Conditional Tail Expectations for Multivariate Phase Type Distributions

Jun Cai
University of Waterloo
jcai@uwaterloo.ca

Haijun Li
Washington State University
lih@math.wsu.edu

September 2005

ASTIN 2005, Zurich

Outline

- Conditional tail expectations (CTEs) of the total risk and extreme risks
- CTEs for univariate phase type distributions
- CTEs for multivariate phase distributions
- Effects of dependence on the CTEs of the total risk and extreme risks

- **Conditional Tail Expectation (CTE):**
  - Let X denote the amount of claims on an insurance portfolio or the loss on an investment portfolio. The conditional expectation of X given that $X > t$, denoted by $CTE_X(t) = E(X|X > t)$, is called the *conditional tail expectation* (CTE) of X at t.
  - The CTE of continuous risks is a *coherent risk measure* (Artzner et al. 1999).
  - $CTE_X(t) = t + E(X - t|X > t)$, where the conditional random variable $X - t|X > t$ is known as the *residual lifetime* in reliability (Shaked and Shanthikumar 1994) and the *excess loss* or *excess risk* in insurance and finance (Embrechts et al. 1997).
  - The CTE function $CTE_X(t)$ is increasing in $t \geq 0$.

- Let $(X_1, ..., X_n)$ be a risk vector, where X_i denotes risk (claim or loss) in subportfolio i for $i = 1, ..., n$. Then, $S = X_1 + ... + X_n$ is the total risk and $X_{(1)} = \min\{X_1, ..., X_n\}$ and $X_{(n)} = \max\{X_1, ..., X_n\}$ are extreme risks in the portfolio consisting of the n subportfolios. In risk analysis, we are interested in the following CTEs:

$$\begin{aligned}
CTE_S(t) &= E(S \mid S > t), \\
CTE_{X_{(1)}}(t) &= E(X_{(1)} \mid X_{(1)} > t), \\
CTE_{X_{(n)}}(t) &= E(X_{(n)} \mid X_{(n)} > t), \\
CTE_{X_i|S}(t) &= E(X_i \mid S > t), \\
CTE_{X_i|X_{(1)}}(t) &= E(X_i \mid X_{(1)} > t), \\
CTE_{X_i|X_{(n)}}(t) &= E(X_i \mid X_{(n)} > t), \\
CTE_{X_i|X_{(n)}}(t) &= E(X_{(n)} \mid X_i > t),
\end{aligned}$$

for $i = 1, 2, ..., n$.

- $CTE_{X_i|S}(t)$ represents the average contribution of risk X_i to the total risk S since $CTE_S(t) = \sum_{i=1}^{n} CTE_{X_i|S}(t)$ and it is of interest in the study of the risk or capital allocation.

- $E(X_{(1)}|X_{(1)} > t)$ ($E(X_{(n)}|X_{(n)} > t)$) describes the expected minimal (maximal) risk in all the subportfolios given that the minimal (maximal) risk exceeds some threshold t.

- $E(X_i|X_{(1)} > t)$ represents the average contribution of risk X_i given that all the risks exceed some value t. In a group life insurance, $E(X_i|X_{(1)} > t)$ is the expected lifetime of member i given that all members are alive at time t.

- $E(X_i|X_{(n)} > t)$ represents the average contribution of risk X_i given that at least one risk exceeds a certain value t. In a group life insurance, $E(X_i|X_{(n)} > t)$ is the expected lifetime of member i given that there is at least one member who is alive at time t.

- **CTEs for dependent risks:**
  - Panjer (2001) obtained the explicit formulas of $CTE_S(t)$ and $CTE_{X_i|S}(t)$ for **multivariate normal distributions**.
  - Landsman and Valdez (2003) obtained the explicit formulas of $CTE_S(t)$ and $CTE_{X_i|S}(t)$ for **multivariate elliptical distributions**.
  - Cai and Tan (2005) derived the explicit formulas of $CTE_S(t)$ and $CTE_{X_i|S}(t)$ for **multivariate skew elliptical distributions**.
  - The focus of this paper is to derive the explicit formulas of various CTEs, such as $CTE_S(t)$, $CTE_{X_{(1)}}(t)$, $CTE_{X_{(n)}}(t)$, $E(X_{(n)}|X_{(1)} > t)$, $E(X_{(n)}|X_i > t)$ for $i = 1, 2, ..., n$, for **multivariate phase type (MPH) distributions**.
  - What are MPH distributions? Why do we consider MPH distributions for dependent risks?

