

$$\delta({}_t\bar{V}) + \pi(t) - \mu$$

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Fundamentals of Actuarial Mathematics

Second Edition

S. David Promislow

$$\frac{d}{dt}{}_t\bar{V} = \delta({}_t\bar{V}) + \pi(t) - \mu_x(t)(b(t) - {}_t\bar{V})$$

$$({}_t\bar{V})$$

+

$$- \pi(t) - \mu_x(t)(b(t) -$$

Fundamentals of Actuarial Mathematics

Second Edition

S. David Promislow

York University, Toronto, Canada



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Preface

Several factors motivated the writing of this book. After teaching undergraduate actuarial courses for many years, it became clear that there was a definite need for more instructional material in this area. In most undergraduate courses, students who had problems reading a particular text could go to the library and find dozens of other references which might assist them. By comparison there were very few resources dealing with actuarial mathematics.

In addition, there was need for a book which would give full recognition to modern computing methods and techniques. Many existing books still emphasize material which was developed in a time when calculations were done by hand. At present, basic actuarial calculations are easily done using computer spreadsheets, and I felt it was time for a text which would develop the ideas and methods with this in mind.

The book covers two fundamental topics in actuarial mathematics. These are life contingencies and risk theory, including the basics of ruin theory.

The modern approach towards life contingencies is through a stochastic model, as opposed to the older deterministic viewpoint. I certainly agree that mastering the stochastic model is the desirable end. However, my classroom experience has convinced me that this is not the right place to begin the instruction. I find that students are much better able to learn the new ideas, the new notation, the new ways of thinking involved in this subject, when done first in the simplest possible setting, namely a deterministic discrete model, and I have followed this approach in this book. After the main ideas are presented in this fashion, continuous models are introduced. In Part II of the book, the full stochastic model can then be dealt with in reasonably quick fashion.

The book covers a great deal of the material on the modeling exams of the Society of Actuaries and the Casualty Actuarial Society. A major audience for the book will be students preparing for these exams. The order of topics, however, provides a degree of flexibility, so that the book can be of interest to different readers. Part I of the book will serve the needs of those who want only an introduction to the subject, without necessarily specializing in it. The only mathematical background required for this material is some elementary linear algebra and probability theory, and, beginning in Chapter 8, some basic calculus.

A more advanced knowledge of probability theory is needed from Chapter 13 onward. All of this material is summarized in Appendix A. Basic concepts of stochastic processes are used in Part III of the book, which deals with the collective risk model. These are developed in the text in Chapters 18 and 19.

For the most part, we do not include statistical aspects of the subject, unlike for example Klugman *et al.* (2008). Rather, the emphasis is on methods of using the information that the statistician would produce. No prior knowledge of statistical inference, as opposed to probability theory, is required.

A usual prerequisite for this type of material is a course in the theory of interest. Although this may be useful, it is not strictly required. All the interest theory that is needed is presented as a particular case of the general deterministic actuarial model in Chapter 2.

A major source of difficulty for many students in learning actuarial mathematics is to master the rather complex system of actuarial notation. We have introduced some notational innovations, which tie in well with modern calculation procedures as well as allowing us to greatly simplify the notation that is required. We have, however, included all the standard notation in separate sections, at the end of the relevant chapters, which can be read by those readers who desire this material.

The book is intended to cover the material at a basic level and is not as encyclopedic as a work like Bowers *et al.* (1997). To meet this goal, and to keep the length reasonable, we have necessarily had to omit certain important topics. The most notable of these is stochastic interest rates. There is a brief discussion of this idea, but for the most part interest rates are taken as deterministic. There is more of an emphasis on life insurance and annuities as opposed to casualty insurance. Some important casualty topics, such as loss reserving, are not covered here.

Keeping in mind the nature of the book and its intended audience, we have avoided excessive mathematical rigor. Nonetheless, careful proofs are given in all cases where these are thought to be accessible to the typical senior undergraduate mathematics student. For the few proofs not given in their entirety, mainly those involving continuous-time stochastic processes, we have tried at least to provide some motivation and intuitive reasoning for the results.

Exercises appear at the end of each chapter. In Parts I and II these are divided up into different types. Type A exercises generally are those which involve direct calculation from the formulas in the book. Type B involve problems where more thought is involved. Derivations and problems which involve symbols rather than numeric calculation are normally included in Type B problems. A third type is spreadsheet exercises which themselves are divided into two subtypes. The first of these ask the reader to solve problems using a spreadsheet. Detailed descriptions of applicable Microsoft Excel® spreadsheets are given at the end of the relevant chapters. Readers of course are free to modify these or construct their own. The second subtype does not ask specific questions but instead asks the reader to modify the given spreadsheets to handle additional tasks. Answers to most of the calculation-type exercises appear at the end of the book.

