

Contents

Preface	<i>page xxv</i>
1 Introduction	1
1.1 A view on the evaluation of risk	1
1.1.1 The role of mathematics	1
1.1.2 Risk methodology	1
1.1.3 The computer model	3
1.2 Insurance risk: Basic concepts	4
1.2.1 Introduction	4
1.2.2 Pricing insurance risk	4
1.2.3 Portfolios and solvency	5
1.2.4 Risk ceding and reinsurance	6
1.3 Financial risk: Basic concepts	6
1.3.1 Introduction	6
1.3.2 Rates of interest	7
1.3.3 Financial returns	7
1.3.4 Log-returns	8
1.3.5 Financial portfolios	8
1.4 Risk over time	9
1.4.1 Introduction	9
1.4.2 Accumulation of values	10
1.4.3 Forward rates of interest	10
1.4.4 Present and fair values	11
1.4.5 Bonds and yields	12
1.4.6 Duration	12
1.4.7 Investment strategies	13
1.5 Method: A unified beginning	14
1.5.1 Introduction	14

1.5.2	Monte Carlo algorithms and notation	14
1.5.3	Example: Term insurance	15
1.5.4	Example: Property insurance	16
1.5.5	Example: Reversion to mean	17
1.5.6	Example: Equity over time	18
1.6	How the book is planned	19
1.6.1	Mathematical level	19
1.6.2	Organization	20
1.6.3	Exercises and R	20
1.6.4	Notational rules and conventions	21
1.7	Bibliographical notes	21
1.7.1	General work	21
1.7.2	Monte Carlo	22
	PART I TOOLS FOR RISK ANALYSIS	23
2	Getting started the Monte Carlo way	25
2.1	Introduction	25
2.2	How simulations are used	26
2.2.1	Introduction	26
2.2.2	Mean and standard deviation	26
2.2.3	Example: Financial returns	26
2.2.4	Percentiles	28
2.2.5	Density estimation	28
2.2.6	Monte Carlo error and selection of m	30
2.3	How random variables are sampled	31
2.3.1	Introduction	31
2.3.2	Inversion	31
2.3.3	Acceptance–rejection	32
2.3.4	Ratio of uniforms	33
2.4	Making the Gaussian work	34
2.4.1	Introduction	34
2.4.2	The normal family	34
2.4.3	Modelling on logarithmic scale	35
2.4.4	Stochastic volatility	36
2.4.5	The t -family	37
2.4.6	Dependent normal pairs	38
2.4.7	Dependence and heavy tails	39
2.4.8	Equicorrelation models	40

Contents

vii

2.5	Positive random variables	40
2.5.1	Introduction	40
2.5.2	The Gamma distribution	41
2.5.3	The exponential distribution	42
2.5.4	The Weibull distribution	42
2.5.5	The Pareto distribution	43
2.5.6	The Poisson distribution	44
2.6	Mathematical arguments	45
2.6.1	Monte Carlo error and tails of distributions	45
2.6.2	Algorithm 2.7 revisited	46
2.6.3	Algorithm 2.9 revisited	46
2.6.4	Algorithm 2.10 revisited	47
2.6.5	Algorithm 2.14 revisited	47
2.7	Bibliographical notes	48
2.7.1	Statistics and distributions	48
2.7.2	Sampling	48
2.7.3	Programming	48
2.8	Exercises	49
3	Evaluating risk: A primer	61
3.1	Introduction	61
3.2	General insurance: Opening look	62
3.2.1	Introduction	62
3.2.2	Enter contracts and their clauses	62
3.2.3	Stochastic modelling	63
3.2.4	Risk diversification	64
3.3	How Monte Carlo is put to work	64
3.3.1	Introduction	64
3.3.2	Skeleton algorithms	65
3.3.3	Checking the program	65
3.3.4	Computing the reserve	66
3.3.5	When responsibility is limited	67
3.3.6	Dealing with reinsurance	68
3.4	Life insurance: A different story	69
3.4.1	Introduction	69
3.4.2	Life insurance uncertainty	69
3.4.3	Life insurance mathematics	70
3.4.4	Simulating pension schemes	71
3.4.5	Numerical example	72
3.5	Financial risk: Derivatives as safety	72

