

# The Retrospective Testing of Stochastic Loss Reserve Models

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## Abstract

Given an  $n \times n$  triangle of losses,  $x_{AY,Lag}$  ( $AY = 1, \dots, n$ ,  $Lag = 1, \dots, n$ ,  $AY + Lag < n + 2$ ), the goal of a stochastic loss reserve model is to predict the distribution of outcomes,  $X_{AY,Lag}$  ( $AY + Lag > n + 1$ ), and sums of losses such as  $\sum_{AY=2}^n \sum_{Lag=n+2-AY}^n X_{AY,Lag}$ . This paper will propose a set of diagnostics to test the predictive distribution and illustrate the use of these diagnostics on American insurer data as reported to the National Association of Insurance Commissioners (NAIC).

- The data will consist of incremental paid losses for the commercial automobile line of insurance. This data will come from a database containing both the original loss triangles and the outcomes. This database will contain data for hundreds of American insurers, and it will be posted on the Casualty Actuarial Society (CAS) website for all researchers to access.
- The retrospective tests are performed on the familiar stochastic loss reserve model, the bootstrap chain ladder overdispersed Poisson model. The paper will also perform the retrospective tests on a model proposed by the authors.
- The authors' model will assume that the incremental paid losses have a Tweedie distribution, with the expected loss ratio and calendar year trend parameters following an AR(1) time series model. The model will be a hierarchical Bayesian model with the posterior distribution of parameters being estimated by Markov-Chain Monte-Carlo (MCMC) methods.

## **1. Introduction**

In the classic reserving problem for property-casualty insurers, the primary goal of actuaries is to set an adequate reserve to fund losses that have been incurred but not yet developed. In this regard, the reserving actuaries are more interested in a reasonable reserve range rather than a best estimate. Traditional deterministic algorithms are often sufficient for the best estimation of outstanding liabilities, but often insufficient in estimating the downside potential in loss reserves. Over the past three decades, stochastic claims reserving methods have received extensive development, emphasizing the role of variability in claims reserves.

In claims reserving literature, different stochastic methods are proposed to calculate the predictive uncertainty of reserves and, ideally, to derive a full distribution of outstanding payments. The variability of claims reserves could be decomposed into two components, a process error which is intrinsic to the stochastic model and an estimation error that describes the uncertainty in parameter estimates. Both non-parametric and parametric approaches have been discussed along this line of studies. The so-called non-parametric models (various Chain-Ladder techniques among others) are considered by some to be distribution-free and focus on (conditional) mean-squared prediction error to measure the quality of reserve estimates. Parametric models, in contrast, are based on distributional families and thus could lead to a distribution of outstanding claims. Because of the small sample size typically encountered in loss reserving context, the bootstrapping technique and Bayesian method are often involved to incorporate the uncertainty in parameter estimates and thus to provide a predictive distribution for unpaid losses. We refer to Taylor (2000), England and Verrall (2002), and Wüthrich and Merz (2008) for excellent reviews on stochastic loss reserving methods.

With an increasing number of stochastic claims reserving methods emerging in the literature, one critical question to ask is how to evaluate their predictive performance. This question could only be answered based on retrospective tests using the actual realized claims in the lower triangle. Unfortunately, such issue has rarely been addressed in the current literature. Shi *et al.* (2011) is one recent example.

## *The Retrospective Testing of Stochastic Loss Reserve Models*

The goals of this paper are threefold: 1) We will propose a stochastic loss reserving model based on a Tweedie distribution that captures the calendar year trend in claims development. 2) A set of diagnostics will be discussed to test the predictive distribution of outstanding liabilities. The retrospective evaluation will be performed for the proposed method as well as standard formulas. 3) We emphasize the importance of retrospective testing in both loss reserving and risk management practice, and we anticipate that this work will initialize more relevant studies and draw attention from both practitioners and researchers in this perspective.

We note that the sparsity of studies on retrospective tests might be attributed to the unavailability of the data on realized claims. Our access to a rich database from the National Association of Insurance Commissioners (NAIC) provides us an opportunity to perform such evaluation. A great deal of effort has been devoted to the preparation of a quality dataset for loss reserve studies. The detailed summary of the loss reserve dataset is given in Section 2 and the Appendix. We will also post the dataset on the website of the Casualty Actuarial Society (CAS)<sup>1</sup>.

The NAIC database contains information on both posted reserves and subsequent paid losses, which allows us to evaluate: 1) the performance of the predictive distribution based on actual losses; 2) the predictive distribution based on posted reserves; 3) the sufficiency of the posted reserves. We will compare the predictive performance between the proposed method and a standard formula. Our analysis will focus on claims-reserve models for a single line of business. It is worth mentioning the emerging reserve studies for dependent lines of business. The retrospective tests for multivariate loss reserving methods could be a direction of future research.

The structure of this article is as follows: Section 2 describes the run-off triangle data from the NAIC and discusses the selection process for the insurers in our analysis. Section 3 presents two stochastic loss reserving method, the chain-ladder over-dispersed Poisson and the Bayesian Tweedie model. Section 4 and Section 5 report the results of retrospective tests for a single insurer and multiple insurers, respectively. Section 6 concludes the paper.

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<sup>1</sup> The link for these data is [http://www.casact.org/research/index.cfm?fa=loss\\_reserves\\_data](http://www.casact.org/research/index.cfm?fa=loss_reserves_data)

## 2. Data

The claims triangle data used for the retrospective test are from Schedule P of the NAIC database. The NAIC is an American organization of insurance regulators that provides a forum to promote uniformity in insurance regulation among different states. It maintains one of the world's largest insurance regulatory databases, including the statutory accounting report for all insurance companies in the United States.

We consider Schedule P of property-casualty insurers, which includes firm-level run-off triangles of aggregated claims for major personal and commercial lines of business. And the claims are available for both incurred and paid losses<sup>2</sup>. The triangles of paid losses in Schedule P of year 1997 will be used to develop stochastic loss reserving models. Each triangle contains losses for accident years 1988-1997 and at most ten development years. The net premiums earned in each accident year are available for the measurement of business volume. For any insurer, the triangle for a single line of business could be illustrated as in Figure 1. The crosses indicate the data point extracted from 1997 Schedule P.