Sections marked with an asterisk * deal with more advanced material, or with special topics that are not used elsewhere in the book. They can be omitted on first reading. The exercises dealing with such sections are likewise marked with *.

The material in the book comprises approximately three semesters of work in the typical North American university. A rough guide would be to do Chapters 1–8 in the first semester, Chapters 9–16 in the second semester, and Chapters 17–23 in the third. Part III is for the most part independent of Parts I and II. A major exception is Chapter 23, which generalizes material in Chapter 11, and can be read immediately after that chapter, for the reader with a basic knowledge of Markov chains, as presented in Chapter 19. Another exception is Section 20.4.1 which alludes to previous material. Chapters 7 (except for Section 7.3.1), 9 and 12 deal with topics that are important in applications, but which are not used in other parts of the book. They could be omitted without loss of continuity.

Changes in the second edition

There are several additions and changes for the second edition. The most important of these of these are the inclusion of three new chapters, and substantial modifications to a few others.

A chapter on *credibility theory*, has been added. This is a major actuarial topic which was not addressed in the first edition. While the emphasis of the book is still on the life and pension side of actuarial science, this chapter provides additional material for those whose main interest is in casualty insurance.

A chapter was added on *risk assessment*, another major subject area which received only minimal coverage in the first edition. The theme here is the comparison and measurement of risk in random alternatives, and the chapter introduces such topics as utility theory, a stochastic ordering method, and risk measures, with a concentration on VaR and TailVaR.

The subject of *multi-state* models, has proved to be an effective way of unifying much of actuarial theory. Some aspects of the discrete model were included in the first edition as an application of Markov chain theory. This material has been extended and combined with the continuous time model, to form a new chapter on this topic.

Chapter 10 has been extended to include situations involving a duration that runs from a death of an individual rather than from time zero. This provides additional techniques, and equips the reader to handle a greater variety of multiple-life contracts. The chapter also includes a section outlining applications to credit risk in annuities.

In the first edition, the multiple-decrement theory was contained in two chapters, the classical model in Chapter 11 and a more general treatment in Chapter 16. In this edition, much of the Chapter 16 material has been rewritten and moved back to Chapter 11, so that this earlier chapter now contains a more complete exposition of the subject.

Other changes include the following:

- In Chapter 2 there is some additional material dealing with forward prices and term structure for bonds.
- A section has been added to Chapter 6, outlining the provisions of some modern types of contracts such as universal life and variable annuities.
- In Chapter 9 on select mortality, there is a new section illustrating how projections in annuity tables fit into the select framework.
- The method of presentation of some of the preliminary material has been changed, and time diagrams are introduced as a visual aid for depicting insurance and annuity contracts.
- The spreadsheets covering the early chapters have been modified to improve efficiency of use.
- Additional examples and exercises have been added to several chapters.

This book includes an accompanying website. Please visit www.wiley.com/go/actuarial for more information.

Acknowledgements

Several individuals assisted in the completion of this project. A special debt of gratitude is owed to Virginia Young for her work on the first edition. She read large portions of the manuscript, worked nearly all of the exercises, and made several suggestions for improvement. Many people found misprints in the first edition and earlier drafts. These include Valerie Michkine, Jacques Labelle, Karen Antonio, Kristen Moore, as well as students at York University and the University of Michigan. Moshe Milevsky provided enlightening comments on annuities and it was his ideas that motivated the credit risk applications in Chapter 10, as well as some of the material on generational annuity tables in Chapter 9. Elias Shiu suggested some interesting exercises. Christian Hess asked some questions which led to the inclusion of Example 17.10 to clear up an ambiguous point. Exercise 19.13 was motivated by Bob Jewett's progressive practice routines for pool. My son Michael, a life insurance actuary, provided valuable advice on several practical aspects of the material. I would like to thank the editorial and production teams at Wiley, for their much appreciated assistance. Finally, I would like to thank my wife Shirley who provided support and encouragement throughout the writing of both editions of this book.