3.5.1	Introduction	72
3.5.2	Equity puts and calls	73
3.5.3	How equity options are valued	74
3.5.4	The Black–Scholes formula	75
3.5.5	Options on portfolios	75
3.5.6	Are equity options expensive?	76
3.6	Risk over long terms	77
3.6.1	Introduction	77
3.6.2	The ruin problem	78
3.6.3	Cash flow simulations	78
3.6.4	Solving the ruin equation	79
3.6.5	An underwriter example	80
3.6.6	Financial income added	80
3.7	Mathematical arguments	82
3.7.1	The Black–Scholes formula	82
3.7.2	The derivative with respect to σ	83
3.7.3	Solvency without financial earning	83
3.7.4	A representation of net assets	83
3.8	Bibliographical notes	84
3.8.1	General work	84
3.8.2	Monte Carlo and implementation	84
3.8.3	Other numerical methods	84
3.9	Exercises	84
4	Monte Carlo II: Improving technique	97
4.1	Introduction	97
4.2	Table look-up methods	97
4.2.1	Introduction	97
4.2.2	Uniform sampling	98
4.2.3	General discrete sampling	98
4.2.4	Example: Poisson sampling	100
4.2.5	Making the continuous discrete	100
4.2.6	Example: Put options	101
4.3	Correlated sampling	102
4.3.1	Introduction	102
4.3.2	Common random numbers	102
4.3.3	Example from finance	104
4.3.4	Example from insurance	104
4.3.5	Negative correlation: Antithetic designs	105
4.3.6	Examples of designs	106

Contents

ix

4.3.7	Antithetic design in property insurance	107
4.4	Importance sampling and rare events	108
4.4.1	Introduction	108
4.4.2	The sampling method	108
4.4.3	Choice of importance distribution	109
4.4.4	Importance sampling in property insurance	109
4.4.5	Application: Reserves and reinsurance premia	110
4.4.6	Example: A Pareto portfolio	111
4.5	Control variables	112
4.5.1	Introduction	112
4.5.2	The control method and reinsurance	113
4.5.3	Control scheme with equity options	113
4.5.4	Example: Put options	114
4.6	Random numbers: Pseudo- and quasi-	115
4.6.1	Introduction	115
4.6.2	Pseudo-random numbers	115
4.6.3	Quasi-random numbers: Preliminaries	116
4.6.4	Sobol sequences: Construction	118
4.6.5	Higher dimension and random shifts	119
4.6.6	Quasi-random numbers: Accuracy	120
4.7	Mathematical arguments	121
4.7.1	Efficiency of antithetic designs	121
4.7.2	Antithetic variables and property insurance	121
4.7.3	Importance sampling	123
4.7.4	Control scheme for equity options	123
4.8	Bibliographical notes	124
4.8.1	General work	124
4.8.2	Special techniques	124
4.8.3	Markov chain Monte Carlo	125
4.8.4	High-dimensional systems	125
4.9	Exercises	126
5	Modelling I: Linear dependence	138
5.1	Introduction	138
5.2	Descriptions of first and second order	138
5.2.1	Introduction	138
5.2.2	What a correlation tells us	139
5.2.3	Many correlated variables	140
5.2.4	Estimation using historical data	141
5.3	Financial portfolios and Markowitz theory	142

