Estimation of Tail Development Factors in the Paid-Incurred Chain Reserving Method

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ABSTRACT
In many applied claims reserving problems in P&C insurance, the claims settlement process goes beyond the latest development period available in the observed claims development triangle. This makes it necessary to estimate so-called tail development factors which account for the unobserved part of the insurance claims. We estimate these tail development factors in a mathematically consistent way. This paper is a modification of the paid-incurred chain (PIC) reserving model of Merz and Wüthrich (2010). This modification then allows for the prediction of the outstanding loss liabilities and the corresponding prediction uncertainty under the inclusion of tail development factors.

KEYWORDS
Tail factors, claims reserving, paid-incurred chain, outstanding loss liabilities, PIC model, claims development triangle, ultimate claim prediction, prediction uncertainty, MSEP
1. Introduction and model assumptions

Often in P&C claims reserving problems, the claims settlement process goes beyond the latest development period available in the observed claims development triangle. This means that there is still an unobserved part of the insurance claims for which one needs to build claims reserves. In such situations, claims reserving actuaries apply so-called tail development factors to the last column of the claims development triangle which account for the settlement that goes beyond this latest development period. Typically, one has only limited information for the estimation of such tail development factors. Therefore, various techniques are applied to estimate these tail development factors. Most of these estimation methods are ad hoc methods that do not fit into any stochastic modeling framework. Popular estimation techniques, for example, fit parametric curves to the data using the right-hand corner of the claims development triangle (Mack 1999; Boor 2006; Verrall and Wüthrich 2012). In practice, one often does a simultaneous study of claims payments and claims incurred data, i.e., incurred-paid ratios are used to determine tail development factors (see Section 3 in Boor 2006).

In this paper we review the paid-incurred chain (PIC) reserving method. The log-normal PIC reserving model introduced in Merz and Wüthrich (2010) can easily be extended so that it allows for the inclusion of tail development factors in a natural and mathematically consistent way. Similar to common practice, the tail development factor estimates will then be based on incurred-paid ratios within our PIC reserving framework.

In the following, we denote accident years by \( i \in \{0, \ldots, J\} \) and development years by \( j \in \{0, \ldots, J, J+1\} \). Development year \( J \) refers to the latest observed development year of accident year \( i = 0 \) and the step from \( J \) to \( J+1 \) refers to the tail development factors (see Figure 1). Cumulative payments in accident year \( i \) after \( j \) development years are denoted by \( P_{i,j} \) and the corresponding claims incurred by \( I_{i,j} \). Moreover, for the ultimate claim we assume \( P_{i,J+1} = I_{i,J+1} \) with probability 1 (see Figure 1). This means that we assume that—for several development periods beyond the latest observed development year \( J \)—the cumulative payments and the claims incurred lead to the same ultimate claim amount. That is, ultimately, when all claims of accident year \( i \) are settled, \( I_{i,J+1} \) and \( P_{i,J+1} \) must coincide.

Model Assumptions 1.1 Log-normal PIC reserving model, Merz and Wüthrich (2010)
- Conditionally, given parameters \( \Theta = (\Phi_0, \ldots, \Phi_{J+1}, \Psi_0, \ldots, \Psi_J, \sigma_0, \ldots, \sigma_{J+1}, \tau_0, \ldots, \tau_J) \), we have
the random vector $(\xi_{0,i}, \ldots, \xi_{J,i}, \zeta_{0,0}, \ldots, \zeta_{L,0})$ has a multivariate Gaussian distribution with uncorrelated components given by

$$
\xi_{i,j} \sim N(\Phi_j, \Sigma_j^2) \quad \text{for } i \in \{0, \ldots, J\} \text{ and } j \in \{0, \ldots, J+1\}, \text{ and }
\zeta_{i,j} \sim N(\Psi_j, \tau_j^2) \quad \text{for } i \in \{0, \ldots, J\} \text{ and } j \in \{0, \ldots, J\};
$$

- cumulative payments $P_{i,j}$ are given by the recursion, $j = 0, \ldots, J+1$,

$$
P_{i,j} = P_{i,j-1} \exp(\xi_{i,j}), \quad \text{with initial value } P_{i,-1} = 1;
$$
- claims incurred $I_{i,j}$ are given by the (backwards) recursion, $j = 0, \ldots, J$,

$$
I_{i,j} = I_{i,j+1} \exp(-\zeta_{i,j}), \quad \text{with initial value } I_{i,J+1} = P_{i,J+1}.
$$

- The components of $\Theta$ are independent and $\sigma_j, \tau_j > 0$ for all $j$ (with probability 1).

For an extended model discussion we refer to Merz and Wüthrich (2010). Basically, the PIC Model Assumptions 1.1 are a combination of Hertig’s (1985) log-normal model (applied to cumulative payments) and Gogol’s (1993) Bayesian claims reserving model (applied to claims incurred). In contrast to the PIC reserving model in Merz and Wüthrich (2010), we now add an extra development period from $J$ to $J+1$. This is exactly the crucial step that allows for the consideration of tail development factors and it leads to the study of incurred-paid ratios for the inclusion of such tail development factors.

The PIC Model Assumptions 1.1 may be criticized because of two restrictive assumptions. We briefly discuss how these can be relaxed.

- Assumption $P_{i,-1} = 1$ for all $i \in \{0, \ldots, J\}$: If there are known (prior) differences between different accident years $i$, this can easily be integrated by setting $P_{i,-1} = v_i$ with constants $v_0, \ldots, v_J > 0$ describing these prior differences.
- Independence between $\xi_{i,j}$ and $\zeta_{i,j}$: This is probably the main weakness of the model. However, this assumption can easily be relaxed in the spirit of Happ and Wüthrich (2013). To keep the analysis simple, we refrain from studying this more complex model in the present paper.