Figure 1. Schedule P of 1997

Accident Year	Premium	Settlement Lag											
		1	2	3	4	5	6	7	8	9	10		
1988	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	
1989	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 1998
1990	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 1999
1991	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 2000
1992	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 2001
1993	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 2002
1994	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 2003
1995	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 2004
1996	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 2005
1997	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	← 2006

To perform the retrospective test, one needs the realized claims in the lower triangle. We square the triangles from Schedule P of year 1997 with outcomes from the Schedule P of

<sup>2</sup> By “losses” we mean “Incurred net losses and defense & cost containment expenses reported at year end” as specified by the NAIC Schedule P instructions.

## *The Retrospective Testing of Stochastic Loss Reserve Models*

subsequent years. To be more specific, as shown in Figure 1, the losses in accident year 1989 are pulled from the Schedule P of year 1998, the losses in accident year 1990 are pulled from the Schedule P of year 1999, and so on. The overlapping observations from the Schedule P of year 1997 and subsequent years are used to validate the quality of our data. The insurers with inconsistency in the overlapping period are dropped from this study. The detailed process of data preparation can be found in the Appendix. In addition to the actual losses in the lower triangle, the NAIC database provides posted reserves of year 1997. The posted reserves represent the actual amount of fund set by reserving actuaries, based on the predictions from certain claim reserving models, as well as actuarial judgments.

We focus on the run-offs of commercial auto in the retrospective test. Commercial auto is a relatively short tail line and thus the claims are very likely to be closed within ten years. This fact makes the Schedule P data an appropriate first candidate for the retrospective evaluation. The triangles consist of losses net of reinsurance, and quite often insurer groups have mutual reinsurance arrangements between the companies within the group. Consequently, we limit our analysis to single entities, be they insurer groups or true single insurers.

For the retrospective tests, we wanted to test only those insurers we deemed to be “going concern” insurers. Our criterion for selecting insurers was that: (1) earned premium was not subject to wide swings; and (2) the insurers were generally profitable. To implement these criteria we first calculated the coefficient of variation for the earned premium over each of the ten accident years. We then sorted the insurers in increasing order of this coefficient of variation. Then we individually examined the profitability of each insurer, rejecting those insurers that we deemed unprofitable. In the end we selected 50 insurers for this analysis.

Figure 2 shows the earned premiums and cumulative paid losses by accident year for the first insurer we accepted, and Figure 3 shows the earned premium and losses by accident year for the first insurer we rejected. Table 1 gives the Group Codes for all insurers included in this analysis.

The Retrospective Testing of Stochastic Loss Reserve Models

Table 1  
Insurer Group Codes

1236	353	14974	21270	1406	914	4839	7080	833	1767
37036	5428	26077	13641	86	1538	38733	2674	388	1759
3492	6947	11037	1090	4731	3240	2623	3034	18767	5185
2500	14176	2135	620	26433	31550	44130	2208	10022	310
2283	1066	8427	10839	19020	26905	671	13528	715	9504

Figure 2

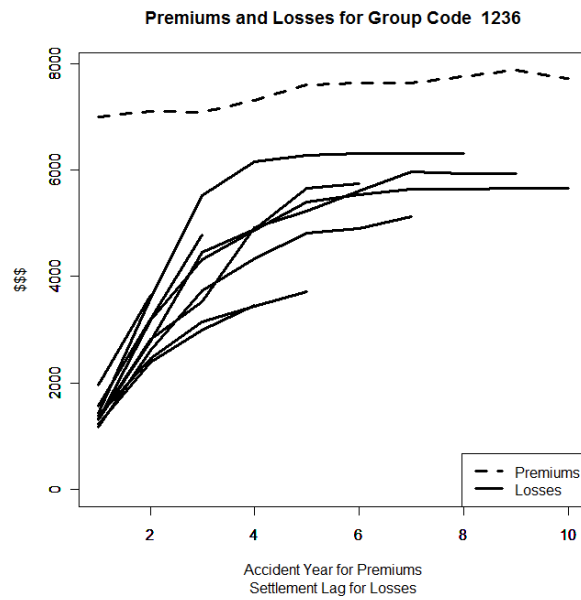
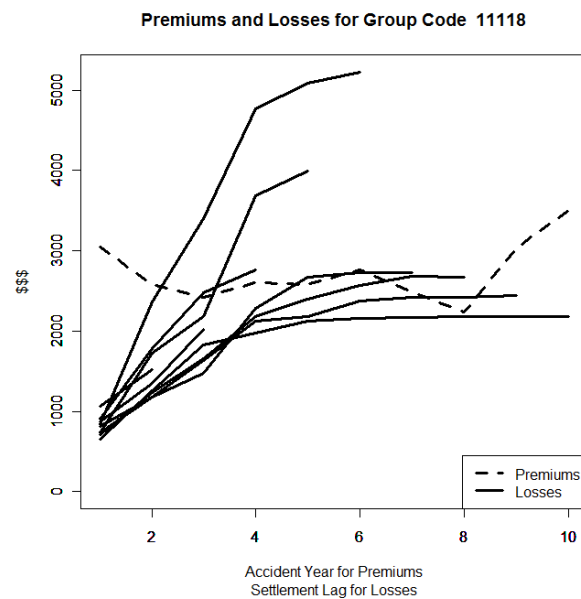


Figure 3



### **3. Two Loss Reserving Models**

Our analysis focuses on incremental paid data. In each run-off triangle, we use  $X_{AY,Lag}$  to indicate incremental paid losses for accident years,  $AY = 1, \dots, 10$  and settlement lags,  $Lag = 1, \dots, 10$ . Thus, the paid losses in the upper triangle (training data) and unpaid losses in the lower triangle (test data) could be represented by  $\mathbf{X}^U$  and  $\mathbf{X}^L$ , respectively:

$$\mathbf{X}^U = \{X_{AY,Lag} : AY + Lag \leq 11\} \text{ and } \mathbf{X}^L = \{X_{AY,Lag} : AY + Lag > 11\}.$$

The retrospective test will be performed for the predictive distributions of elements or functions of elements in set  $\mathbf{X}^L$ .