5.3.1	Introduction	142
5.3.2	The Markowitz problem	142
5.3.3	Solutions	143
5.3.4	Numerical illustration	144
5.3.5	Two risky assets	144
5.3.6	Example: The crash of a hedge fund	145
5.3.7	Diversification of financial risk I	146
5.3.8	Diversification under CAPM	146
5.4	Dependent Gaussian models once more	147
5.4.1	Introduction	147
5.4.2	Uniqueness	148
5.4.3	Properties	148
5.4.4	Simulation	149
5.4.5	Scale for modelling	149
5.4.6	Numerical example: Returns or log-returns?	150
5.4.7	Making tails heavier	150
5.5	The random walk	151
5.5.1	Introduction	151
5.5.2	Random walk and equity	151
5.5.3	Elementary properties	152
5.5.4	Several processes jointly	153
5.5.5	Simulating the random walk	153
5.5.6	Numerical illustration	154
5.6	Introducing stationary models	155
5.6.1	Introduction	155
5.6.2	Autocovariances and autocorrelations	155
5.6.3	Estimation from historical data	156
5.6.4	Autoregression of first order	157
5.6.5	The behaviour of first-order autoregressions	158
5.6.6	Non-linear change of scale	159
5.6.7	Monte Carlo implementation	160
5.6.8	Numerical illustration	160
5.7	Changing the time scale	161
5.7.1	Introduction	161
5.7.2	Historical data on short time scales	162
5.7.3	The random walk revisited	162
5.7.4	Continuous time: The Wiener process	163
5.7.5	First-order autoregression revisited	164
5.7.6	Continuous-time autoregression	165

Contents

xi

5.8	Mathematical arguments	166
5.8.1	Markowitz optimality	166
5.8.2	Risk bound under CAPM	166
5.8.3	Covariances of first-order autoregressions	167
5.8.4	Volatility estimation and time scale	167
5.8.5	The accuracy of covariance estimates	167
5.9	Bibliographical notes	168
5.9.1	General work	168
5.9.2	Continuous-time processes	169
5.9.3	Historical data and the time scale	169
5.10	Exercises	169
6	Modelling II: Conditional and non-linear	182
6.1	Introduction	182
6.2	Conditional modelling	183
6.2.1	Introduction	183
6.2.2	The conditional Gaussian	183
6.2.3	Survival modelling	184
6.2.4	Over-threshold modelling	184
6.2.5	Stochastic parameters	185
6.2.6	Common factors	185
6.2.7	Monte Carlo distributions	186
6.3	Uncertainty on different levels	187
6.3.1	Introduction	187
6.3.2	The double rules	187
6.3.3	Financial risk under CAPM	188
6.3.4	Insurance risk	188
6.3.5	Impact of subordinate risk	189
6.3.6	Random claim intensity in general insurance	190
6.4	The role of the conditional mean	191
6.4.1	Introduction	191
6.4.2	Optimal prediction and interest rates	191
6.4.3	The conditional mean as a price	192
6.4.4	Modelling bond prices	192
6.4.5	Bond price schemes	193
6.4.6	Interest rate curves	194
6.5	Stochastic dependence: General	195
6.5.1	Introduction	195
6.5.2	Factorization of density functions	195
6.5.3	Types of dependence	196

6.5.4	Linear and normal processes	197
6.5.5	The multinomial situation	197
6.6	Markov chains and life insurance	198
6.6.1	Introduction	198
6.6.2	Markov modelling	199
6.6.3	A disability scheme	200
6.6.4	Numerical example	200
6.7	Introducing copulas	202
6.7.1	Introduction	202
6.7.2	Copula modelling	202
6.7.3	The Clayton copula	203
6.7.4	Conditional distributions under copulas	204
6.7.5	Many variables and the Archimedean class	205
6.7.6	The Marshall–Olkin representation	206
6.7.7	Copula sampling	207
6.7.8	Example: An equity portfolio	208
6.7.9	Example: Copula log-normals against pure log-normals	209
6.8	Mathematical arguments	210
6.8.1	Portfolio risk when claim intensities are random	210
6.8.2	Optimal prediction	211
6.8.3	Vasiček bond prices	211
6.8.4	The Marshall–Olkin representation	212
6.8.5	A general scheme for copula sampling	213
6.8.6	Justification of Algorithm 6.4	213
6.9	Bibliographical notes	214
6.9.1	General work	214
6.9.2	Applications	214
6.9.3	Copulas	214
6.10	Exercises	215
7	Historical estimation and error	229
7.1	Introduction	229
7.2	Error of different origin	230
7.2.1	Introduction	230
7.2.2	Quantifying error	231
7.2.3	Numerical illustration	232
7.2.4	Errors and the mean	232
7.2.5	Example: Option pricing	233
7.2.6	Example: Reserve in property insurance	234
7.2.7	Bias and model error	235