## 2. Estimation of tail development factors

At time $J$ one has observed data given by the set

$$
D_j = \{P_{i,j}, I_{i,j} : i + j \leq J, 0 \leq i \leq J, 0 \leq j \leq J\},
$$

and one needs to predict the ultimate claim amounts $P_{i,J+1} = I_{i,J+1}$, conditional on these observations $D_j$. On the one hand, this involves the calculation of the conditional expectations $E[P_{i,J+1} | D_j, \Theta]$ and, on the other hand, it involves Bayesian inference on the parameters $\Theta$, given $D_j$ (see Theorems 2.4 and 3.4 in Merz and Wüthrich 2010). In this section we discuss how to modify the general outline of Model Assumptions 1.1 to incorporate tail development estimation.

### 2.1. Ultimate claims prediction conditional on parameters

We apply Model Assumptions 1.1 to the tail development factor estimation problem. Therefore, we need to specify the prior distribution of the parameter vector $\Theta$.

Often, there is subjectivity in claims incurred data $I_{i,j}$ because the use of different claims adjusters with different estimation methods and changing reserving guidelines. Therefore, for the present set-up we have decided to consider claims incurred data $I_{i,j}$ only for the estimation of tail development factors, i.e., we work under the assumption of having incomplete claims incurred triangles (see also Dahms (2008) and Happ and Wüthrich (2013) for claims reserving methods on incomplete data). It is not difficult to extend the model to incorporate all claims incurred information, but in the present work this would detract from the tail development factor estimation discussion.
The prediction based on incomplete claims incurred data is done as follows. Assume there exists \( J^* \in \{0, \ldots, J \} \) such that with probability 1
\[
\Psi_j = \frac{\tau_j}{2}, \quad (2.1)
\]
and if \( J^* < J \)
\[
\tau_j = \tau_{j,1} = \cdots = \tau_{j,J^*} \equiv \tau_j, \quad \Psi_j = \Psi_{j,1} = \cdots = \Psi_{j,J^*} \equiv \tau_j/2. \quad (2.2)
\]

Note that if \( J^* = J \) we simply assume \( \Psi_j = \tau^2_j/2 \).

These assumptions imply that there is no substantial claims incurred development after claims development period \( J^* \), i.e., there is no systematic drift in the claims incurred development after \( J^* \). This is seen as follows, for \( j \in \{J^* + 1, \ldots, J \} \)
\[
E[\exp{-\zeta_{i,j}}] = E[E[\exp{-\zeta_{i,j}}|\Theta]] = E[\exp{-\Psi_j + \tau_j^2/2}] = 1.
\]

This implies that on average the claims incurred prediction is correct (and we have only pure random fluctuations around this prediction), i.e., for \( j \in \{J^* + 1, \ldots, J + 1 \} \)
\[
E[I_{i,j}|I_{i,j}] = I_{i,j}, \quad V\text{co}(I_{i,j}|I_{i,j}) = (\exp{\tau^2_{i,j}} - 1)^{1/2},
\]

where Vco(·) denotes the coefficient of variation. The fact that we allow \( \tau \), to differ from \( \tau \) corresponds to the difficulty that the tail development factor may cover several development years beyond the last observed column in the claims development triangle and therefore we may allow for standard deviation parameters \( \tau_j > \tau \) for the development period from \( J \) to \( J + 1 \) (possibly covering more than one period).

**Remark.** If there is expert judgment about a drift term in the claims incurred development \( I_{i,j-1}, \ldots, I_{i,J^*+1} \) this can easily be integrated by adjusting assumptions (2.1)–(2.2). This also allows one to consider parametric curves, as mentioned in Section 1, but in this case it is more appropriate to treat this knowledge as informative as to prior distributions specifying prior uncertainty in this expert judgment, similar to Verrall and Wüthrich (2012).

Thus, assumptions (2.1)–(2.2) imply that there is no systematic drift in \( \{J^* + 1, \ldots, J + 1 \} \), and under these assumptions we consider tail factor estimation under the restricted observations given by
\[
D^*_l = \{P_{i,j}, I_{i,j} : i + j \leq J, k + l \leq J, l \geq J^* \} \quad D^*_l \cap \{P_{i,j}, I_{i,j} : l \geq J^* \}.
\]

In this spirit, we consider all cumulative payment observations but only claims incurred observations from development year \( J^* \). That is, only the claims incurred \( I_{i,j} \) from the latest \( J - J^* + 1 \) development periods \( J^*, J^* + 1, \ldots, J \) are used to estimate tail development factors and the claims reserves. We define the following parameters
\[
\eta_j = \sum_{i=0}^{\Psi_s} \Phi_s \quad \text{and} \quad w_j = \sum_{i=0}^{\Psi_s} \sigma^2_s, \quad \text{for } j = 0, \ldots, J + 1,
\]
\[
\mu_l = \sum_{i=0}^{\Psi_s} \Psi_s \quad \text{and} \quad v_j = w_j + \sum_{i=0}^{\Psi_s}, \quad \text{for } l = J^*, \ldots, J.
\]

Moreover, we define the parameters
\[
\beta_j = \begin{cases} 
\frac{w_j - w_j^*}{v_j - w_j^*} & \text{for } j = J^*, \ldots, J, \\
0 & \text{for } j = 0, \ldots, J^* - 1.
\end{cases}
\]

The following result shows that \( \beta_j \) can be interpreted as the credibility weight for the claims incurred observations:

**Theorem 2.1.** Under Model Assumptions 1.1 we have, conditional on \( \Theta \) and \( D^*_l \)
\[
E[P_{i,j}|D^*_l, \Theta] = D_{i,J^*+1}^\beta_{j,J^*+1} \exp\left\{\left(1 - \beta_{j,J^*+1}\right) \sum_{i=0}^{\Psi_s} (\Phi_s + \sigma^2_s/2) + \beta_{j,J^*+1} \sum_{i=0}^{\Psi_s} \Psi_s\right\}.
\]
For the conditional variance we obtain

\[ \text{Var}(P_{i,j+,i}|D^p_j, \Theta) = \mathbb{E}[P_{i,j+,i}|D^p_j, \Theta] + \left(\exp\left\{ (1 - \beta_{i,j+,i}) \sum_{j=0}^{i} \sigma_i^2 \right\} - 1 \right). \]