The predictive distribution of outstanding liabilities could be obtained either through bootstrapping techniques or Bayesian methods. In this study, we will propose a Bayesian Autoregressive Tweedie (BAT) model for the prediction of unpaid loss, which is described in the next section. We compare the performance of the proposed method with an industry benchmark, the bootstrap chain-ladder (BCL) model, where the predictive variability of unpaid losses is derived through bootstrapping technique with an over-dispersed Poisson process error. A common thread running through the two models is that they both treat parameter risk by producing simulations of possible parameters for the model (BCL – bootstrap, BAT – Markov Chain Monte-Carlo). Both models treat process risk (BCL – the overdispersed Poisson distribution, BAT - the Tweedie distribution).

### 3.1 The Bootstrap Chain Ladder (BCL) Model

Bootstrap chain-ladder is simply a chain-ladder algorithm where bootstrapping is employed to accommodate estimation uncertainty. This technique has been applied to both univariate and multivariate loss reserving context; for example, see England and Verrall (2002) and Kirschner et al. (2008). To make this work self-contained, we briefly review the method as follows:

- Apply chain-ladder algorithm to cumulative payments and obtain the fitted incremental payments  $\hat{X}_{AY,Lag}$  for  $AY + Lag \leq 11$ .
- Calculate scale parameter and adjusted Pearson residual

$$\hat{\phi} = \frac{1}{m-p} \sum_{AY+Lag \leq n+1} \left( \frac{X_{AY,Lag} - \hat{X}_{AY,Lag}}{\sqrt{\hat{X}_{AY,Lag}}} \right)^2 \quad \text{and} \quad \hat{R}_{AY,Lag} = \sqrt{\frac{m}{m-p}} \frac{X_{AY,Lag} - \hat{X}_{AY,Lag}}{\sqrt{\hat{X}_{AY,Lag}}},$$

respectively, where  $m = n(n+1)/2=55$  and  $p = 2n - 1=19$ .

- Resample the residuals  $\hat{R}_{AY,Lag}^{(s)}$  ( $AY + Lag \leq 11$ ) and create pseudo-triangle by  $X_{AY,Lag}^{(s)} = \hat{R}_{AY,Lag}^{(s)} \sqrt{\hat{X}_{AY,Lag}} + \hat{X}_{AY,Lag}$  for  $s = 1, \dots, S$ .
- Apply chain-ladder algorithm to the cumulative pseudo-payments obtained from  $X_{AY,Lag}^{(s)}$  ( $AY + Lag \leq 11$ ) and project the incremental payments in the lower triangle  $\hat{X}_{AY,Lag}^{(s)}$  for  $AY + Lag > 11$ .
- For each cell  $(AY, Lag)$  ( $AY + Lag > 11$ ), simulate a payment from a process distribution with mean  $\hat{X}_{AY,Lag}^{(s)}$  and variance  $\hat{\phi} \hat{X}_{AY,Lag}^{(s)}$ , for  $s = 1, \dots, S$ .

Commonly used process distributions include gamma and over-dispersed Poisson. We report the results based on the latter process error since it is well known that the over-dispersed Poisson model using incremental payments reproduces chain-ladder predictions under certain regularity conditions (see Renshaw and Verrall (1998) and Verrall (2000) for details). Furthermore, a preliminary analysis shows the difference in the predictions based on the two types of process distributions is negligible. We implemented the bootstrap chain-ladder method using the “ChainLadder” package in the statistical computing software R.



### **3.2 The Bayesian Autoregressive Tweedie (BAT) Model**

The objective of this model is given the observed data  $X^U$ , predict the distribution of the sum of all amounts in  $X^L$ .

The high-level considerations made in formulating this model include:

1. The model should use the reported premiums as a measure of exposure. This consideration has precedent with the Bornhuetter-Ferguson method, but it differs from other popular models such as the chain-ladder. Given that the model uses premiums, it should recognize that competitive conditions in the American insurance industry lead to slowly changing loss ratios over time.
2. As the settlement lag increases, the payments follow no discernable natural pattern other than ultimately, they approach zero.
3. The model should reflect inflationary changes in loss levels by calendar year. This consideration has precedent with other models such as the one proposed by Barnett and Zehnwirth (2000). The model should recognize that inflation can change slowly over time.
4. Process risk is present and important for  $(AY, Lag)$  cells with low expected losses. In general, the coefficient of variation of the process risk should decrease as the expected loss increases, but it should never approach zero. Also, the process risk in the later settlement lags should reflect the larger claims that take longer to settle.
5. The model is Bayesian. Loss reserve models tend to have many parameters. As demonstrated by Meyers (2007a), loss reserve models fit by maximum likelihood with a large number of parameters tend to understate the variance of the outcomes. Bayesian approaches will correct for this by incorporating parameter risk into calculating the variance of the outcomes. Other approaches, such as bootstrapping, also incorporate parameter risk.

## The Retrospective Testing of Stochastic Loss Reserve Models

The unknown parameters for this model are as follows.

- $ELR_{AY}$ , for  $AY = 1, \dots, 10$ . These parameters represent the expected loss ratio for accident year  $AY$ .
- $Dev_{Lag}$ , for  $Lag = 1, \dots, 10$ . These parameters represent the paid incremental loss development factors for settlement lag  $Lag$ . To prevent overdetermining the model we imposed the constraint that  $\sum_{Lag=1}^{10} Dev_{Lag} = 1$ .
- $CYT_i$ , for  $i = 1, \dots, 19$ . These parameters represent the calendar year trend factor. For a given  $(AY, Lag)$  cell, we have  $i = AY + Lag - 1$ . To prevent overdetermining the model we set  $CYT_1 = 1$ .
- $Sev$  represents the claim severity for claims that settle in the 10<sup>th</sup> settlement lag. For  $Lag < 10$ , the claim severity is given by  $Sev \cdot (1 - (1 - Lag / 10)^3)$ . This expression for the claim severity guarantees that the claim severity increases as the settlement lag increases.
- $c$  represents the contagion parameter as described in Meyers(2007b). Its role is to keep the coefficient of variation of the process risk from decreasing to zero as the expected loss increases. Its precise role will be specified in the likelihood function below.

