clayton copula (cf. McNeil et al. (2005))

Concept

• Measurement of the deviations in risk measures when comparing the three modified solvency models to the basic setting via a risk measure ratio:
  \[ \text{risk measure ratio} = \frac{\text{risk measure}^{BS}}{\text{risk measure}^{RE}}. \]
• Quantification of the reduction in model uncertainty due to requiring interim financial reports in addition to the annually disclosed financial statements
2. Model Framework and Methodology

Stylized graphs to illustrate the updating mechanism when considering mandatory interim reports

Illustration of a semi-annual update of the liability process from the basic setting (BS) with values from a more realistic framework (RE). The starred values correspond to the values obtained after updating at time $t=0.5$.

Illustration of the development of liabilities in the model framework including a jump component (RE), displayed by two jumps in the considered period $T=1$. 

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3. Numerical Results

Numerical analyses

- Reference case a) + case b) and c)
- Sensitivity analysis
- Examples based on a Monte Carlo simulation
- For reasonable accuracy, 5'000'000 iterations (for a)) and 10'000'000 iterations (for b) and c)) are calculated

Input parameters (I)

- Asset Allocation: Stocks 5%; Bonds 95%
- Liabilities with jump $\Rightarrow E(Y)$ is set to 1.05, $\sigma(Y) = 5\%$ (cf. Gatzert / Schmeiser, IME 2008)

$$J_t = \sum_{j=1}^{N_t} (Y_j - 1).$$
### 3. Numerical Results

#### Input parameters (II)

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Symbol</th>
<th>Initial value at $t = 0$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time horizon</td>
<td>$T$</td>
<td>1</td>
</tr>
<tr>
<td>Size of time steps within $T$</td>
<td>$dT$</td>
<td>${1, \frac{1}{2}, \frac{1}{4}, \frac{1}{12}}$</td>
</tr>
<tr>
<td>Market value of asset class 1 (high-risk investments)</td>
<td>$A_{1,0}$</td>
<td>CU 0.5 billion</td>
</tr>
<tr>
<td>Market value of asset class 2 (low-risk investments)</td>
<td>$A_{2,0}$</td>
<td>CU 9.5 billion</td>
</tr>
<tr>
<td>Market value of liabilities</td>
<td>$L_0$</td>
<td>CU 8 billion</td>
</tr>
<tr>
<td>Risk-free rate of return</td>
<td>$r_f$</td>
<td>0.02</td>
</tr>
<tr>
<td>Drift of the geometric Brownian motion of asset class 1</td>
<td>$\mu_{A_1}$</td>
<td>0.04</td>
</tr>
<tr>
<td>Drift of the geometric Brownian motion of asset class 2</td>
<td>$\mu_{A_2}$</td>
<td>0.04</td>
</tr>
<tr>
<td>Drift of the geometric Brownian motion of liabilities</td>
<td>$\mu_L$</td>
<td>0.03</td>
</tr>
<tr>
<td>Volatility of the geometric Brownian motion of asset class 1</td>
<td>$\sigma_{A_1}$</td>
<td>0.2</td>
</tr>
<tr>
<td>Volatility of the geometric Brownian motion of asset class 2</td>
<td>$\sigma_{A_2}$</td>
<td>0.08</td>
</tr>
<tr>
<td>Volatility of the geometric Brownian motion of liabilities</td>
<td>$\sigma_L$</td>
<td>0.05</td>
</tr>
</tbody>
</table>
3. Numerical Results

Input parameters (III)

- Pearson’s correlation coefficient between asset class 1 and asset class 2: \( \rho(A_1, A_2) \) [0, 1]
- Pearson’s correlation coefficient between asset class 1 and liabilities: \( \rho(A_1, L) \) 0
- Pearson’s correlation coefficient between asset class 2 and liabilities: \( \rho(A_2, L) \) 0
- Copula parameter modeling the dependence between asset class 1 and 2: \( \theta_1 \) [0, 8]
- Copula parameter modeling the dependence between assets and liabilities: \( \theta_2 \) 0
- Expected value of \( Y_j \): \( E(Y_j) \) 1.05
- Volatility of \( Y_j \): \( \sigma_{Y_j} \) 0.05
- Average number of jumps over time horizon (intensity): \( \lambda \) [0, 0.5]
- Parameter for the log-normal distribution of \( Y_j \): \( a \) 0.048
- Parameter for the log normal distribution of \( Y_j \): \( b^2 \) 0.023
- Confidence level of value at risk: \( \alpha_{VaR} \) 0.005
- Confidence level of tail value at risk: \( \alpha_{TVaR} \) 0.01
3. Numerical Results