- **Univariate Phase Type Distributions:**
  - Let $\{X(t), t \geq 0\}$ be a continuous-time and finite-state Markov chain with state space $\{0, 1, \ldots, d\}$, initial distribution $\boldsymbol{\beta} = (0, \boldsymbol{\alpha})$, and generator

$$Q = \begin{bmatrix} 0 & \mathbf{0} \\ -A\boldsymbol{e} & A \end{bmatrix},$$

    where state 0 is the absorbing state.

  - Let $X = \inf\{t \geq 0 : X(t) = 0\}$ is the absorbing time to the absorbing state 0 in the Markov chain. Then the distribution of the random variable X is said to be of *phase type* (PH) with representation $(\boldsymbol{\alpha}, A, d)$.

– Let $\bar{F}(x) = 1 - F(x)$. Then X is of phase type with representation $(\boldsymbol{\alpha}, A, d)$ if and only if

$$\bar{F}(x) = \boldsymbol{\alpha}\, e^{xA}\, \boldsymbol{e},\ x \geq 0.$$

– If X has a PH distribution with representation $(\boldsymbol{\alpha}, A, d)$, then for any $t > 0$, the excess risk $X - t \mid X > t$ has a PH distribution with representation $(\boldsymbol{\alpha}_t, A, d)$ and

$$CTE_X(t) = t - \frac{\boldsymbol{\alpha}\, A^{-1}\, e^{tA}\, \boldsymbol{e}}{\boldsymbol{\alpha}\, e^{tA}\, \boldsymbol{e}},$$

where

$$\boldsymbol{\alpha}_t = \frac{\boldsymbol{\alpha}\, e^{tA}}{\boldsymbol{\alpha}\, e^{tA}\, \boldsymbol{e}}. \tag{1}$$

- **Multivariate Phase Type Distributions:**
  - Let $\{X(t), t \geq 0\}$ be a continuous-time Markov chain on a finite state space $\mathcal{E}$ with generator $Q = \begin{bmatrix} 0 & \mathbf{0} \\ -A\boldsymbol{e} & A \end{bmatrix}$.
  - A subset of the state space is said to be a **closed or absorbing subset** if once the process $\{X(t), t \geq 0\}$ enters the subset, $\{X(t), t \geq 0\}$ never leaves.
  - Let $\mathcal{E}_i$, $i = 1, \ldots, n$, be n closed or absorbing subsets of $\mathcal{E}$ and X_i be the absorbing time to the absorbing subset $\mathcal{E}_i$, i.e.

$$X_i = \inf\{t \geq 0 : X(t) \in \mathcal{E}_i\}, \quad i = 1, \ldots, n.$$

    Then the joint distribution of $(X_1, \ldots, X_n)$ is called a *multivariate phase type* distribution (MPH) with representation $(\boldsymbol{\alpha}, A, \mathcal{E}, \mathcal{E}_1, \ldots, \mathcal{E}_n)$, and $(X_1, \ldots, X_n)$ is called a phase type random vector (Assaf et al. (1984)).

- When $n = 1$, the MPH distribution reduces to the univariate PH distribution.

- Examples of MPH distributions include, among many others, the well-known Marshall-Olkin distribution (Marshall and Olkin 1967).

- As in the univariate case, MPH distributions (and their densities, Laplace transforms and moments) can be expressed in a closed form.

- The set of n-dimensional MPH distributions is dense in the set of all distributions on $[0, \infty)^n$.

- Any multivariate nonnegative distribution such as multivariate lognormal distribution and multivariate Pareto distribution can be approximated by a sequence of MPH distributions.