To allow the  $\{ELR_{AY}\}$  parameters to change slowly over time, we impose the following AR(1) structure on the parameters.

$$ELR_{AY} = \mu_A \cdot (1 - \rho_A) + \rho_A \cdot ELR_{AY-1} + \varepsilon_A.$$

From the standard properties of the AR(1) model we have that:

- The long-term average of the  $ELR_{AY}$  parameters =  $\mu_A$ .
- $\text{Corr}(ELR_{AY}, ELR_{AY-k}) = \rho_A^k$ .
- $\varepsilon_A \sim N(0, \sigma_A)$ .

## The Retrospective Testing of Stochastic Loss Reserve Models

The prior distribution of  $\{\{ELR_{AY}\}, \mu_A, \rho_A, \sigma_A\}$  takes the form:

$$p(\{\{ELR_{AY}\}, \mu_A, \rho_A, \sigma_A\}) = f(\mu_A) \cdot g(\rho_A) \cdot h(\sigma_A) \cdot \prod_{AY=2}^{10} \Phi(ELR_{AY} - \mu_A \cdot (1 - \rho_A) - \rho_A \cdot ELR_{AY-1} | 0, \sigma_A)$$

where:

- $\Phi$  is the standard normal distribution.
- $f$  is a gamma distribution with mean 0.7 and coefficient of variation 0.18.
- $g$  is a uniform (0,1) distribution.
- $h$  is a gamma distribution with mean 0.025 and coefficient of variation 0.5.

We impose a similar structure on  $\{CYT_i\}$  with the prior distribution taking the form:

$$p(\{\{CYT_i\}, \mu_c, \rho_c, \sigma_c\}) = f(\mu_c) \cdot g(\rho_c) \cdot h(\sigma_c) \cdot \prod_{i=2}^{10} \Phi(CYT_i - \mu_c \cdot (1 - \rho_c) - \rho_c \cdot CYT_{i-1} | 0, \sigma_c)$$

where:

- $\Phi$  is the standard normal distribution.
- $f$  is a gamma distribution with mean 1 and coefficient of variation 0.18.
- $g$  is a uniform (0,1) distribution.
- $h$  is a gamma distribution with mean 0.025 and coefficient of variation 0.5.

*The Retrospective Testing of Stochastic Loss Reserve Models*

The prior distributions for the remaining parameters were gamma distributions with the parameters given in Table 2. These were derived by fitting a similar model by maximum likelihood to a large number of insurers.

Table 2

Parameter	$\alpha$	$\theta$	Implied	
			Mean	Std. Dev.
<i>Sev</i>	1.3676	136.248	186.3386	159.3400
<i>c</i>	0.074	0.1391	0.0103	0.0379
<i>Dev</i> <sub>1</sub>	15.81	0.0135	0.2137	0.0537
<i>Dev</i> <sub>2</sub>	42.8538	0.0059	0.2517	0.0385
<i>Dev</i> <sub>3</sub>	56.4944	0.0036	0.2028	0.0270
<i>Dev</i> <sub>4</sub>	30.4528	0.0046	0.1403	0.0254
<i>Dev</i> <sub>5</sub>	10.2309	0.0085	0.0870	0.0272
<i>Dev</i> <sub>6</sub>	5.8094	0.0083	0.0480	0.0199
<i>Dev</i> <sub>7</sub>	3.6954	0.0068	0.0250	0.0130
<i>Dev</i> <sub>8</sub>	2.3934	0.0057	0.0135	0.0087
<i>Dev</i> <sub>9</sub>	1.3559	0.0066	0.0090	0.0077
<i>Dev</i> <sub>10</sub>	0.4552	0.0200	0.0091	0.0135

The joint prior distribution for all the parameters is the product of all the individual prior distributions given above.

We used the Tweedie distribution with index  $p = 1.67$  to describe the process risk. For a given  $(AY, Lag)$  cell, the expected loss is given by:

$$E[X_{AY, Lag}] = Premium_{AY} \cdot ELR_{AY} \cdot Dev_{Lag} \cdot \prod_{i=1}^{AY+Lag-1} CYT_i.$$

The scale parameter for the Tweedie distribution for each  $(AY, Lag)$  cell is given by:

$$\phi = \frac{E[X_{AY, Lag}]^{1-p} \cdot Sev \cdot \left(1 - \frac{Lag}{10}\right)^3}{2-p} + c \cdot E[X_{AY, Lag}]^{2-p}.$$

## The Retrospective Testing of Stochastic Loss Reserve Models

This expression for  $\phi$  can be explained by noting that the variance for the Tweedie distribution is usually written in the form  $\phi \cdot \mu^p$ . Substituting  $\mu = E[X_{AY,Lag}]$  and the value above for  $\phi$  into the expression for the Tweedie variance yields a variance of  $E[X_{AY,Lag}]/(2-p) + c \cdot E[X_{AY,Lag}]^2$ . The coefficient of variation squared is then equal to  $\frac{1}{E[X_{AY,Lag}] \cdot (2-p)} + c$ . This coefficient of variation squared decreases to  $c$  as the expected loss,  $E[X_{AY,Lag}]$ , increases.

The likelihood function for the data<sup>3</sup> in the upper triangle is the product of the Tweedie density functions over all the  $(AY,Lag)$  cells in the upper triangle,  $\mathbf{X}^U$ .

With the prior distribution and the likelihood function specified above, we used the Metropolis Hastings algorithm<sup>4</sup> to generate a sample of size 1,000 parameter sets from the posterior distribution.

Figures 4 to 14 below graphically show how the data reduces the uncertainty in the range in the parameters by comparing the prior and posterior distributions of the parameters. We produced these plots using the data of the insurer with group code 914.