Notation index

The following is a list of the major symbols which are used in the book. For the most part, the first page they appear on is listed. An exception is the notation in Appendix A, where the first appearance in that chapter is noted. This list excludes that part of the standard actuarial notation which is not used in the main body of the text. The latter can be found in the appropriate sections of Chapters 2–6, 8 and 10 entitled ‘Standard Notation and Terminology’.

Chapter 2

$\ddot{a}(\mathbf{c}; \nu)$ 15
 $B_k(\mathbf{c}; \nu)$ 20
 $\tilde{B}_k(\mathbf{c})$ 24
 ${}_k\mathbf{c}$ 20
 ${}^k\mathbf{c}$ 20
 $\mathbf{c} \circ k$ 25
 d_k 12
 \mathbf{e}^k 17
 i_k 12
 ${}_kV(\mathbf{c}; \nu)$ 20
 $v(k)$ 11
 $v(k, n)$ 10
 $\nu \circ k$ 25
 $\text{Val}_n(\mathbf{c}; \nu)$ 14

Chapter 3

d_x 37
 e_x 40
 \dot{e}_x 40
 ${}_np_x$ 38
 ${}_nq_x$ 38
 p_x 38
 q_x 38

ℓ_x 37

ω 38

Chapter 4

$\ddot{a}_x(\mathbf{c})$ 47
 (1_∞) 49
 $y_x(k)$ 48
 $\ddot{a}_{[x]+k}(\mathbf{c})$ 50

Chapter 5

$A_x(\mathbf{b})$ 61
 $\mathbf{a} * \mathbf{b}$ 67
 $w_x(k)$ 67
 $\Delta(\mathbf{b})$ 69
 $\ddot{A}_{[x]+k}(\mathbf{c})$ 68

Chapter 6

η_k 81
 ${}_kV$ 76

Chapter 7

$\ddot{a}^{(m)}(\mathbf{c}; y)$ 102
 $a^{(m)}(\mathbf{c}; y)$ 106
 $\ddot{a}_x^{(m)}(\mathbf{c})$ 104

$d^{(m)}$ 103
 $i^{(m)}$ 103
 $\alpha(m)$ 105
 $\beta(m)$ 105

Chapter 8

$\bar{a}(c; y)$ 116
 $\bar{a}_x(c)$ 118
 $\bar{A}_x(\mathbf{b})$ 122
 $\alpha(\infty)$ 119
 $\beta(\infty)$ 119
 $\delta_y(t)$ 116
 δ 117
 $\mu(x)$ 121
 $\mu_x(t)$ 121

Chapter 9

$\ddot{a}_{[x]+k}$ 139
 $A_{[x]+k}$ 139
 $\ell_{[x]+k}$ 138
 ${}_s p_{[x]+t}$ 137
 ${}_s q_{[x]+t}$ 136
 $q_{[x]+t}$ 137

Chapter 10

$\ddot{a}_{xy}(\mathbf{c})$ 145
 $\bar{a}_{xy}(c)$ 145
 $\ddot{a}_{\overline{xy}}(\mathbf{c})$ 147
 $A_{xy}(\mathbf{c})$ 146
 $\bar{A}_{xy}(c)$ 148
 $A_{\overline{xy}}(\mathbf{c})$ 148
 $\bar{A}_{\overline{xy}}(c)$ 148
 $A^1_{xy}(b)$ 152
 $A^2_{xy}(b)$ 152
 $\bar{A}^1_{xy}(b)$ 153
 $\bar{A}^2_{xy}(b)$ 153
 ${}_n p_{xy}$ 143
 ${}_n p_{\overline{xy}}$ 146
 ${}_n q_{xy}$ 144
 ${}_n q_{\overline{xy}}$ 146
 ${}_s q^1_{xy}$ 153
 $\mu_{xy}(t)$ 147

Chapter 11

$\bar{A}_x^{(j)}(\mathbf{b})$ 168
 $d_x^{(j)}$ 165

$d_x^{(\tau)}$ 165
 $\ell_x^{(\tau)}$ 165
 $\ell_x^{(j)}$ 166
 ${}_n p_x^{(j)}$ 167
 ${}_n p_x^{(\tau)}$ 162
 ${}_n q_x^{(j)}$ 166
 $q_x^{(j)}$ 166
 $q_x^{(j)}$ 173
 $\mu_x^{(j)}(t)$ 167

Chapter 13

$f_x(t)$ 199
 $s_x(t)$ 199
 $T \circ u$ 197
 \tilde{T} 198
 $\lambda(k)$ 192
 $\mu(t)$ 194