Overview and Interpretation

<table>
<thead>
<tr>
<th>Risk measure</th>
<th>Basic Model</th>
<th>Model with jumps ($\lambda = 0.5$)</th>
<th>Model with linear correlation ($\rho = 1$)</th>
<th>Model with Clayton copula ($\theta_1 = 8$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$SC^{VaR}$</td>
<td>$13.4 \cdot 10^8$</td>
<td>$23.3 \cdot 10^8$</td>
<td>$14.8 \cdot 10^8$</td>
<td>$14.7 \cdot 10^8$</td>
</tr>
<tr>
<td></td>
<td>(0.0%)</td>
<td>(73.9%)</td>
<td>(10.4%)</td>
<td>(9.7%)</td>
</tr>
<tr>
<td>$SC^{TVaR}$</td>
<td>$13.9 \cdot 10^8$</td>
<td>$24.7 \cdot 10^8$</td>
<td>$15.3 \cdot 10^8$</td>
<td>$15.3 \cdot 10^8$</td>
</tr>
<tr>
<td></td>
<td>(0.0%)</td>
<td>(77.7%)</td>
<td>(10.1%)</td>
<td>(10.1%)</td>
</tr>
<tr>
<td>$SP$</td>
<td>0.0001</td>
<td>0.0106</td>
<td>0.0003</td>
<td>0.0003</td>
</tr>
<tr>
<td></td>
<td>(0.0%)</td>
<td>(10'500%)</td>
<td>(200%)</td>
<td>(200%)</td>
</tr>
<tr>
<td>$EPD$</td>
<td>$15.3 \cdot 10^3$</td>
<td>$47.6 \cdot 10^5$</td>
<td>$53.4 \cdot 10^3$</td>
<td>$49.7 \cdot 10^3$</td>
</tr>
<tr>
<td></td>
<td>(0.0%)</td>
<td>(31'011.1%)</td>
<td>(249.0%)</td>
<td>(224.8%)</td>
</tr>
</tbody>
</table>

Table 2: Values of the four risk measures in the basic setting, the jump component model (for $\lambda = 0.5$), the model including linear correlation between $A_{1,t}$ and $A_{2,t}$ (with $\rho = 1$) and the model including non-linear dependence between $A_{1,t}$ and $A_{2,t}$ via a Clayton copula (with $\theta = 8$). Values in brackets denote the percentage increase compared to the value of the basic setting.
3. Numerical Results

Risk measure ratios in case of stochastic jumps for different numbers of jumps per year ($\lambda \in [0,0.5]$)
Risk measure ratios in case of linear correlation between the two asset classes for $\rho(A_1,A_2) \in [0,1]$, and in case of non-linear dependence introducing a Clayton copula function for $\theta \in [0,8]$
3. Numerical Results

**Number of updates (n) on financial information per year and its impact on the four risk measure ratios**

(a) Impact of $n$ on risk measure ratios when including stochastic jumps with $\lambda = 0.2$.

<table>
<thead>
<tr>
<th>$n$</th>
<th>$\frac{SC_{Var}^{BS}}{SC_{Var}^{RE}}$</th>
<th>$\frac{SC_{TVar}^{BS}}{SC_{TVar}^{RE}}$</th>
<th>$SP_{BS}$</th>
<th>$EPD_{BS}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>74.0%</td>
<td>72.7%</td>
<td>3.7%</td>
<td>1.5%</td>
</tr>
<tr>
<td>2</td>
<td>87.7%</td>
<td>87.7%</td>
<td>42.5%</td>
<td>37.2%</td>
</tr>
<tr>
<td>4</td>
<td>94.4%</td>
<td>94.2%</td>
<td>70.1%</td>
<td>64.8%</td>
</tr>
<tr>
<td>12</td>
<td>98.0%</td>
<td>98.1%</td>
<td>88.8%</td>
<td>87.1%</td>
</tr>
</tbody>
</table>

(b) Impact of $n$ on risk measure ratios when including linear correlation with $\rho = 0.2$.