For \( i > J - j^* \) there holds \( \beta_{i,j+,i} = 0 \) and, therefore, we obtain a purely claims payment based prediction [see also Hertig’s model (1985) presented in Section 2.1 of Merz and Wüthrich (2010)]

\[ P_{i,j+,i} \exp\left\{ \sum_{j=0}^{i} (\Phi_i + \sigma_i^2/2) \right\}. \]

For \( i \leq J - j^* \) there holds \( \beta_{i,j+,i} > 0 \) and, therefore, we obtain a correction term to the purely claims payment based prediction which is based on the claims incurred-paid ratio \( I_{i,j+,i}/P_{i,j+,i} \), i.e., for a large incurred-paid ratio we get a higher expected ultimate claim as can be seen from

\[ P_{i,j+,i} I_{i,j+,i}^{j^*} = \exp\{ (1 - \beta_{i,j+,i}) \log P_{i,j+,i} + \beta_{i,j+,i} \log I_{i,j+,i} \} = P_{i,j+,i} \exp\left\{ \beta_{i,j+,i} \log \frac{I_{i,j+,i}}{P_{i,j+,i}} \right\}. \]

### 2.2. Parameter estimation, the general case

The likelihood function of the restricted observations \( D^p_j \) is given by [see also (3.5) in Merz and Wüthrich (2010)]

\[
I_{d^p} (\Theta) \propto \prod_{j=0}^{J} \prod_{i=j+1}^{J} \frac{1}{\sigma_i} \exp\left\{ -\frac{1}{2\sigma_i^2} \left( \Phi_i - \log \frac{P_{i,j+,i}}{P_{i,j+,i}} \right)^2 \right\} \\
\times \prod_{j=0}^{J} \frac{1}{\sqrt{2\pi}} \exp\left\{ -\frac{1}{2} \left( \frac{\mu_{i,j+,i} - \eta_i}{\sigma_i^2} \right)^2 \right\} \times \prod_{j=0}^{J} \frac{1}{\tau_j} \exp\left\{ -\frac{1}{2\tau_j^2} \left( \Psi_j + \log \frac{I_{i,j+,i}}{P_{i,j+,i}} \right)^2 \right\},
\]

where \( \propto \) means that only relevant terms dependent on \( \Theta \) are considered. The first line describes the claims payment development, the last line describes the claims incurred development, and the middle line describes the gap between the diagonal claims incurred and the diagonal claims payment observations.

In order to perform a Bayesian inference analysis on the parameters we need to specify the prior distribution of \( \Theta \).

#### Model Assumptions 2.2 PIC tail development factor model

We assume Model Assumptions 1.1 hold true with positive constants \( \sigma_0, \ldots, \sigma_{j+1}, \tau_j = \cdots = \tau_{j+1} = \tau, \)

\( \Psi_j = \cdots = \Psi_{j+1} = \tau^2/2 \) and \( \Psi_j = \tau^2/2 \). Moreover, it holds

\[ \Phi_m - N(\phi_m, s_m^2) \quad \text{for} \ m \in \{0, \ldots, J+1\}, \]

with prior parameters \( \phi_m \in \mathbb{R} \) and \( s_m > 0 \). \( \square \)

Under Model Assumptions 2.2 the posterior distribution \( u(\Phi|D^p_j) \) of \( \Phi = (\Phi_0, \ldots, \Phi_{j+1}) \), given \( D^p_j \), is given by

\[ u(\Phi|D^p_j) \propto I_{d^p} (\Theta) \prod_{i=j+1}^{J} \exp\left\{ -\frac{1}{2s_m^2} (\phi_m - \phi_m)^2 \right\}. \tag{2.3} \]

This immediately implies the following theorem:

#### Theorem 2.3. Under Model Assumptions 2.2 the posterior \( u(\Phi|D^p_j) \) of \( \Phi \) is a multivariate Gaussian distribution with posterior mean \( (\phi_{0,\text{post}}, \ldots, \phi_{j+1,\text{post}}) \) and posterior covariance matrix \( \Sigma(D^p_j) \). Define the posterior standard deviation by

\[ s_{j,\text{post}} = (s_j^2 + (J - j + 1)\sigma_j^2)^{-1/2} \quad \text{for} \ j = 0, \ldots, J+1. \]

Then, the inverse covariance matrix \( \Sigma(D^p_j)^{-1} = (a_{m,m})_{0 \leq m \leq j+1} \) is given by

\[
a_{m,m} = (s_{j,\text{post}}^2)^{-1} \left[ 1_{m=0} \right] + \left[ \sum_{j,\text{post}} \left( v^2 - w^2 \right) \right]_{1_{m=0},1,2,\ldots},
\]

where \( a_{m,m} \) is obtained by

\[ (\phi_{0,\text{post}}, \ldots, \phi_{j+1,\text{post}})' = \sum(D^p_j)(c_0, \ldots, c_{j+1})'. \]
with vector \( (c_1, \ldots, c_{\nu}^\nu) \) given by
\[
c_j = \frac{\phi_j}{\sigma_j^2} + \frac{1}{\sigma_j^2} \sum_{i=1}^{\nu} \log \frac{P_{i,j}}{P_{i,j}} + \frac{1}{2} \left( \log I_{i,j} + \mu_i + \frac{\sigma_i^2}{2} \right) \in [0,2\nu].
\]

Note that the last term in the definition of \( a_{\nu,m} \) and in the definition of \( c_j \) corresponds to the development years in \( D_j^\nu \) where we have both claims payments and claims incurred information. Theorem 2.3 immediately implies the following corollary:

**Corollary 2.4.** Under Model Assumptions 2.2 the posterior \( u(\Phi|D_j^\nu) \) of \( \Phi \) is a multivariate Gaussian distribution with \( \Phi_n, \ldots, \Phi_p, (\Phi_{p+1}, \ldots, \Phi_{\nu}) \) being independent with
\[
\Phi_j |_{\{0\}} \sim N(\phi_j^\nu, \sigma_j^\nu) = \gamma_j \phi_j + (1 - \gamma_j) \phi_j(s_j^\nu)^{-1}) \tag{2.4}
\]
for \( j \leq \nu \) and credibility weight and empirical mean defined by
\[
\gamma_j = \frac{J - j + 1}{J - j + 1 + \sigma_j^2/s_j^2} \quad \text{and} \quad \phi_j = \frac{1}{J - j + 1} \sum_{i=1}^{\nu} \log \frac{P_{i,j}}{P_{i,j}}
\]
for \( j = 0, \ldots, \nu \).

Henceforth, Corollary 2.4 shows that for development years \( j \leq \nu \) we obtain the well-known credibility weighted average between the prior mean \( \phi_j \) and the average observation \( \bar{\phi}_j \). The case \( j > \nu \) is more involved: one basically obtains a weighted average between the prior mean \( \phi_j \), the average observation \( \bar{\phi}_j \), and the incurred-paid ratios \( \log I_{i,j}/P_{i,j}, i \geq J - j + 1 \).

**Remark.** Model Assumptions 2.2 specify a Bayesian model with multivariate Gaussian distributions. This setup allows for closed-form solutions. For other distributional assumptions the problem can only be solved numerically using Markov chain Monte Carlo methods. Bayesian statistics, like the Bayesian information criterion BIC, would then allow for model testing and model selection. If one restricts to linear credibility estimators, see Bühlmann and Gisler (2005), then \( \phi_j^\nu \) given in (2.4) corresponds to the linear credibility estimator in more general models. □

### 2.3. Parameter estimation, special case \( J^* = J \)

We consider the special case \( J^* = J \), that is, only the claims incurred observation \( I_{i,j} \) is considered in the tail development factor analysis. This immediately provides:

**Corollary 2.5.** Choose \( J^* = J \). Under Model Assumptions 2.2, the posterior distribution \( u(\Phi|D_j^\nu) \) of \( \Phi \) is a multivariate Gaussian distribution with \( \Phi_n, \ldots, \Phi_{p+1}, (\Phi_{p+2}, \ldots, \Phi_{\nu}) \) being independent. For \( m \leq \nu = J \) the posterior distribution of \( \Phi_m \) is given by (2.4). The posterior of \( \Phi_{p+1} \) is given by
\[
\Phi_{p+1} |_{\{0\}} \sim N(\phi_{p+1}^\nu, \sigma_{p+1}^\nu) = \gamma_{p+1} \left( \log I_{p+1,j} + \tau_{p+1} \right) + (1 - \gamma_{p+1}) \phi_{p+1} \sigma_{p+1,j}^{-1}
\]
with inverse variance given by
\[
a_{p+1,j} = s_{p+1,j}^2 + (\sigma_{p+1,j}^2 + \tau_{p+1}^2),
\]
and credibility weight given by
\[
\gamma_{p+1} = \frac{1}{1 + (\sigma_{p+1,j}^2 + \tau_{p+1}^2)/s_{p+1,j}^2}.
\]

This means that in the case \( J^* = J \) we obtain a credibility-weighted average between the prior tail development factor \( \phi_{p+1} \) and the observation \( I_{p+1,j} \).

Henceforth, in this case only the latest incurred-paid ratio is considered for the estimation of the tail development factor.

### 3. Posterior claims prediction and prediction uncertainty

#### 3.1. General case

In view of Theorems 2.1 and 2.3 we can now predict the ultimate claim \( P_{i,j+1} \), conditional on the restricted observations \( D_j^\nu \), under Model Assumptions 2.2.
Proposition 3.1. Bayesian ultimate claims predictor. Under Model Assumptions 2.2 we predict the ultimate claim \( P_{i,j+1} \) given \( D_j^\# \) by

\[
E[P_{i,j+1}|D_j^\#] = \frac{\hat{P}_{i,j+1} - \sum_{j=0}^{\infty} \Phi_{i,j+1}}{2} + (1 - \beta_{j+1}) \frac{\Phi_{i,j+1}}{2} + (1 - \beta_{j+1}) \frac{\Phi_{i,j+1}}{2} \text{exp}\left\{\frac{1}{2} \left(\beta_{j+1} - 1\right) \sum_{j=0}^{\infty} \sigma_j^2 \right\}
\]

where \( \beta_j \in (0, 1) \) and \( \sigma_j^2 = \epsilon_j^2 \sum_{j=0}^{\infty} \Phi_{i,j+1} \).

Next we determine the prediction uncertainty. Model Assumptions 2.2 and Theorem 2.3 constitute a full distributional model which allows for the calculation of any risk measure (using Monte Carlo simulations) under the posterior distribution, given \( D_j^\# \). Here, we use the most popular measure for the prediction uncertainty in claims reserving, the so-called conditional mean square error of prediction (MSEP). The conditional MSEP has the advantage that we can calculate it analytically. Analytical solutions have the advantage that they allow for more basic sensitivity analysis. The conditional MSEP is given by (see also Section 3.1 in Wüthrich and Merz (2008))

\[
\text{msep} = \sum_{i=0}^{\infty} \beta_i \left( E\left[ \sum_{j=0}^{\infty} P_{i,j+1} | D_j^\# \right] \right)^2 = \sum_{i=0}^{\infty} \left( \beta_i \right) \left( \sum_{j=0}^{\infty} P_{i,j+1} | D_j^\# \right) \left( \sum_{j=0}^{\infty} P_{i,j+1} | D_j^\# \right)
\]

i.e., in this Bayesian setup the conditional MSEP is equal to the posterior variance. This posterior variance allows for the usual decoupling into average processes error and average parameter estimation error; see (A.3). The conditional MSEP satisfies

\[
\text{Var}\left( \sum_{j=0}^{\infty} P_{i,j+1} | D_j^\# \right) = \sum_{j=0}^{\infty} \text{Cov}(P_{i,j+1}, P_{i,j+1} | D_j^\#).
\]