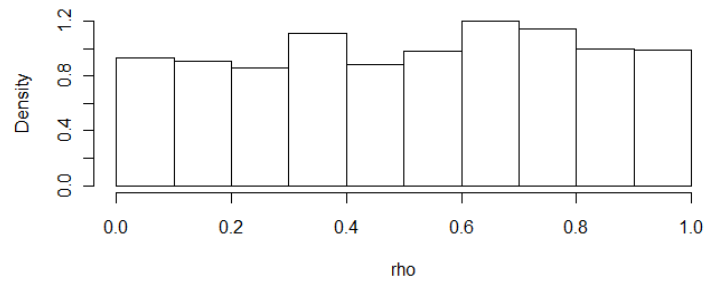
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<sup>3</sup> In fitting the data, we dropped all  $(AY,Lag)$  cells with negative paid incremental losses.

<sup>4</sup> See Meyers (2009) for an explanation of the Metropolis Hastings Algorithm. For each parameter, we used a gamma distribution with a shape parameter,  $\alpha = 2,000$ , for the proposal density function. To obtain convergence and guard against autocorrelation, we ran 50,000 iterations and took a sample of size 1,000 from the last 25,000 iterations.

Figure 4

Prior Distribution of 'rho' for ELR Model



Posterior Distribution of 'rho' for ELR Model

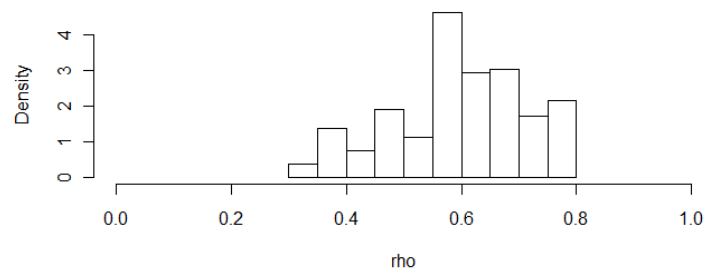
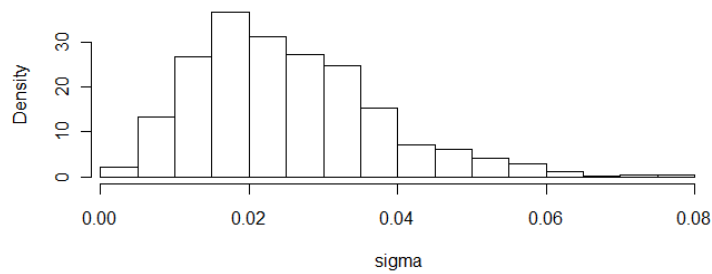


