Statistical Estimation
Connecting Regulation to Theory

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15 July 2011
From the “Solvency II Directive” 2009/138/EC

Article 101: Calculation of the Solvency Capital Requirement

1. The Solvency Capital Requirement shall be calculated in accordance with paragraphs 2 to 5.
2. The Solvency Capital Requirement shall be calculated on the presumption that the undertaking will pursue its business as a going concern.
3. The Solvency Capital Requirement shall be calibrated so as to ensure that all quantifiable risks to which an insurance or reinsurance undertaking is exposed are taken into account. It shall cover existing business, as well as the new business expected to be written over the following 12 months. With respect to existing business, it shall cover only unexpected losses. It shall correspond to the Value-at-Risk of the basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 99.5 % over a one-year period.
4. ...
Value at Risk

$\text{VaR} \leq \text{Own Funds}(0) \iff (1-\alpha) \text{ quantile OF}(1) \geq 0$

The standard definition requires knowledge of the “true” distribution:
This is the conceptual problem we address here.
A world without a unique “true” model

Degree of prudence depends on {underlying model, VaR forecast method}
Why there are always aggressive models
Another aspect of the problem of induction

• Given an estimation methodology, there are always some models for which that methodology is aggressive
  – Models where volatility suddenly explodes at the next point
  – Models with discontinuous tail behaviour
  – Nuclear safety example, extrapolating meltdown risk from “slips and falls” operational loss data

• Our proposed approach is to define a “null hypothesis”, $H_0$, that is, a set of (subjectively) reasonable models for which the forecast methodology is (by design) either unbiased or cautious
Model-Agnostic Quantile Forecasts  
Expansions for sums large numbers of iid random variables

Cornish-Fisher expansion (derived from Central Limit Theorem 2\textsuperscript{nd} & 3\textsuperscript{rd} order terms)

\[
F^{-1}\{\Phi(z)\} = mean + \left(z + \frac{z^2 - 1}{6} skew + \frac{z^3 - 3z}{24} kurt - \frac{2z^3 - 5z}{36} skew^2 + \ldots\right) \times stdev
\]

\[
F^{-1}(0.995) = mean + \left(2.5758 + 0.9391 \times skew + 0.3901 \times kurt - 0.5917 \times skew^2 + \ldots\right) \times stdev
\]

We want to modify this based on a data sample.  
Inspired by Cornish-Fisher, we try expressions of the form

\[
Q = mean + \left(w_2 + w_3 \times skew + w_4 \times kurt - w_5 \times skew^2 + \ldots\right) \times stdev
\]

Use classical moment estimators for mean, stdev etc rather than “true” parameters.  
Special case: “multiple of standard deviation” rule: \(w_3 = w_4 = w_5 = 0\)  
The coefficients \(w_j\) depend on confidence level which we have set at 99.5\%.
Our $H_0$: Normal, Logistic, Laplace and Esscher
Distributions are all standardised to mean=0, stdev=1

Esscher tilting parameter can take values in (-1,1). We consider multiples of $\frac{1}{4}$. 
If there were no model error or estimation error ... “Process error” showing 0.5%-ile and 99.5%-ile of standardised distribution.
Combining Models with Model-Agnostic Forecasts

• Inputs
  – Probability law $P_i$ in $H_0$
  – Training random sample $x_1, x_2, \ldots, x_t$
  – Quantile forecast $Q(x_1, x_2, \ldots, x_t)$: this is a random variable
  – Next observation $x_{t+1}$ independent of history

• Feasibility constraints
  – $P_i\{x_{t+1} \leq Q\}$ is at least $\alpha = 0.995$, $Q$ is stochastic
  – We might like equality for all $H_0$ but if $H_0$ is large we cannot easily achieve this
  – The difference is a (new) measure of model risk
Feasible Quantile Forecasts for a Finite Null Hypothesis

- The modified quantile forecast is
  \[ Q = \text{mean} + \left( w_2 + w_3 \times \text{skew} + w_4 \times \text{kurt} - w_5 \times \text{skew}^2 + \ldots \right) \times \text{stdev} \]
- Let us fix \( w_3, w_4, w_5 \) and consider \( w_2 \)
- Under law \( P_i \), set \( w_2 \) as the \( \alpha \)-quantile of
  \[ \frac{x_{t+1} - \text{mean}}{\text{stdev}} - w_3 \times \text{skew} - w_4 \times \text{kurt} + w_5 \times \text{skew}^2 \]
- Then take the largest \( w_2 \) across all the \( P_i \)
- The resulting \( \{w_2, w_3, w_4, w_5\} \) satisfy the feasibility condition
- \( P_i \{x_{t+1} \leq Q\} \) is at least \( \alpha = 0.995 \) for all \( i \)
Monte Carlo Investigation: Sample Size = 10