Chapter 14

$\ddot{a}_{\bar{T}}(\mathbf{c}; v)$ 209
 $\bar{a}_T(c, v)$ 212
 $A_{\bar{T}}(\mathbf{b}, v)$ 206
 $\bar{A}_T(b; v)$ 206
 $CV(X)$ 218
 ${}_r L$ 214
 L 215

Chapter 15

\hat{F}_X 231
 \hat{f}_X 231

Chapter 16

$f_{T_1, T_2, \dots, T_M}(t_1, t_2, \dots, t_m)$ 238
 $F_{T_1, T_2, \dots, T_M}(t_1, t_2, \dots, t_m)$ 239
 $s_{T_1, T_2, \dots, T_M}(t_1, t_2, \dots, t_m)$ 239
 $F_{T, J}(t, j)$ 241
 $f_{T, J}(t, j)$ 243
 $s_{T, J}(t, j)$ 243
 $\mu_{T, J}(t, j)$ 245

Chapter 17

$\langle N, X \rangle$ 263
 $(X - d)_+$ 276

$X \wedge d$ 276

 \widehat{X} 271

Chapter 19

 $p_{xy}(k)$ 310

 p_{xy} 311

 $\mathbf{P}_m^{(n)}$ 320

Chapter 21

 $D(u)$ 336

 $J(u)$ 345

 \mathcal{L} 353

 $\psi(u)$ 332

 $\psi_k(u)$ 321

 $\psi(u, t)$ 332

Chapter 22

 $E(X|Y)$ 365

 $\text{Var}(X|Y)$ 368

 \propto 372

Chapter 23

 $p_{ij}(s, t)$ 395

 $\mu_{ij}(t)$ 395

Appendix A

 $P(A)$ 406

 $P(A|B)$ 408

 $f_X(x)$ 409

 $F_X(x)$ 409

 $E(X)$ 410

 $\text{Var}(X)$ 411

 $s_T(t)$ 411

 $\text{Cov}(X, Y)$ 414

 $E(X|B)$ 416

 $f * g$ 420

 $F * G$ 420

 f^{*n} 420

 F^{*n} 420

 $M_X(t)$ 420

 $P_X(t)$ 423

Contents

Preface	xvii
Acknowledgements	xxi
Notation index	xxiii
Part I THE DETERMINISTIC MODEL	1
1 Introduction and motivation	3
1.1 Risk and insurance	3
1.2 Deterministic versus stochastic models	4
1.3 Finance and investments	5
1.4 Adequacy and equity	5
1.5 Reassessment	6
1.6 Conclusion	6
2 The basic deterministic model	7
2.1 Cashflows	7
2.2 An analogy with currencies	8
2.3 Discount functions	9
2.4 Calculating the discount function	11
2.5 Interest and discount rates	12
2.6 Constant interest	12
2.7 Values and actuarial equivalence	13
2.8 Regular pattern cashflows	17
2.9 Balances and reserves	19
2.9.1 Basic concepts	19
2.9.2 Relationship between balances and reserves	21
2.9.3 Prospective versus retrospective methods	22
2.9.4 Recursion formulas	23
2.10 Time shifting and the splitting identity	24

*2.11	Change of discount function	26
*2.12	Internal rates of return	27
*2.13	Forward prices and term structure	29
2.14	Standard notation and terminology	31
2.14.1	Standard notation for cashflows discounted with interest	31
2.14.2	New notation	32
2.15	Spreadsheet calculations	33
2.16	Notes and references	33
2.17	Exercises	33
3	The life table	37
3.1	Basic definitions	37
3.2	Probabilities	38
3.3	Constructing the life table from the values of q_x	39
3.4	Life expectancy	40
3.5	Choice of life tables	42
3.6	Standard notation and terminology	42
3.7	A sample table	43
3.8	Notes and references	43
3.9	Exercises	43
4	Life annuities	45
4.1	Introduction	45
4.2	Calculating annuity premiums	46
4.3	The interest and survivorship discount function	48
4.3.1	The basic definition	48
4.3.2	Relations between y_x for various values of x	50
4.3.3	Tontines	51
4.4	Guaranteed payments	52
4.5	Deferred annuities with annual premiums	53
4.6	Some practical considerations	54
4.6.1	Gross premiums	54
4.6.2	Gender aspects	55
4.7	Standard notation and terminology	55
4.8	Spreadsheet calculations	56
4.9	Exercises	57
5	Life insurance	60
5.1	Introduction	60
5.2	Calculating life insurance premiums	60
5.3	Types of life insurance	63
5.4	Combined insurance–annuity benefits	63
5.5	Insurances viewed as annuities	67
5.6	Summary of formulas	68
5.7	A general insurance–annuity identity	69
5.7.1	The main theorem	69
5.7.2	The endowment identity	69