Figure 5

Prior Distribution of 'sigma' for ELR Model



Posterior Distribution of 'sigma' for ELR Model

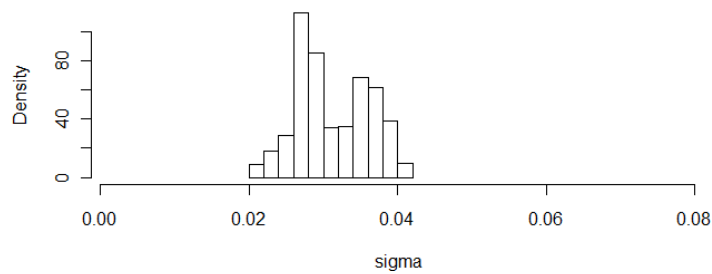


Figure 6

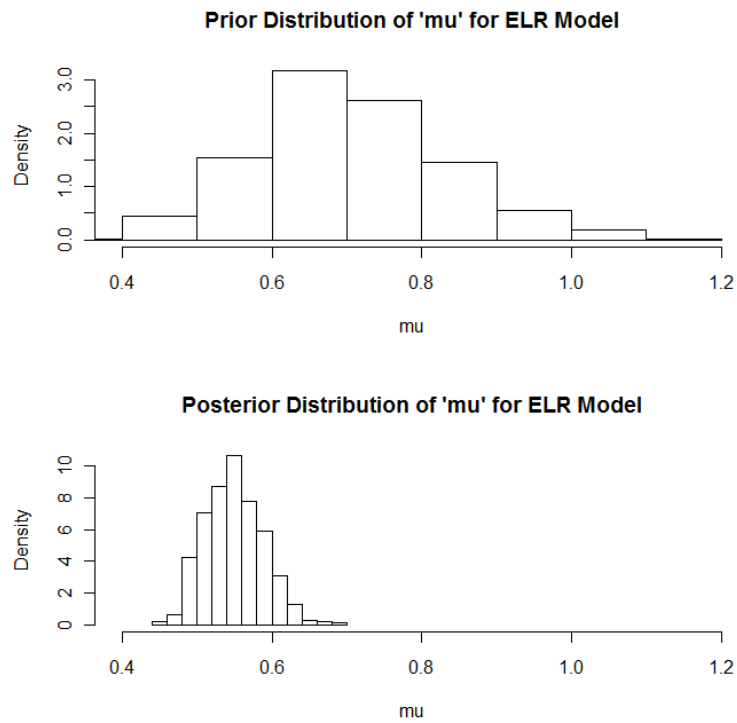


Figure 7

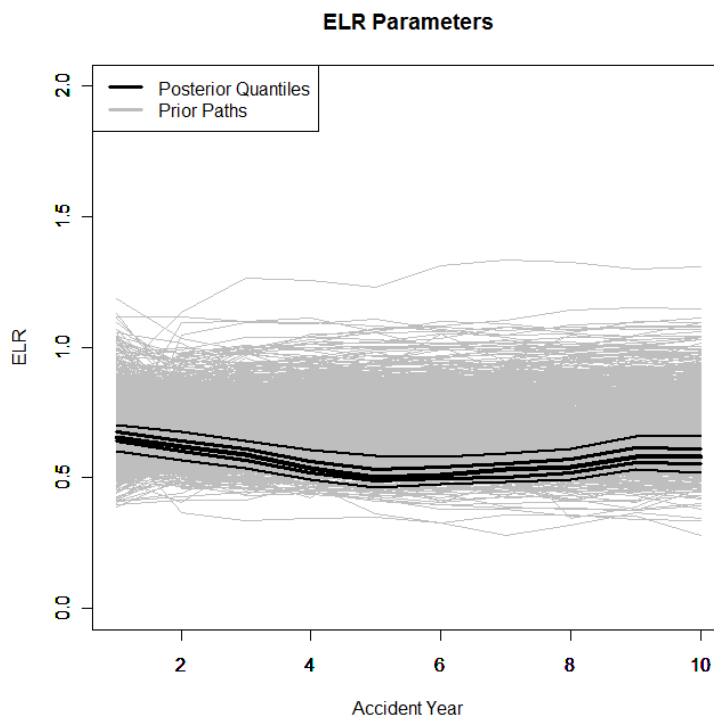


Figure 8

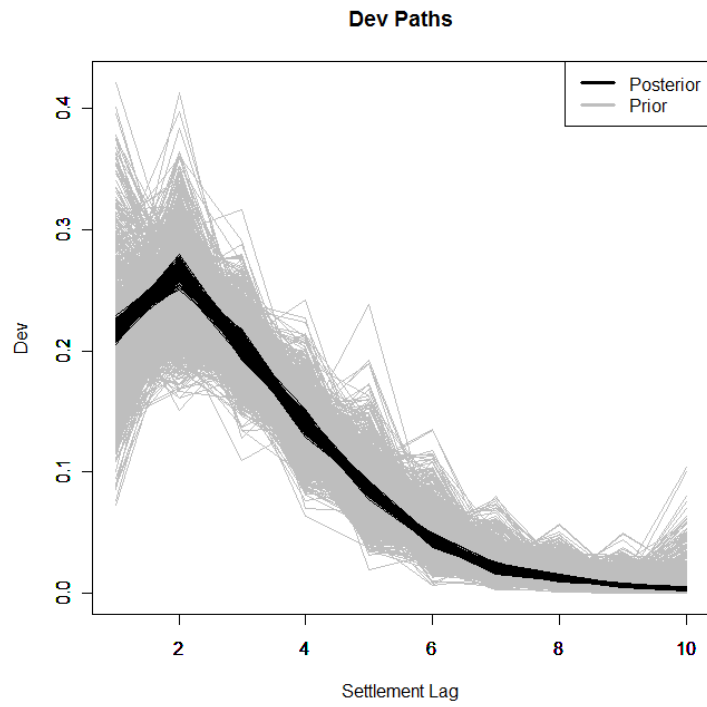