- **Our main results on dependent risks with multivariate phase type distributions:** Assume that a risk vector $(X_1, ..., X_n)$ follows a MPH distribution, we derive

  - the PH representations of the total risk $S = X_1 + \cdots + X_n$ and the extreme risks $X_{(1)}$ and $X_{(n)}$ and the explicit formulas of CTEs for S, $X_{(1)}$, and $X_{(n)}$; and

  - the joint distributions of risk vector $(X_{(1)}, X_i, X_{(n)})$ and excess risk vector

$$X_1 - t, ..., X_n - t \mid X_1 > t, ..., X_n > t$$

    and the explicit formulas for $E(X_{(n)} \mid X_{(1)})$, $E(X_{(n)} \mid X_i)$, and other CTEs for $i = 1, ..., n$.

- **PH representation and CTE of the total risk**:
  - Let $(X_1, \ldots, X_n)$ be a PH type vector with representation $(\boldsymbol{\alpha}, A, \mathcal{E}, \mathcal{E}_i, i = 1, \ldots, n)$, where $A = (a_{i,j})$. Then

(i) $\sum_{i=1}^{n} X_i$ has a phase type distribution with representation $(\boldsymbol{\alpha}, T, |\mathcal{E}| - 1)$, where $T = (t_{i,j})$ is given by,

$$t_{i,j} = \frac{a_{i,j}}{k(i)}, \tag{2}$$

where $k(i) =$ number of indexes in $\{j : i \notin \mathcal{E}_j, 1 \leq j \leq n\}$; and

(ii) the CTE of $S = X_1 + \cdots + X_n$ is given by, for any $t > 0$,

$$CTE_S(t) = t - \frac{\boldsymbol{\alpha}\, T^{-1}\, e^{tT}\, \boldsymbol{e}}{\boldsymbol{\alpha}\, e^{tT}\, \boldsymbol{e}},$$

where T is defined by (2). □

- **PH representations and CTE of extreme risks:**

  - For any d-dimensional probability vector $\boldsymbol{\alpha}$ and any subset $S \subseteq \mathcal{E}$, we denote by $\boldsymbol{\alpha}_S$ the $|S|$-dimensional sub-vector of $\boldsymbol{\alpha}$ by removing its s-th entry for all $s \notin S$.

  - For any $S \subseteq \mathcal{E}$, we write $\boldsymbol{\alpha}_t(S)$ for the following $|S|$-dimensional row vector

$$\boldsymbol{\alpha}_t(S) = \frac{\boldsymbol{\alpha}_S \, e^{tA_S}}{\boldsymbol{\alpha}_S \, e^{tA_S} \, \boldsymbol{e}}.$$

  - Define A_S as the sub-matrix of A by removing the i-th row and the i-th column of A for all $i \notin S$.

– Let $(X_1, \ldots, X_n)$ be of PH type with representation $(\boldsymbol{\alpha}, A, \mathcal{E}, \mathcal{E}_1, \ldots, \mathcal{E}_n)$. Then

(i) $X_{(1)}$ is of phase type with representation $\left(\frac{\boldsymbol{\alpha}_{\mathcal{E}_0}}{\boldsymbol{\alpha}_{\mathcal{E}_0}\boldsymbol{e}},\, A_{\mathcal{E}_0},\, |\mathcal{E}_0|\right)$ and

$$CTE_{X_{(1)}}(t) = t - \boldsymbol{\alpha}_t(\mathcal{E}_0)\, A_{\mathcal{E}_0}^{-1}\, \boldsymbol{e};$$

(ii) $X_{(n)}$ is of phase type with representation $(\boldsymbol{\alpha},\, A,\, |\mathcal{E}| - 1)$ and

$$CTE_{X_{(n)}}(t) = t - \boldsymbol{\alpha}_t\, A^{-1}\, \boldsymbol{e};$$

(iii) and $(X_{(n)} - t \mid X_i > t)$ is of phase type with representation $\left((\mathbf{0},\, \boldsymbol{\alpha}_t(\mathcal{E} - \mathcal{E}_i))\right,\, A,\, |\mathcal{E}| - 1)$ and

$$E(X_{(n)} \mid X_i > t) = t - (\mathbf{0},\, \boldsymbol{\alpha}_t(\mathcal{E} - \mathcal{E}_i))\;A^{-1}\, \boldsymbol{e}.$$