<table>
<thead>
<tr>
<th>$n$</th>
<th>$\frac{SC_{Var}^{BS}}{SC_{Var}^{RE}}$</th>
<th>$\frac{SC_{TVar}^{BS}}{SC_{TVar}^{RE}}$</th>
<th>$SP_{BS}$</th>
<th>$EPD_{BS}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>97.5%</td>
<td>97.4%</td>
<td>69.6%</td>
<td>68.9%</td>
</tr>
<tr>
<td>2</td>
<td>98.7%</td>
<td>98.7%</td>
<td>86.4%</td>
<td>83.1%</td>
</tr>
<tr>
<td>4</td>
<td>99.3%</td>
<td>99.3%</td>
<td>89.8%</td>
<td>87.4%</td>
</tr>
<tr>
<td>12</td>
<td>99.8%</td>
<td>99.8%</td>
<td>99.6%</td>
<td>99.1%</td>
</tr>
</tbody>
</table>

(c) Impact of $n$ on risk measure ratios when including a Clayton copula with $\theta = 0.5$.

<table>
<thead>
<tr>
<th>$n$</th>
<th>$\frac{SC_{Var}^{BS}}{SC_{Var}^{RE}}$</th>
<th>$\frac{SC_{TVar}^{BS}}{SC_{TVar}^{RE}}$</th>
<th>$SP_{BS}$</th>
<th>$EPD_{BS}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>94.6%</td>
<td>94.7%</td>
<td>48.4%</td>
<td>44.1%</td>
</tr>
<tr>
<td>2</td>
<td>97.7%</td>
<td>97.8%</td>
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</tr>
<tr>
<td>12</td>
<td>99.8%</td>
<td>99.7%</td>
<td>98.4%</td>
<td>98.9%</td>
</tr>
</tbody>
</table>
3. Numerical Results

Sensitivity analysis (I)

- Basis setting a) and jump model b) with $\lambda = 0.2$; variation of the asset allocation

(a) Risk measure deviations depending on the $A_{1,0}/A_{0}$ ratio when comparing the basic setting with the model framework of Section 3.1 with $\lambda = 0.2$
Sensitivity analysis (II)

- Basis setting a) and jump model b) with $\lambda = 0.2$; variation of the asset to liability ratio

\[ \text{Risk measure ratio [in %]} \]

\[ \text{Ratio } L_0/A_0 \]

(b) Risk measure deviations depending on the $L_0/A_0$ ratio when comparing the basic setting with the model framework of Section 3.1 with $\lambda = 0.2$
3. Numerical Results

Sensitivity analysis (III)

- Basis setting a) and dependency model c) with $p(A_1, A_2) = 0.2$; variation of the asset allocation

(a) Risk measure deviations for different $A_{1,0}/A_0$ ratios in model with linear correlation $\rho(A_1, A_2) = 0.2$. 
3. Numerical Results

Sensitivity analysis (IV)

- Basis setting a) and dependency model c) with $p(A_1, A_2) = 0.2$; variation of the asset to liability ratio

(b) Risk measure deviations for different $L_0/A_0$ ratios in model with linear correlation $\rho(A_1, A_2) = 0.2$. 

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4. Implications and Conclusion

- Stochastic jumps and non-linear dependencies seem to have a greater impact on capital requirements and shortfall risk measures than linear correlation. This can imply considerable model risk for capital standards that do not include these modeling aspects.

- The extensive discussion which risk measure (value at risk vs. tail value at risk) should be used in the solvency context seems not to be too important from the point of view of our paper.

- Shortfall risk measures react much more sensitive to modifications in the solvency framework than capital requirements. Therefore, the sole consideration of the sensitivity of capital requirements as risk measures might underestimate the actual model risk an insurance company is exposed to.

- Hence, the focus on the sensitivity of the capital requirements as it is currently done in the SST (and planned in Solvency II) is rather misleading. For the policyholders – and in the end maybe for taxpayers too –, the expected policyholder deficit is the important figure.

- However, the expected policyholder deficit reacts extremely sensitive to modifications in the model setup. The resilience of these kind of models is in this respect questionable.

- Mandatory interim reports on the solvency and financial situation of the property-liability insurer could be a useful way to reduce model risk, from a regulatory point of view.