Figure 9

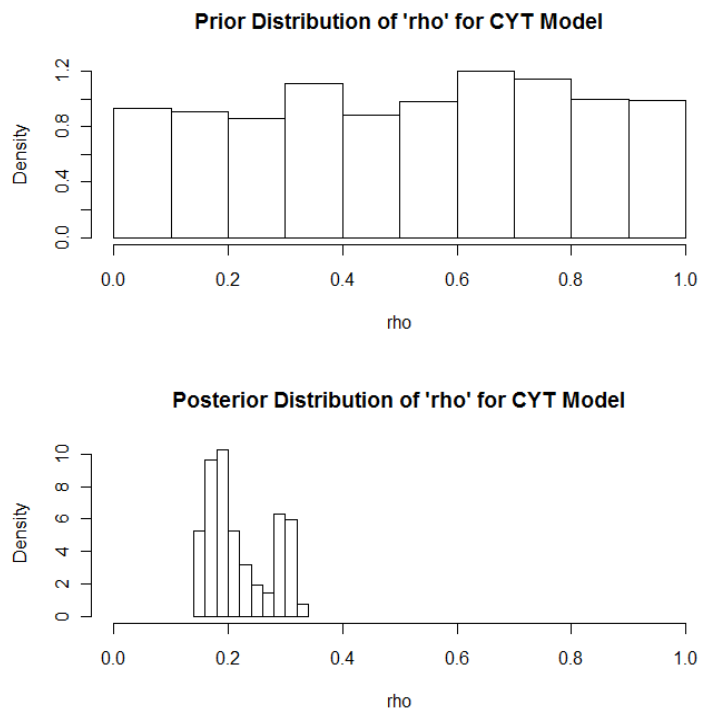




Figure 10

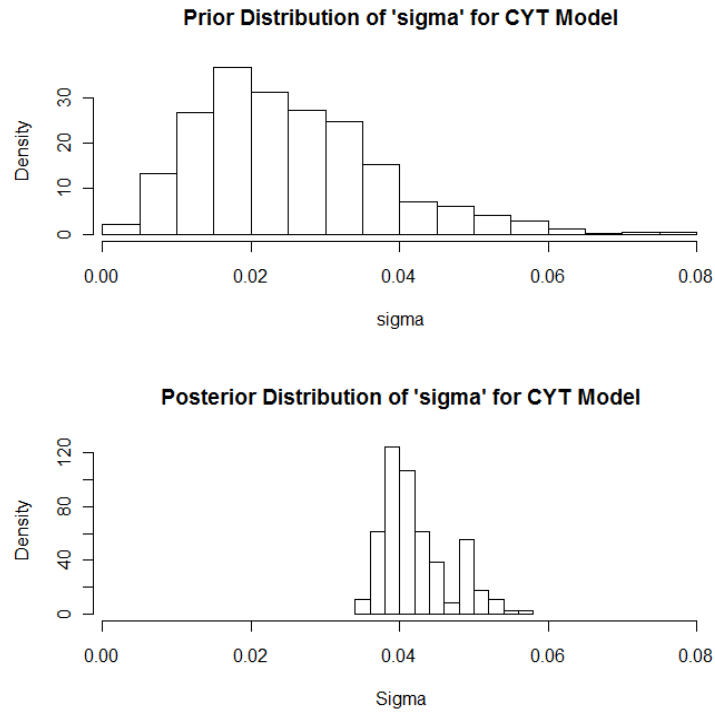


Figure 11

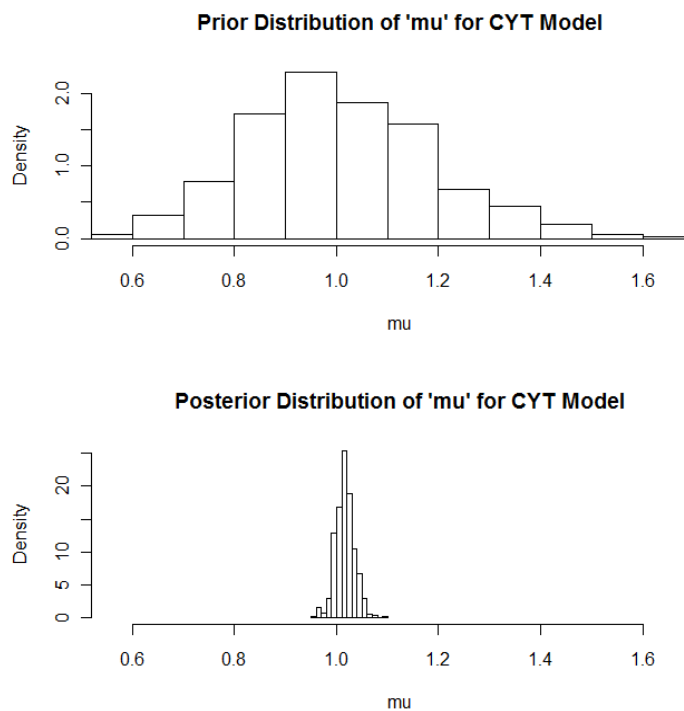


Figure 12

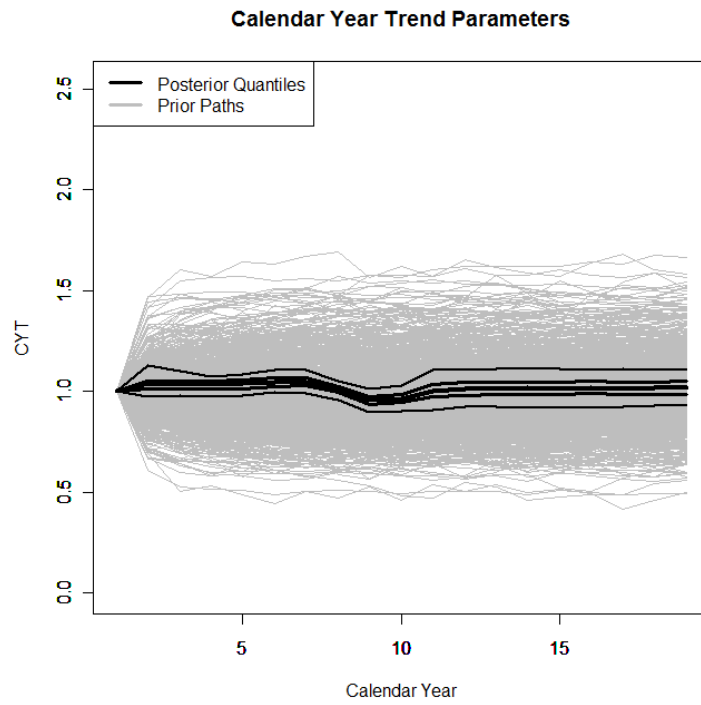


Figure 13

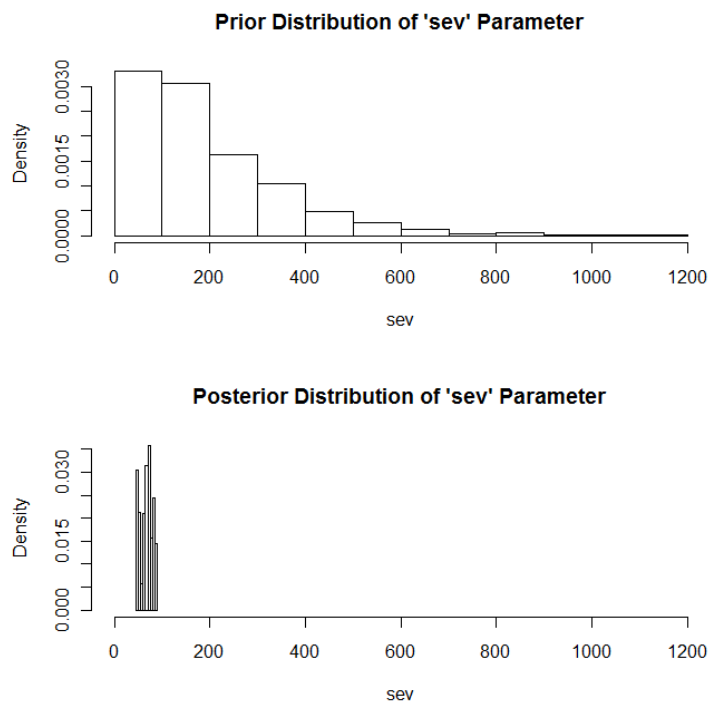
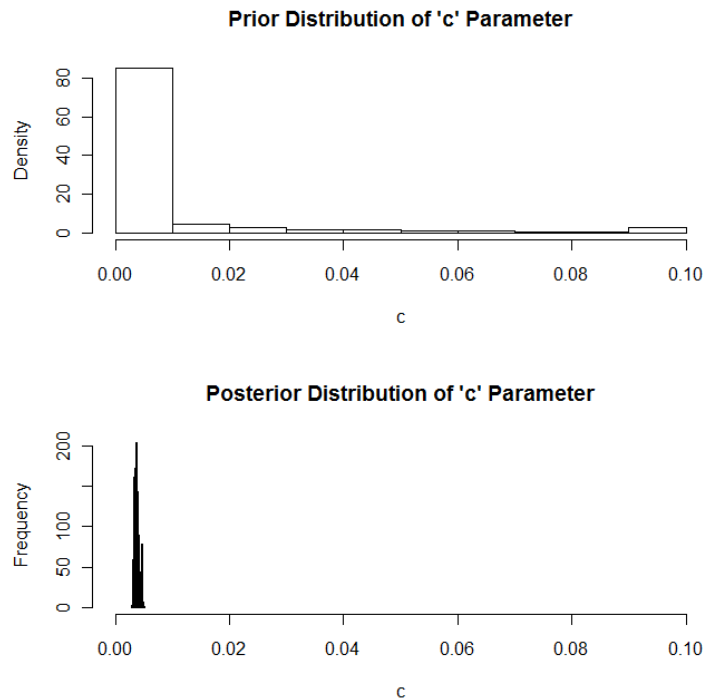