Contents

xiii

7.3	How parameters are estimated	236
7.3.1	Introduction	236
7.3.2	The quick way: Moment matching	237
7.3.3	Moment matching and time series	237
7.3.4	The usual way: Maximum likelihood	238
7.3.5	Example: Norwegian natural disasters	239
7.4	Evaluating error I	240
7.4.1	Introduction	240
7.4.2	Introducing the bootstrap	241
7.4.3	Introductory example: The Poisson bootstrap	242
7.4.4	Second example: The Pareto bootstrap	243
7.4.5	The pure premium bootstrap	244
7.4.6	Simplification: The Gaussian bootstrap	245
7.4.7	The old way: Delta approximations	246
7.5	Evaluating error II: Nested schemes	247
7.5.1	Introduction	247
7.5.2	The nested algorithm	247
7.5.3	Example: The reserve bootstrap	248
7.5.4	Numerical illustration	248
7.5.5	A second example: Interest-rate return	249
7.5.6	Numerical illustration	251
7.6	The Bayesian approach	252
7.6.1	Introduction	252
7.6.2	The posterior view	252
7.6.3	Example: Claim intensities	253
7.6.4	Example: Expected return on equity	253
7.6.5	Choosing the prior	255
7.6.6	Bayesian simulation	255
7.6.7	Example: Mean payment	256
7.6.8	Example: Pure premium	258
7.6.9	Summing up: Bayes or not?	258
7.7	Mathematical arguments	258
7.7.1	Bayesian means under Gaussian models	258
7.8	Bibliographical notes	259
7.8.1	Analysis of error	259
7.8.2	The bootstrap	259
7.8.3	Bayesian techniques	260
7.9	Exercises	260

	PART II GENERAL INSURANCE	277
8	Modelling claim frequency	279
8.1	Introduction	279
8.2	The world of Poisson	279
8.2.1	Introduction	279
8.2.2	An elementary look	280
8.2.3	Extending the argument	280
8.2.4	When the intensity varies over time	282
8.2.5	The Poisson distribution	283
8.2.6	Using historical data	283
8.2.7	Example: A Norwegian automobile portfolio	284
8.3	Random intensities	285
8.3.1	Introduction	285
8.3.2	A first look	286
8.3.3	Estimating the mean and variance of μ	286
8.3.4	The negative binomial model	287
8.3.5	Fitting the negative binomial	288
8.3.6	Automobile example continued	288
8.4	Intensities with explanatory variables	289
8.4.1	Introduction	289
8.4.2	The model	289
8.4.3	Data and likelihood function	289
8.4.4	A first interpretation	290
8.4.5	How variables are entered	291
8.4.6	Interaction and cross-classification	292
8.5	Modelling delay	293
8.5.1	Introduction	293
8.5.2	Multinomial delay	294
8.5.3	IBNR claim numbers	294
8.5.4	Fitting delay models	295
8.5.5	Syntetic example: Car crash injury	295
8.6	Mathematical arguments	297
8.6.1	The general Poisson argument	297
8.6.2	Estimating the mean and standard deviation of μ	298
8.6.3	Large-sample properties	299
8.6.4	The negative binomial density function	300
8.6.5	Skewness of the negative binomial	301
8.6.6	The convolution property of the negative binomial	301
8.6.7	IBNR: The delay model	302