We obtain the following theorem:

Theorem 3.2. Under Model Assumptions 2.2 the conditional MSEP of the Bayesian predictor \( E[\sum_{j=0}^{\infty} P_{i,j+1} | D_j^\#] \) for the aggregate ultimate claim \( \sum_{j=0}^{\infty} P_{i,j+1} \) is given by

\[
\text{msep} = \sum_{i=0}^{\infty} \beta_i \left( E\left[ \sum_{j=0}^{\infty} P_{i,j+1} | D_j^\# \right] \right)^2 = \sum_{i=0}^{\infty} \left( \beta_i \right) \left( \sum_{j=0}^{\infty} P_{i,j+1} | D_j^\# \right) \left( \sum_{j=0}^{\infty} P_{i,j+1} | D_j^\# \right)
\]

3.2. Special case \( J^\# = J \) with non-informative priors

We revisit the special case \( J^\# = J \) and we also assume non-informative priors meaning that \( s_j^2 \to \infty \). In that case we obtain that the posterior distributions of \( \Phi_{i,j} \) are independent Gaussian distributions with

\[
\Phi_{i,j+1} \sim N\left( \frac{\Phi_{i,j+1}^\text{post}}{\Phi_{i,j+1}^\text{post}} \right) = \frac{1}{J-j+1} \sum_{j=0}^{\infty} \log \frac{P_{i,j+1}}{P_{i,j+1}},
\]

for \( j \leq J \), and

\[
\Phi_{i,j+1} \sim N\left( \frac{\Phi_{i,j+1}^\text{post}}{\Phi_{i,j+1}^\text{post}} \right) = \frac{1}{J-j+1} \sum_{j=0}^{\infty} \log \frac{P_{i,j+1}}{P_{i,j+1}} + \frac{\tau_j^2}{2}.
\]

This implies for the ultimate claim prediction for \( i > 0 \)

\[
E[P_{i,j+1}|D_j^\#] = P_{i,j+1} \exp\left\{ \sum_{j=0}^{\infty} \Phi_{i,j+1}^\text{post} + \frac{\sigma_j^2}{2} \right\}
\]

with chain-ladder factors

\[
\hat{\sigma}_j = \exp\left\{ \Phi_{i,j+1}^\text{post} + \left(1 + \frac{1}{J-j+1} \right) \frac{\sigma_j^2}{2} \right\}.
\]
We first need to determine $J^* \leq J$. We choose the value $J^*$ such that there is no substantial claims incurred development (no systematic drift) after development period $J^*$. This choice is made based on actuarial judgment. We therefore look at the individual chain-ladder factors $I_{i,J}^{I+1}/I_{i,j}$, $j \geq 0$ and $i+j+1 \leq J$. These are provided in Table 3. In the upper right triangle in Table 3 (with the individual chain ladder factors for years 6, 7, 8) we see no further systematic development, so we concentrate on possible choices $J^* \in \{6, \ldots, 9\}$.

The standard deviation parameters $s_j$, $\sigma_j$ and $\tau_j$ should be determined with prior knowledge only. In our example we assume that we have non-informative priors, which means that we set $s_j = \infty$. For $\sigma_j$ and $\tau_j$ we take an empirical Bayesian point of

\[ \hat{j}^{\omega(j)}_{i,i} = \frac{I_{i,J}}{P_{i,j}} \exp\{\sigma_{i,i} + \tau_{i}\}. \quad (3.3) \]

That is, the first terms in the product on the right-hand side of (3.1) are the classical chain-ladder factors for Hertig’s log-normal model (1985); see also (5.11)–(5.12) in Wüthrich and Merz (2008). The last term in (3.1), however, describes the tail development factor (adjusted for the variance).

For $i = 0$ we have

\[ E[P_{0,j} | D^*] = P_{0,j} \hat{j}^{\omega(j)}_{0,j} = I_{0,j} \exp\{\sigma_{0,j} + \tau_{j}\}. \quad (3.4) \]

### 4. Example

In this section we provide an example. We assume that $J = 9$ and that the claims payment data $P_{i,j}$ and the claims incurred data $I_{i,j}$ for $i + j \leq J$ are given by Tables 1 and 2, respectively.

We first need to determine $J^* \leq J$. We choose the value $J^*$ such that there is no substantial claims incurred development (no systematic drift) after development period $J^*$. This choice is made based on actuarial judgment. We therefore look at the individual chain-ladder factors $I_{i,J}^{I+1}/I_{i,j}$, $j \geq 0$ and $i+j+1 \leq J$. These are provided in Table 3. In the upper right triangle in Table 3 (with the individual chain ladder factors for years 6, 7, 8) we see no further systematic development, so we concentrate on possible choices $J^* \in \{6, \ldots, 9\}$.

The standard deviation parameters $s_j$, $\sigma_j$ and $\tau_j$ should be determined with prior knowledge only. In our example we assume that we have non-informative priors, which means that we set $s_j = \infty$. For $\sigma_j$ and $\tau_j$ we take an empirical Bayesian point of

Table 1. Observed claims payments data $P_{i,j}$, $i + j \leq J$.

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<th></th>
<th>0</th>
<th>1</th>
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Table 2. Observed claims incurred data $I_{i,j}$, $i + j \leq J$.

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Estimation of Tail Development Factors in the Paid-Incurred Chain Reserving Method

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uncertain
ty in our model according to Proposition 3.1 and Theorem 3.2. We do this for \( J^* \in \{6, \ldots, 9\} \). The results are provided in Table 5.