5.8	Standard notation and terminology	71
5.8.1	Single premium notation	71
5.8.2	Annual premium notation	72
5.8.3	Identities	72
5.9	Spreadsheet applications	72
5.10	Exercises	73
6	Insurance and annuity reserves	76
6.1	Introduction to reserves	76
6.2	The general pattern of reserves	79
6.3	Recursion	80
6.4	Detailed analysis of an insurance or annuity contract	81
6.4.1	Gains and losses	81
6.4.2	The risk-savings decomposition	83
6.5	Interest and mortality bases for reserves	84
6.6	Nonforfeiture values	86
6.7	Policies involving a 'return of the reserve'	87
6.8	Premium difference and paid-up formulas	88
6.8.1	Premium difference formulas	88
6.8.2	Paid-up formulas	89
6.8.3	Level endowment reserves	89
*6.9	Universal life and variable annuities	89
6.9.1	Universal life	90
6.9.2	Variable annuities	93
6.10	Standard notation and terminology	94
6.11	Spreadsheet applications	95
6.12	Exercises	96
7	Fractional durations	101
7.1	Introduction	101
7.2	Cashflows discounted with interest only	102
7.3	Life annuities paid <i>m</i> thly	104
7.3.1	Uniform distribution of deaths	104
7.3.2	Present value formulas	105
7.4	Immediate annuities	106
7.5	Approximation and computation	107
*7.6	Fractional period premiums and reserves	109
7.7	Reserves at fractional durations	110
7.8	Notes and references	112
7.9	Exercises	112
8	Continuous payments	115
8.1	Introduction to continuous annuities	115
8.2	The force of discount	116
8.3	The constant interest case	117
8.4	Continuous life annuities	118
8.4.1	Basic definition	118

8.4.2	Evaluation	119
8.4.3	Life expectancy revisited	120
8.5	The force of mortality	121
8.6	Insurances payable at the moment of death	122
8.6.1	Basic definitions	122
8.6.2	Evaluation	123
8.7	Premiums and reserves	125
8.8	The general insurance–annuity identity in the continuous case	126
8.9	Differential equations for reserves	127
8.10	Some examples of exact calculation	128
8.10.1	Constant force of mortality	128
8.10.2	Demoivre’s law	129
8.10.3	An example of the splitting identity	130
8.11	Standard actuarial notation and terminology	131
8.12	Notes and references	131
8.13	Exercises	132
9	Select mortality	136
9.1	Introduction	136
9.2	Select and ultimate tables	137
9.3	Changes in formulas	138
9.4	Projections in annuity tables	140
9.5	Further remarks	141
9.6	Exercises	141
10	Multiple-life contracts	143
10.1	Introduction	143
10.2	The joint-life status	143
10.3	Joint-life annuities and insurances	145
10.4	Last-survivor annuities and insurances	146
10.5	Moment of death insurances	147
10.6	The general two-life annuity contract	149
10.7	The general two-life insurance contract	150
10.8	Contingent insurances	151
10.8.1	First-death contingent insurances	151
10.8.2	Second-death contingent insurances	152
10.8.3	Moment-of-death contingent insurances	153
10.8.4	General contingent probabilities	153
10.9	Duration problems	154
10.10	Applications to annuity credit risk	157
10.11	Standard notation and terminology	158
10.12	Spreadsheet applications	159
10.13	Notes and references	159
10.14	Exercises	159
11	Multiple-decrement theory	164
11.1	Introduction	164

11.2	The basic model	164
11.2.1	The multiple-decrement table	165
11.2.2	Quantities calculated from the multiple-decrement table	166
11.3	Insurances	167
11.4	Determining the model from the forces of decrement	168
11.5	The analogy with joint-life statuses	169
11.6	A machine analogy	169
11.6.1	Method 1	170
11.6.2	Method 2	171
11.7	Associated single-decrement tables	173
11.7.1	The main methods	173
11.7.2	Forces of decrement in the associated single-decrement tables	174
11.7.3	Conditions justifying the two methods	175
11.7.4	Other approaches	178
11.8	Notes and references	179
11.9	Exercises	179
12	Expenses	182
12.1	Introduction	182
12.2	Effect on reserves	184
12.3	Realistic reserve and balance calculations	185
12.4	Notes and references	187
12.5	Exercises	187