Contents

xv

8.7	Bibliographical notes	302
8.7.1	Poisson modelling	302
8.7.2	Generalized linear models	302
8.7.3	Reserving over long	303
8.8	Exercises	303
9	Modelling claim size	314
9.1	Introduction	314
9.2	Parametric and non-parametric modelling	314
9.2.1	Introduction	314
9.2.2	Scale families of distributions	315
9.2.3	Fitting a scale family	316
9.2.4	Shifted distributions	316
9.2.5	Skewness as a simple description of shape	317
9.2.6	Non-parametric estimation	318
9.3	The log-normal and Gamma families	319
9.3.1	Introduction	319
9.3.2	The log-normal: A quick summary	319
9.3.3	The Gamma model	319
9.3.4	Fitting the Gamma family	320
9.3.5	Regression for claims size	321
9.4	The Pareto families	322
9.4.1	Introduction	322
9.4.2	Elementary properties	322
9.4.3	Likelihood estimation	323
9.4.4	Over-threshold under Pareto	323
9.4.5	The extended Pareto family	324
9.5	Extreme value methods	325
9.5.1	Introduction	325
9.5.2	Over-threshold distributions in general	325
9.5.3	The Hill estimate	327
9.5.4	The entire distribution through mixtures	327
9.5.5	The empirical distribution mixed with Pareto	328
9.6	Searching for the model	329
9.6.1	Introduction	329
9.6.2	Using transformations	329
9.6.3	Example: The Danish fire claims	330
9.6.4	Pareto mixing	331
9.6.5	When data are scarce	332
9.6.6	When data are scarce II	333

9.7	Mathematical arguments	334
9.7.1	Extended Pareto: Moments	334
9.7.2	Extended Pareto: A limit	335
9.7.3	Extended Pareto: A representation	335
9.7.4	Extended Pareto: Additional sampler	336
9.7.5	Justification of the Hill estimate	336
9.8	Bibliographical notes	337
9.8.1	Families of distributions	337
9.8.2	Extreme value theory	337
9.8.3	Over thresholds	337
9.9	Exercises	337
10	Solvency and pricing	351
10.1	Introduction	351
10.2	Portfolio liabilities by simple approximation	352
10.2.1	Introduction	352
10.2.2	Normal approximations	352
10.2.3	Example: Motor insurance	353
10.2.4	The normal power approximation	353
10.2.5	Example: Danish fire claims	354
10.3	Portfolio liabilities by simulation	355
10.3.1	Introduction	355
10.3.2	A skeleton algorithm	355
10.3.3	Danish fire data: The impact of the claim size model	356
10.4	Differentiated pricing through regression	357
10.4.1	Introduction	357
10.4.2	Estimates of pure premia	358
10.4.3	Pure premia regression in practice	359
10.4.4	Example: The Norwegian automobile portfolio	359
10.5	Differentiated pricing through credibility	361
10.5.1	Introduction	361
10.5.2	Credibility: Approach	361
10.5.3	Linear credibility	362
10.5.4	How accurate is linear credibility?	363
10.5.5	Credibility at group level	364
10.5.6	Optimal credibility	364
10.5.7	Estimating the structural parameters	365
10.6	Reinsurance	366
10.6.1	Introduction	366
10.6.2	Traditional contracts	366

Contents

xvii

10.6.3	Pricing reinsurance	367
10.6.4	The effect of inflation	368
10.6.5	The effect of reinsurance on the reserve	369
10.7	Mathematical arguments	370
10.7.1	The normal power approximation	370
10.7.2	The third-order moment of X	370
10.7.3	Normal power under heterogeneity	371
10.7.4	Auxiliary for linear credibility	372
10.7.5	Linear credibility	372
10.7.6	Optimal credibility	373
10.7.7	Parameter estimation in linear credibility	374
10.8	Bibliographical notes	375
10.8.1	Computational methods	375
10.8.2	Credibility	375
10.8.3	Reinsurance	376
10.9	Exercises	376
11	Liabilities over long terms	386
11.1	Introduction	386
11.2	Simple situations	387
11.2.1	Introduction	387
11.2.2	Lower-order moments	387
11.2.3	When risk is constant	388
11.2.4	Underwriter results in the long run	388
11.2.5	Underwriter ruin by closed mathematics	389
11.2.6	Underwriter ruin under heavy-tailed losses	391
11.3	Time variation through regression	391
11.3.1	Introduction	391
11.3.2	Poisson regression with time effects	391
11.3.3	Example: An automobile portfolio	392
11.3.4	Regression with random background	393
11.3.5	The automobile portfolio: A second round	394
11.4	Claims as a stochastic process	396
11.4.1	Introduction	396
11.4.2	Claim intensity as a stationary process	396
11.4.3	A more general viewpoint	397
11.4.4	Model for the claim numbers	397
11.4.5	Example: The effect on underwriter risk	399
11.4.6	Utilizing historical data	399
11.4.7	Numerical experiment	400