Interpretations

• The analysis shows that in the presence of tail development, Hertig’s model (1985) may substantially underestimate the outstanding loss liabilities compared to the PIC tail development factor models for \( J^* = 9, 8, 7 \). Only the PIC tail development factor model for \( J^* = 6 \) gives similar reserves. This comes from the fact that the incurred development factors still give a downward trend to incurred losses in development periods 6 and 7 (see average in Table 3), which contradicts our model assumptions (2.1)–(2.2) and suggests to choose \( J^* = 8 \) or 9. Of course, as mentioned above, this expert choice is based on the rationale that there is no systematic drift after \( J^* \), and statistical methods could justify this hypothesis/choice.

• Including tail development factors for \( J^* = 8, 9 \) also gives a higher prediction uncertainty msep\(^{1/2} \) compared to Hertig’s model (1985) without tail development factors. This finding is in line with the

| Table 3. Individual chain ladder factors \( l_{j+1}/l_j \) for \( j \geq 0 \) and \( i + j + 1 \leq J \). |
|---|---|---|---|---|---|---|---|---|---|
| 0 | 1.5518 | 0.9114 | 0.9215 | 0.9441 | 0.9897 | 0.9816 | 0.9957 | 1.0000 | 1.0000 |
| 1 | 1.7587 | 0.8333 | 0.8394 | 0.9549 | 0.9736 | 0.9855 | 0.9969 | 0.9976 |
| 2 | 1.6618 | 0.8453 | 0.8572 | 0.9740 | 0.9895 | 0.9826 | 1.0012 |
| 3 | 1.8065 | 0.8401 | 0.8313 | 0.9602 | 0.9764 | 0.9840 |
| 4 | 1.6830 | 0.8449 | 0.8924 | 0.9637 | 0.9746 |
| 5 | 1.6328 | 0.8508 | 0.8469 | 0.9747 |
| 6 | 1.7314 | 0.8024 | 0.9109 |
| 7 | 1.5538 | 0.9201 |
| 8 | 1.4967 |
| 9 | 1.6529 | 0.8561 | 0.8714 | 0.9619 | 0.9807 | 0.9834 | 0.9980 | 0.9988 | 1.0000 |

We estimate the parameter \( \tau = \tau^*_j = \cdots = \tau^*_{j-1} \) with the empirical standard deviation of \( \log l_{j+1}/l_j \) for \( i + j + 1 \leq J \) and \( j \geq 6 \) (because we assume that there is no systematic claims incurred development after development period 6; see Table 3). Finally, for \( \tau_j \), we do the ad hoc (expert) choice \( \tau^*_j = 3\tau^2 \). This suggests that we have (approximately) another three uncorrelated development periods beyond \( J = 9 \) until all claims are finally settled. Of course, additional information about \( \tau_j \) (if available) should be used here. These choices provide the standard deviation parameters given in Table 4. Now we are ready to calculate the claims reserves and the corresponding prediction uncertainty in our model according to Proposition 3.1 and Theorem 3.2. We do this for \( J^* \in \{6, \ldots, 9\} \). The results are provided in Table 5.

| Table 4. Estimated \( \hat{\sigma}_j \) for \( j = 0, \ldots, J + 1 \), and \( \hat{\tau}_j \) for \( j = 6, \ldots, J \). |
|---|---|---|---|---|---|---|---|---|---|---|---|
| \( \hat{\sigma}_j \) | 0.1393 | 0.0650 | 0.0731 | 0.0640 | 0.0264 | 0.0271 | 0.0405 | 0.0227 | 0.0494 | 0.0227 | 0.0227 |
| \( \hat{\tau}_j \) | 0.0021 | 0.0021 | 0.0021 | 0.0037 |
Table 5. Estimated claims reserves and corresponding prediction standard deviation in the PIC tail development factor model (Model Assumptions 2.2) for \( J^* \in \{6, \ldots, 9\} \), and the estimated claims reserves according to Hertig’s model (1985) [see Section 3.1 in Merz and Wüthrich (2010)] without tail development factor

<table>
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<th>( J^* )</th>
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<th>PIC tail factor</th>
<th>PIC tail factor</th>
<th>PIC tail factor</th>
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<td>reserves</td>
<td>msep(^{1/2})</td>
<td>reserves</td>
<td>msep(^{1/2})</td>
</tr>
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<tr>
<td>tot</td>
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<td>11,298,552</td>
<td>1,747,672</td>
<td>12,960,980</td>
</tr>
</tbody>
</table>

ones in Verrall and Wüthrich (2012) and shows that prediction uncertainty needs a careful evaluation in the presence of tail development.

• Note that for \( J^* = 9 \) we simultaneously consider claims payments and claims incurred information for accident year \( i = 0 \). For \( J^* = 8 \) we simultaneously consider claims payments and claims incurred information for accident years \( i = 0, 1 \). This results in a much lower prediction uncertainty in these accident years (above the horizontal line in the corresponding columns of Table 5). The reason is that the claims incurred information has only little uncertainty (since we assume \( \Psi_j \) to be constant for \( j \geq J^* \)). This substantially reduces the prediction uncertainty.

We may question whether there is so much information in these last claims incurred observations. If this is not the case, we should either increase \( \tau \) and \( \tau_r \), or we should use less informative priors in (2.1)–(2.2). The latter would bring us back to the model of Merz and Wüthrich (2010) and Happ and Wüthrich (2013) with the additional assumption that there is no systematic drift after \( J^* \). Moreover, this latter model would also allow us to consider more information than just the restricted one given by \( D_J^* \). In the present work we have decided to work with the restricted information \( D_J^* \) only because then we can fully concentrate on tail factor estimation. Otherwise tail factor estimation would be more hidden in the data and analysis.