Minimal feasible w[2], sample size 10, w[3]=1, w[4]=0
Trade off model risk and estimation risk

Comparing capital requirement for different rules

<table>
<thead>
<tr>
<th>Rule Description</th>
<th>Capital Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal</td>
<td>(6.6,1,0,0)</td>
</tr>
<tr>
<td>Laplace with beta = -0.75</td>
<td>(6,1,0,-1)</td>
</tr>
<tr>
<td>Laplace with beta = -0.5</td>
<td>(6.34,0.93,0.39,-0.59)</td>
</tr>
<tr>
<td>Laplace with beta = 0.25</td>
<td>Average</td>
</tr>
<tr>
<td>Laplace with beta = 0.5</td>
<td>Average</td>
</tr>
<tr>
<td>Logistic with beta = 0.75</td>
<td>Average</td>
</tr>
<tr>
<td>Logistic with beta = -0.75</td>
<td>Average</td>
</tr>
</tbody>
</table>

Number of standard deviations

0 2 4 6 8 10

Average

Average

Average
What is a “good” Quantile Forecast?

- Quantile estimates drive capital
- Capital has a cost: to minimise that cost, minimise $E(Q)$

\[
\begin{align*}
P\{x_{t+1} \leq E_i(x_{t+1})\} &\leq \alpha \leq P_i\{x_{t+1} \leq Q\} = E_i\{F_i(Q)\} \leq F_i\{E_i(Q)\} \\
E_i(x_{t+1}) &\leq F_i^{-1}(\alpha) \leq F_i^{-1}(P_i\{x_{t+1} \leq Q\}) \leq E_i(Q)
\end{align*}
\]

- Extreme Quantile
- Tower Law
- Feasibility
- Jensen Effect
- Inverse cdf $F_i^{-1}$
- Model error: Gerrard & Tsanakas (2009)
- Estimation error

Expected capital required under $P_i$
Bank Model Validation under Basel
How do you know your model is right?

- Banks have different rules: 10 day VaR at 99% Confidence
  - Look back over last year (250 trading days, overlapping periods each looking 10 days back) in which both VaR and profit are updated

- What does this process test?
  - The “back test” includes implicit tests of model and parameter error as well as outcomes
  - Although it won’t test risks that didn’t materialise in the last year

Green zone

Amber zone

Red zone

unbiased (2.5 = 250 * 1%)  Number of exceptions in a year

0 5 10 15
Validation Approaches in Insurance
Three Approaches that Don’t Work

A. Check the documentation and formulas against best statistical practice.

B. Compare insurers, and, (as with ICAS) invite insurers with the most aggressive assumptions to reconsider them on a risk by risk basis.

C. Require back-testing as with VaR models under Basel.

But documentation is very lengthy and there’s a shortage of real experts to conduct in-depth reviews.

But now more difficult because you are comparing probability distribution forecasts rather than stress tests so it’s not clear who is being most prudent. This is only a test of relative numerical conformity rather than confirmation of the 1-in-200 standard.

Under Basel II, VaR is calculated at 99% confidence over 10 days. Allowing overlapping intervals and 250 trading days over a year, a correct model should produce 2.5 exceptions. Based on 1-year 99.5% VaR, you would need 500 years of test data for insurers
Monte Carlo Calibration Test
Is this a practical test of quantile estimates?

- **Years 1-25**
  - Sim #1
  - Sim #2
  - Sim #200

- **Fitted %-iles**
  - 8 fitted percentiles (eg 0.5%, 1%, 5%, 10%, 90%, 95%, 99%, 99.5%)
  - 10 000 times
  - Production team prepares

- **Yr26**
  - Test Yr26 outcome against percentiles

- **Model #1**
  - 10 000 runs in total
  - Validator prepares
Conclusions and Discussion

• We interpret EU legal definition of “Solvency Capital Requirements” in terms of forecast profit/loss percentiles

• Forecasts need to take account of
  – Process error (widely investigated and understood)
  – Estimation error (there is much published research but currently rarely applied in practice)
  – Model error (we propose a new probability approach to this difficult problem)

• Rather than defending individual model parameters, it is better to construct a good process and then audit that the process has been followed.