11.5	Building simulation models	401
11.5.1	Introduction	401
11.5.2	Under the top level	401
11.5.3	Hidden, seasonal risk	402
11.5.4	Hidden risk with inflation	403
11.5.5	Example: Is inflation important?	404
11.5.6	Market fluctuations	405
11.5.7	Market fluctuations: Example	406
11.5.8	Taxes and dividend	407
11.6	Cash flow or book value?	408
11.6.1	Introduction	408
11.6.2	Mathematical formulation	408
11.6.3	Adding IBNR claims	409
11.6.4	Example: Runoff portfolios	410
11.7	Mathematical arguments	411
11.7.1	Lower-order moments of \mathcal{Y}_k under constant risk	411
11.7.2	Lundberg's inequality	412
11.7.3	Moment-generating functions for underwriting	412
11.7.4	Negative binomial regression	413
11.8	Bibliographical notes	414
11.8.1	Negative binomial regression	414
11.8.2	Claims as stochastic processes	414
11.8.3	Ruin	415
11.9	Exercises	415
	PART III LIFE INSURANCE AND FINANCIAL RISK	431
12	Life and state-dependent insurance	433
12.1	Introduction	433
12.2	The anatomy of state-dependent insurance	434
12.2.1	Introduction	434
12.2.2	Cash flows determined by states	434
12.2.3	Equivalence pricing	435
12.2.4	The reserve	436
12.2.5	The portfolio viewpoint	437
12.3	Survival modelling	438
12.3.1	Introduction	438
12.3.2	Deductions from one-step transitions	438
12.3.3	Modelling through intensities	439
12.3.4	A standard model: Gompertz–Makeham	440

Contents

xix

12.3.5	Expected survival	441
12.3.6	Using historical data	442
12.4	Single-life arrangements	443
12.4.1	Introduction	443
12.4.2	How mortality risk affects value	443
12.4.3	Life insurance notation	444
12.4.4	Computing mortality-adjusted annuities	445
12.4.5	Common insurance arrangements	445
12.4.6	A numerical example	448
12.5	Multi-state insurance I: Modelling	448
12.5.1	Introduction	448
12.5.2	From one-step to k -step transitions	449
12.5.3	Intensity modelling	450
12.5.4	Example: A Danish disability model	451
12.5.5	Numerical examples	452
12.5.6	From intensities to transition probabilities	453
12.5.7	Using historical data	454
12.6	Multi-state insurance II: Premia and liabilities	455
12.6.1	Introduction	455
12.6.2	Single policies	455
12.6.3	Example 1: A widow scheme	455
12.6.4	Example 2: Disability and retirement in combination	456
12.6.5	Portfolio liabilities	457
12.6.6	Example: A disability scheme	458
12.7	Mathematical arguments	459
12.7.1	Savings and mortality-adjusted value	459
12.7.2	The reserve formula (12.19)	460
12.7.3	The k -step transition probabilities	461
12.8	Bibliographical notes	461
12.8.1	Simple contracts and modelling	461
12.8.2	General work	462
12.9	Exercises	462
13	Stochastic asset models	478
13.1	Introduction	478
13.2	Volatility modelling I	479
13.2.1	Introduction	479
13.2.2	Multivariate stochastic volatility	479
13.2.3	The multivariate t -distribution	480
13.2.4	Dynamic volatility	482
13.2.5	Volatility as driver	483