5. Conclusion

We have modified the PIC reserving model from Merz and Wüthrich (2010) so that it allows for the incorporation of tail development factors. These tail development factors are estimated considering claims incurred-paid ratios in an appropriate way. This extends the ad hoc methods used in practice and because we perform our analysis in a mathematically consistent way we also obtain formulas for the prediction uncertainty. These are obtained analytically for the conditional MSEP and these can be obtained numerically for other uncertainty measures using Monte Carlo simulations (because we work in a Bayesian setup). The case study highlights the need to incorporate tail development factors in the presence of tail development, since otherwise both the outstanding loss liabilities and the prediction uncertainty are underestimated.
A. Appendix: Proofs

In this appendix we prove all the statements. We start with a well-known result for multivariate Gaussian distributions, see, e.g., Appendix A in Posthuma et al. (2008) and Johnson and Wichern (1988):

**Lemma A.1.** Assume \((X_1, \ldots, X_n)'\) is multivariate Gaussian distributed with mean \((m_1, \ldots, m_n)'\) and positive definite covariance matrix \(\Sigma\). Then we have for the conditional distribution:

\[
X_i \mid (x_1, \ldots, x_{i-1}, x_{i+1}, \ldots, x_n) - N \left( m_i + \sum_{j \neq i} \sum_{j \neq i} (X_j - m_j), \sum_{i,j \neq i} \sum_{j \neq i} \Sigma_{ij} \right),
\]

where \(X_j = (X_1, \ldots, X_j)'\) is multivariate Gaussian with mean \(m_j = (m_1, \ldots, m_n)'\) and positive definite covariance matrix \(\Sigma_{j,2,j,1} = \Sigma_{j,1,j,1}\) is the variance between \(X_i\) and \(X_j\).

**Proof of Theorem 2.1.** We first consider the case \(i > J - J^*\), that is \(I_{i,k} \notin D^*_j\) for \(k = 0, \ldots, J - i\), henceforth for accident years \(i > J - J^*\) we do not consider claims incurred information. Using the conditional independence of accident years, given the parameters \(\Theta\), we obtain

\[
E[P_{i,j} \mid D^*_j, \Theta] = E[P_{i,j} \mid P_{i,0}, \ldots, P_{i,j-1}, \Theta].
\]

Furthermore, \(i > J - J^*\) implies \(\beta_{j-i} = 0\). Therefore, the claim follows from Model Assumptions 1.1, as in (2.2) in Merz and Wüthrich (2010), and because \(\beta_j = 0\) for \(j < J^*\). Similarly, we obtain for the conditional variance

\[
\text{Var}(P_{i,j} \mid D^*_j, \Theta) = E \left[ P_{i,j} \mid D^*_j, \Theta \right] \left( \exp \left( \sum_{j=1}^i \sigma_j^2 \right) - 1 \right).
\]

The case \(i \leq J - J^*\) is more involved. Using again the independence of accident years conditional on \(\Theta\), we obtain

\[
E[P_{i,j} \mid D^*_j, \Theta] = E[P_{i,j} \mid P_{i,0}, \ldots, P_{i,j-1}, I_{j,0}, \ldots, I_{j,j-1}, \Theta],
\]

henceforth, we now have both claims payments and claims incurred observations for accident year \(i \leq J - J^*\). We set \(j = J - i\), then using Lemma A.1 we obtain completely analogous to Theorem 2.4 and Corollary 2.5 in Merz and Wüthrich (2010)

\[
E[P_{i,j} \mid D^*_j, \Theta] = \exp \left\{ \eta_{j,i} + (1 - \beta_j)(\log P_{i,j} - \eta_i) + \beta_j (\log I_{j,i} - \mu_j) \right\} + (1 - \beta_j)(w_{j,i} - w_i^*) / 2
\]

\[
= P_{i,j}^* \exp \left\{ (1 - \beta_j) \sum_{j=1}^i (\Phi_j + \sigma_j^2) + \beta_j \sum_{j=1}^i \Psi_j \right\}.
\]

Analogously, Theorem 2.4 from Merz and Wüthrich (2010) implies for the variance

\[
\text{Var}(P_{i,j} \mid D^*_j, \Theta) = E \left[ P_{i,j} \mid D^*_j, \Theta \right] \left( \exp \left( \sum_{j=1}^i \sigma_j^2 \right) - 1 \right).
\]

This proves the theorem. □

**Proof of Theorem 2.3 and Corollary 2.4.** We first write all the relevant terms of the likelihood of \(\Phi\), given \(D^*_j\). They are given by

\[
u(\Phi \mid D^*_j) = \prod_{j=1}^J \exp \left\{ - \frac{1}{2} \sigma_j^2 \left( \Phi_j - \phi_j \right)^2 - \frac{1}{2} \sigma_j \sum_{i=0}^{j-1} \left( \Phi_i - \log \frac{P_{i,j}}{P_{i,j-1}} \right) \right\} \times \prod_{j=1}^J \exp \left\{ - \frac{1}{2} \sigma_j \sum_{i=0}^{j-1} \left( \Phi_i - \log \frac{P_{i,j}}{P_{i,j-1}} \right) \right\} \times \exp \left\{ - \frac{1}{2} \sigma_j \left( \Phi_{j-1} - \phi_{j-1} \right)^2 \right\} \times \prod_{j=1}^J \exp \left\{ - \frac{1}{2} \sigma_j \left( \Phi_{j-1} - \phi_{j-1} \right)^2 \right\}
\]

\[
= \prod_{j=1}^J \exp \left\{ - \frac{1}{2} \sigma_j \left( \sum_{i=1}^{j-1} \Phi_i - \frac{1}{2} t_i^2 + \frac{1}{2} \tau_j^2 \right) - \log \frac{I_{j,i}}{P_{i,j-1}} \right\}.
\] (A.1)