- **Effects of dependence of on the CTEs of the total risk and extreme risks:** Consider a two-dimensional phase type distribution with the state space $\mathcal{E} = \{12, 2, 1, \emptyset\}$, the absorbing subsets $\mathcal{E}_j = \{12, j\}$, $j = 1, 2$, the initial probability vector $\boldsymbol{\alpha} = (0, 0, 1)$, and the sub-generator A

$$A = \begin{bmatrix} -\lambda_{12} - \lambda_1 & 0 & 0 \\ 0 & -\lambda_{12} - \lambda_2 & 0 \\ \lambda_2 & \lambda_1 & -\Lambda + \lambda_\emptyset \end{bmatrix},$$

  where $\Lambda = \lambda_{12} + \lambda_2 + \lambda_1 + \lambda_\emptyset$.

  This example is a two-dimensional Marshall-Olkin distribution (Marshall and Olkin 1967) or the distribution of the joint-life status in a common shock model (Bowers et al. 1997).

Case 1: $\lambda_{12} = 0$, $\lambda_1 = \lambda_2 = 2.5$, $\lambda_\emptyset = 0$. In this case, the vector (X_1, X_2) are independent, and

$$\begin{aligned} CTE_S(t) &= 0.4 + t + \frac{0.16}{0.4 + t}, \\ CTE_{X_{(1)}}(t) &= 0.2 + t, \\ CTE_{X_{(n)}}(t) &= \frac{0.8 + 2\,t - (0.2 + t)e^{-2.5\,t}}{2 - e^{-2.5\,t}}. \end{aligned}$$

Case 2: $\lambda_{12} = 1$, $\lambda_1 = \lambda_2 = 1.5$, $\lambda_\emptyset = 1$. In this case, the vector (X_1, X_2) are positively dependent, and

$$\begin{aligned} CTE_S(t) &= \frac{1 + 2\,t - (0.6 + 1.5\,t)e^{-0.5\,t}}{2 - 1.5\,e^{-0.5\,t}}, \\ CTE_{X_{(1)}}(t) &= 0.25 + t, \\ CTE_{X_{(n)}}(t) &= \frac{0.8 + 2\,t - (0.25 + t)e^{-1.5\,t}}{2 - e^{-1.5\,t}}. \end{aligned}$$

Case 3: $\lambda_{12} = 2.5$, $\lambda_1 = \lambda_2 = 0$, $\lambda_\emptyset = 2.5$. This is the comonotone case where $X_1 = X_2$, and so the vector (X_1, X_2) has the strongest positive dependence. In this case,

$$CTE_S(t) \; = \; 0.8 + t, \quad CTE_{X_{(1)}}(t) \; = \; CTE_{X_{(n)}}(t) \; = \; 0.4 + t.$$

– In all the three cases, (X_1, X_2) has the same marginal distributions. The only difference among them is the different correlation between X_1 and X_2.

– It can be verified that the correlation coefficient of (X_1, X_2) in Case 1 is smaller than that in Case 2, which, in turn, is smaller than that in Case 3.

– Tables 1 and 2 show that the $CTE_S(t)$ and $CTE_{X_{(1)}}(t)$ become larger as the correlation grows. However, $CTE_{X_{(n)}}(t)$ is neither increasing nor decreasing as the correlation grows.

Table 1: Effects of Dependence on the CTE of S

	$CTE_S(t)$		
t	Case 1	Case 2	Case 3
2	2.4667	2.5381	2.8
4	4.4364	4.5113	4.8
6	6.4250	6.5039	6.8
8	8.4191	8.5014	8.8

Table 2: Effects of Dependence on the CTEs of $X_{(1)}$ and $X_{(n)}$

	$CTE_{X_{(1)}}(t)$			$CTE_{X_{(n)}}(t)$		
t	Case 1	Case 2	Case 3	Case 1	Case 2	Case 3
2	2.2	2.25	2.4	2.4007	2.4038	2.4
4	4.2	4.25	4.4	4.4000	4.4002	4.4
6	6.2	6.25	6.4	6.4000	6.4000	6.4
8	8.2	8.25	8.4	8.4000	8.4000	8.4