13.2.6	Log-normal volatility	483
13.2.7	Numerical example	484
13.2.8	Several series in parallel	485
13.3	Volatility modelling II: The GARCH type	485
13.3.1	Introduction	485
13.3.2	How GARCH models are constructed	486
13.3.3	Volatilities under first-order GARCH	486
13.3.4	Properties of the original process	487
13.3.5	Fitting GARCH models	488
13.3.6	Simulating GARCH	488
13.3.7	Example: GARCH and the SP 500 index	489
13.4	Linear dynamic modelling	489
13.4.1	Introduction	489
13.4.2	ARMA models	491
13.4.3	Linear feedback	492
13.4.4	Enter transformations	493
13.5	The Wilkie model I: Twentieth-century financial risk	494
13.5.1	Introduction	494
13.5.2	Output variables and their building blocks	494
13.5.3	Non-linear transformations	496
13.5.4	The linear and stationary part	497
13.5.5	Parameter estimates	498
13.5.6	Annual inflation and returns	499
13.6	The Wilkie model II: Implementation issues	500
13.6.1	Introduction	500
13.6.2	How simulations are initialized	500
13.6.3	Simulation algorithms	502
13.6.4	Interest-rate interpolation	503
13.7	Mathematical arguments	503
13.7.1	Absolute deviations from the mean	503
13.7.2	Autocorrelations under log-normal volatilities	504
13.7.3	The error series for GARCH variances	505
13.7.4	Properties of GARCH variances	505
13.7.5	The original process squared	506
13.7.6	Verification of Table 13.5	507
13.8	Bibliographical notes	508
13.8.1	Linear processes	508
13.8.2	Heavy tails	508
13.8.3	Dynamic volatility	509
13.9	Exercises	509

Contents

xxi

14	Financial derivatives	522
14.1	Introduction	522
14.2	Arbitrage and risk neutrality	523
14.2.1	Introduction	523
14.2.2	Forward contracts	524
14.2.3	Binomial movements	524
14.2.4	Risk neutrality	525
14.3	Equity options I	526
14.3.1	Introduction	526
14.3.2	Types of contract	527
14.3.3	Valuation: A first look	528
14.3.4	The put–call parity	528
14.3.5	A first look at calls and puts	529
14.4	Equity options II: Hedging and valuation	530
14.4.1	Introduction	530
14.4.2	Actuarial and risk-neutral pricing	530
14.4.3	The hedge portfolio and its properties	531
14.4.4	The financial state over time	533
14.4.5	Numerical experiment	533
14.4.6	The situation at expiry revisited	535
14.4.7	Valuation	536
14.5	Interest-rate derivatives	537
14.5.1	Introduction	537
14.5.2	Risk-neutral pricing	537
14.5.3	Implied mean and forward prices	538
14.5.4	Interest-rate swaps	539
14.5.5	Floors and caps	540
14.5.6	Options on bonds	541
14.5.7	Options on interest-rate swaps	542
14.5.8	Numerical experimenting	543
14.6	Mathematical summing up	544
14.6.1	Introduction	544
14.6.2	How values of derivatives evolve	545
14.6.3	Hedging	545
14.6.4	The market price of risk	546
14.6.5	Martingale pricing	547
14.6.6	Closing mathematics	548
14.7	Bibliographical notes	550
14.7.1	Introductory work	550
14.7.2	Work with heavier mathematics	550

14.7.3	The numerical side	550
14.8	Exercises	551
15	Integrating risk of different origin	562
15.1	Introduction	562
15.2	Life-table risk	563
15.2.1	Introduction	563
15.2.2	Numerical example	564
15.2.3	The life-table bootstrap	565
15.2.4	The bootstrap in life insurance	566
15.2.5	Random error and pension evaluations	566
15.2.6	Bias against random error	568
15.2.7	Dealing with longer lives	569
15.2.8	Longevity bias: Numerical examples	570
15.3	Risk due to discounting and inflation	571
15.3.1	Introduction	571
15.3.2	Market-based valuation	572
15.3.3	Numerical example	572
15.3.4	Inflation: A first look	573
15.3.5	Simulating present values under stochastic discounts	574
15.3.6	Numerical examples	575
15.4	Simulating assets protected by derivatives	576
15.4.1	Introduction	576
15.4.2	Equity returns with options	577
15.4.3	Equity options over longer time horizons	577
15.4.4	Money-market investments with floors and caps	579
15.4.5	Money-market investments with swaps and swaptions	579
15.5	Simulating asset portfolios	581
15.5.1	Introduction	581
15.5.2	Defining the strategy	582
15.5.3	Expenses due to rebalancing	583
15.5.4	A skeleton algorithm	584
15.5.5	Example 1: Equity and cash	585
15.5.6	Example 2: Options added	586
15.5.7	Example 3: Bond portfolio and inflation	587
15.5.8	Example 4: Equity, cash and bonds	588
15.6	Assets and liabilities	589
15.6.1	Introduction	589
15.6.2	Auxiliary: Duration and spread of liabilities	590
15.6.3	Classical immunization	591