From this we easily see that the posterior distribution of \(\Phi\), given \(D^*_j\), is again multivariate Gaussian and there only remains to determine the posterior mean and covariance matrix. If we square out all terms in (A.1) for obtaining the \(\Phi^*_j\) and the \(\Phi_\delta^*_j\) terms, we find the covariance matrix \(\Sigma(D^*_j)\). First of all, we observe that the development periods with \(j \leq J^*\) are all on the first line of (A.1) which proves the independence statement on \(\Phi_0, \ldots, \Phi_{J^*}, (\Phi_{J^*+1}, \ldots, \Phi_{J-1})\).
\[ s_i^{\text{out}} = \left(s_i^2 + (J - j + 1)\sigma_j^2\right)^{1/2}, \]

which provides \( a_{nm} \) for \( n, m = 0, \ldots, J^* \). The posterior mean is given by

\[ \phi_j^{\text{out}} = \left(s_j^{\text{out}}\right)^2 \left(\frac{\phi_j}{s_j^2} + \frac{1}{\sigma_j^2}\sum_{m = 0}^{j-1} \log \frac{P_{j,m}}{P_{j-1,m}}\right). \]

Next, we square out all terms for \( j > J^* \) to get the covariance matrix. We obtain

\[ \sum_{i,j=J^*+1}^{J} \left(\frac{1}{s_i^2} + \Phi_i, \Phi_j \Phi_{i, \Phi_{i, j}} - \Phi_{i, \Phi_{i, j}}\right) = \sum_{i,j=J^*+1}^{J} \left(\frac{1}{s_i^2} + \Phi_i, \Phi_j \Phi_{i, \Phi_{i, j}} - \Phi_{i, \Phi_{i, j}}\right) \]

This provides \( a_{nm} \) for \( n, m = J^* + 1, \ldots, J + 1 \). The posterior mean is obtained by solving the posterior maximum likelihood functions for \( \Phi_j, j \geq J^* + 1 \). They are given by

\[ \frac{\partial \log u(\Phi) | D^*}{\partial \Phi_j} = \frac{\phi_j}{s_j^2 - \sum_{i,J=1}^{J} \Phi_{i, \Phi_{i, j}}} + \frac{1}{\sigma_j^2} \sum_{m = 0}^{J} \Phi_{i, \Phi_{i, j}} = 0. \] (A.2)

Henceforth, this implies

\[ (c_0, \ldots, c_{J^*}) = \sum(D^*)^{-1} (\Phi_0, \ldots, \Phi_{J^*}), \]

from which the claim follows. \( \square \)

**Proof of Corollary 2.5.** The corollary follows from Theorem 2.3 and Corollary 2.4. \( \square \)

**Proof of Proposition 3.1.** From Theorem 2.1 we obtain

\[ E[P_{j,J} | D^*] = E[E[P_{j,J} | D^*, \Theta, D^*] = P_{j,J}^{\text{out}} I_{j,J}^{\text{out}} \exp\left\{ (1-\Phi_{j,J}) \sum_{i,J=1}^{J} \sigma_i^2 / 2 + \beta_{j,J} \frac{i \tau^j + \tau^j}{2} \right\} \times E\left[ \exp\left\{ (1-\Phi_{j,J}) \sum_{i,J=1}^{J} \phi_i \right\} | D^* \right] \]

From Theorem 2.3 we know that, given \( D^* \), \( \Phi = (\Phi_0, \ldots, \Phi_{J^*}) \) has a posterior multivariate Gaussian distribution with posterior mean \( (\phi_0^{\text{out}}, \ldots, \phi_{J^*}^{\text{out}}) \) and posterior covariance matrix \( \Sigma(D^*) \). Henceforth, the posterior distribution of \( \sum_{j,J=1}^{J} \Phi_j \) is Gaussian with mean \( \sum_{j,J=1}^{J} \phi_j^{\text{out}} \) and variance \( \exp(\Sigma(D^*) e_{J,J=1}). This proves the proposition. \( \square \)

**Proof of Theorem 3.2.** We obtain with the tower property of conditional expectations

\[ \text{Cov} \left( P_{j,J} | D^* \right) = E \left[ \text{Cov} \left( P_{j,J} | P_{j,J} \right) \left| D^* \right\} \left( D^* \right) \right] + \text{Cov} \left( E \left[ P_{j,J} | D^*, \Theta \right] \right) \left( D^* \right) \]

This is the usual decomposition into average process (co-)variance and average parameter error. The first term in (A.3) is equal to 0 for \( i \neq k \), because accident years \( i \) are independent, conditionally given \( \Theta \). Henceforth there remains the case \( i = k \). Using Theorems 2.1 and 2.3 we obtain

\[ E \left[ \text{Var} \left( P_{j,J} | D^*, \Theta \right) \right| D^* \right] = E \left[ \text{Var} \left( P_{j,J} | D^*, \Theta \right) \right| D^* \right] \exp\left\{ (1-\Phi_{j,J}) \sum_{i,J=1}^{J} \sigma_i^2 / 2 + \beta_{j,J} \frac{i \tau^j + \tau^j}{2} \right\} \times E\left[ \exp\left\{ (1-\Phi_{j,J}) \sum_{i,J=1}^{J} \phi_i \right\} | D^* \right] \]

From Theorem 2.3 we know that, given \( D^* \), \( \Phi = (\Phi_0, \ldots, \Phi_{J^*}) \) has a posterior multivariate Gaussian distribution with posterior mean \( (\phi_0^{\text{out}}, \ldots, \phi_{J^*}^{\text{out}}) \) and posterior covariance matrix \( \Sigma(D^*) \). Henceforth, the posterior distribution of \( \sum_{j,J=1}^{J} \Phi_j \) is Gaussian with mean \( \sum_{j,J=1}^{J} \phi_j^{\text{out}} \) and variance \( \exp(\Sigma(D^*) e_{J,J=1}). This implies for the first term (A.3)
This completes the proof. □

References