Part II THE STOCHASTIC MODEL **189**

13	Survival distributions and failure times	191
13.1	Introduction to survival distributions	191
13.2	The discrete case	192
13.3	The continuous case	193
13.3.1	The basic functions	194
13.3.2	Properties of μ	194
13.3.3	Modes	195
13.4	Examples	195
13.4.1	The exponential distribution	195
13.4.2	The uniform distribution	195
13.4.3	The Gompertz–Makeham distribution	196
13.5	Shifted distributions	197
13.6	The standard approximation	198
13.7	The stochastic life table	199
13.8	Life expectancy in the stochastic model	201
13.9	Stochastic interest rates	202
13.10	Notes and references	202
13.11	Exercises	203

14	The stochastic approach to insurance and annuities	205
14.1	Introduction	205
14.2	The stochastic approach to insurance benefits	206
14.2.1	The discrete case	206
14.2.2	The continuous case	206
14.2.3	Approximation	207
14.2.4	Endowment insurances	208
14.3	The stochastic approach to annuity benefits	209
14.3.1	Discrete annuities	209
14.3.2	Continuous annuities	212
*14.4	Deferred contracts	213
14.5	The stochastic approach to reserves	214
14.6	The stochastic approach to premiums	215
14.6.1	The equivalence principle	215
14.6.2	Percentile premiums	216
14.6.3	Aggregate premiums	217
14.6.4	General premium principles	220
14.7	The variance of ${}_tL$	220
14.8	Standard notation and terminology	223
14.9	Notes and references	223
14.10	Exercises	224
15	Simplifications under level benefit contracts	228
15.1	Introduction	228
15.2	Variance calculations in the continuous case	228
15.2.1	Insurances	228
15.2.2	Annuities	229
15.2.3	Prospective losses	229
15.2.4	Using equivalence principle premiums	229
15.3	Variance calculations in the discrete case	230
15.4	Exact distributions	231
15.4.1	The distribution of \bar{Z}	231
15.4.2	The distribution of \bar{Y}	231
15.4.3	The distribution of L	232
15.4.4	The case where T is exponentially distributed	232
15.5	Non-level benefit examples	233
15.5.1	Term insurance	233
15.5.2	Deferred insurance	234
15.5.3	An annual premium policy	234
15.6	Exercises	235
16	The minimum failure time	238
16.1	Introduction	238
16.2	Joint distributions	238
16.3	The distribution of T	240
16.3.1	The general case	240
16.3.2	The independent case	240

16.4	The joint distribution of (T, J)	240
16.4.1	The distribution function for (T, J)	240
16.4.2	Density and survival functions for (T, J)	243
16.4.3	The distribution of J	244
16.4.4	Hazard functions for (T, J)	245
16.4.5	The independent case	245
16.4.6	Nonidentifiability	247
16.4.7	Conditions for the independence of T and J	248
16.5	Other problems	249
16.6	The common shock model	250
16.7	Copulas	252
16.8	Notes and references	255
16.9	Exercises	255

Part III RISK THEORY 259

17	The collective risk model	261
17.1	Introduction	261
17.2	The mean and variance of S	263
17.3	Generating functions	264
17.4	Exact distribution of S	265
17.5	Choosing a frequency distribution	265
17.5.1	The binomial distribution	266
17.5.2	The Poisson distribution	267
17.5.3	The negative binomial distribution	267
17.6	Choosing a severity distribution	269
17.6.1	The normal distribution	269
17.6.2	The gamma distribution	269
17.6.3	The lognormal distribution	270
17.6.4	The Pareto distribution	271
17.7	Handling the point mass at 0	271
17.8	Counting claims of a particular type	272
17.8.1	One special class	272
17.8.2	Special classes in the Poisson case	274
17.9	The sum of two compound Poisson distributions	275
17.10	Deductibles and other modifications	275
17.10.1	The nature of a deductible	276
17.10.2	Some calculations in the discrete case	277
17.10.3	Some calculations in the continuous case	278
17.10.4	The effect on aggregate claims	280
17.10.5	Other modifications	281
17.11	A recursion formula for S	281
17.11.1	The positive-valued case	281
17.11.2	The case with claims of zero amount	285
17.12	Notes and references	286
17.13	Exercises	287