Contents

xxiii

15.6.4	Net asset values	592
15.6.5	Immunization through bonds	593
15.6.6	Enter inflation	594
15.7	Mathematical arguments	597
15.7.1	Present values and duration	597
15.7.2	Reddington immunization	597
15.8	Bibliographical notes	599
15.8.1	Survival modelling	599
15.8.2	Fair values	599
15.8.3	Financial risk and ALM	599
15.8.4	Stochastic dynamic optimization	600
15.9	Exercises	600
Appendix A Random variables: Principal tools		618
A.1	Introduction	618
A.2	Single random variables	618
A.2.1	Introduction	618
A.2.2	Probability distributions	618
A.2.3	Simplified description of distributions	619
A.2.4	Operating rules	620
A.2.5	Transforms and cumulants	620
A.2.6	Example: The mean	622
A.3	Several random variables jointly	622
A.3.1	Introduction	622
A.3.2	Covariance and correlation	623
A.3.3	Operating rules	624
A.3.4	The conditional viewpoint	624
A.4	Laws of large numbers	626
A.4.1	Introduction	626
A.4.2	The weak law of large numbers	626
A.4.3	Central limit theorem	627
A.4.4	Functions of averages	628
A.4.5	Bias and standard deviation of estimates	629
A.4.6	Likelihood estimates	629
Appendix B Linear algebra and stochastic vectors		631
B.1	Introduction	631
B.2	Operations on matrices and vectors	632
B.2.1	Introduction	632
B.2.2	Addition and multiplication	632
B.2.3	Quadratic matrices	632

B.2.4	The geometric view	633
B.2.5	Algebraic rules	634
B.2.6	Stochastic vectors	634
B.2.7	Linear operations on stochastic vectors	635
B.2.8	Covariance matrices and Cholesky factors	636
B.3	The Gaussian model: Simple theory	636
B.3.1	Introduction	636
B.3.2	Orthonormal operations	637
B.3.3	Uniqueness	638
B.3.4	Linear transformations	638
B.3.5	Block representation	638
B.3.6	Conditional distributions	639
B.3.7	Verification	639
Appendix C	Numerical algorithms: A third tool	641
C.1	Introduction	641
C.2	Cholesky computing	641
C.2.1	Introduction	641
C.2.2	The Cholesky decomposition	642
C.2.3	Linear equations	642
C.2.4	Matrix inversion	643
C.3	Interpolation, integration, differentiation	644
C.3.1	Introduction	644
C.3.2	Numerical interpolation	644
C.3.3	Numerical integration	645
C.3.4	Numerical integration II: Gaussian quadrature	646
C.3.5	Numerical differentiation	647
C.4	Bracketing and bisection: Easy and safe	649
C.4.1	Introduction	649
C.4.2	Bisection: Bracketing as iteration	649
C.4.3	Golden section: Bracketing for extrema	650
C.4.4	Golden section: Justification	651
C.5	Optimization: Advanced and useful	652
C.5.1	Introduction	652
C.5.2	The Newton–Raphson method	652
C.5.3	Variable metric methods	653
C.6	Bibliographical notes	655
C.6.1	General numerical methods	655
C.6.2	Optimization	655
	References	656
	Index	680