Figure 14



For each of the 1,000 randomly selected parameter sets  $\{\{ELR_{AY}\}, \{Dev_{Lag}\}, Sev, c\}$ , we then calculated the mean and variance of the Tweedie distribution of  $X_{AY,Lag}$  for each  $(AY,Lag)$  cell in the lower triangle and then took 10 different random simulations of  $\sum_{AY=2}^{10} \sum_{Lag=12-AY}^{10} X_{AY,Lagx}$ . These simulations produced 10,000 samples of this sum. Given the amount of an outstanding liability, we calculate the cumulative probability by counting the number of simulations that are less than or equal to it.

#### **4. Retrospective Tests for Single Insurers**

Loss reserve models are calibrated using the observed run-off triangle and then are used to forecast outstanding liabilities. From the perspective of risk management, a reasonable reserve range is of more interest to reserving actuaries and risk managers. Stochastic claims reserving models achieve this goal by providing a best estimate as well as a variability measure of reserves; for example, the conditional mean-squared prediction error. This paper focuses on testing the predictive distribution of outstanding claims. We emphasize that a fair test should be based on a retrospective evaluation using the realized claims of predictive interests. In this study, the retrospective test will be performed at two levels: individual firm and portfolio of insurers. This section focuses on the tests for single insurers and the next section performs tests for multiple insurers.

At firm level, the retrospective test informs actuaries on the predictive performance of a stochastic claims reserving method for each individual firm. For a specific insurer, we calculate the percentile of realized unpaid losses  $x_{AY,Lag}$  for each cell  $(AY,Lag)$  in the unobserved triangle, by  $p_{AY,Lag} = F(x_{AY,Lag})$ , where  $F(\cdot)$  denotes the predictive distribution of  $X_{AY,Lag}$  derived from a certain stochastic reserving method. All these  $p_{AY,Lag}$  ( $AY + Lag > 11$ ) are expected to be a random sample of a uniformly distributed variable on  $[0, 1]$ , if the model assumptions of the stochastic reserving method are appropriate for the insurer. The uniformity of percentiles could be visualized through graphical tools such as Probability-Probability (PP) plot, or could be easily tested using formal statistics such as a Kolmogorov-Smirnov (KS) test.

We perform the retrospective test for all the insurers in our sample individually. With the BAT model, we observe that for all the insurers, the PP plots for the training data lie within the KS bounds. It was with the test data that the PP plots often deviated outside the KS bounds. The results for the BCL model are similar; i.e., the model fits data well but could produce bad predictions. We demonstrate these analyses with three insurers. The group code for the three insurers are 914, 2674 and 310. We present the following results from the BCL and the BAT model for each insurer: 1) A PP-plot for training data; 2) The percentiles of training data for accident year, settlement lag as well as calendar year; 3) A PP-plot for test data; 4) The

### *The Retrospective Testing of Stochastic Loss Reserve Models*

percentiles of test data for accident year, settlement lag, as well as calendar year. If the model fits well, we should expect the PP-plot to lie along the 45° line, and to see no pattern in the remaining plots by accident year, settlement lag or calendar year. The results are summarized in Figures 15 – 26.

In terms of goodness-of-fit, the PP-plots of training data suggest that both BCL and BAT models fit training data well for all insurers. When examining the test data, the retrospective test shows that the PP plots of both models are within the KS bounds for insurer 914, but outside the KS bounds for insurer 310. For insurer 2764, the BCL model provides better predictive distribution than the BAT model. We attribute such observations to the potential overfitting of the two loss reserving models. Though not reported here, our analysis showed that the loss development of insurer 914 is rather stable over time, while the payments for insurer 2764 and 310 are more volatile from year to year, especially for insurer 310. The higher variability explains the poor predictive performance of both models on insurer 310. Another factor affecting the predictive performance of loss reserving models appears to be an environmental change in the projecting period. Our analysis in the next section shows that the BCL model somehow did a better job in the perceived changing environment.

Figure 15 – BCL Model for Insurer 914 – Training Data

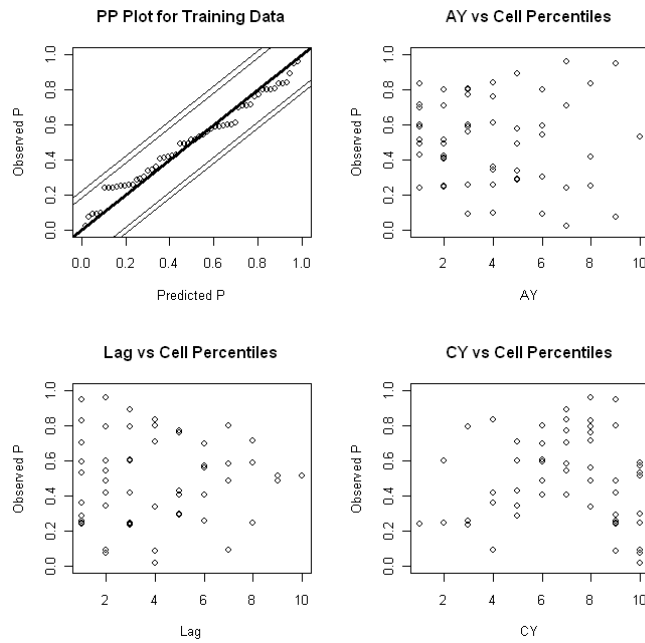


Figure 16 – BCL Model for Insurer 914 – Test Data

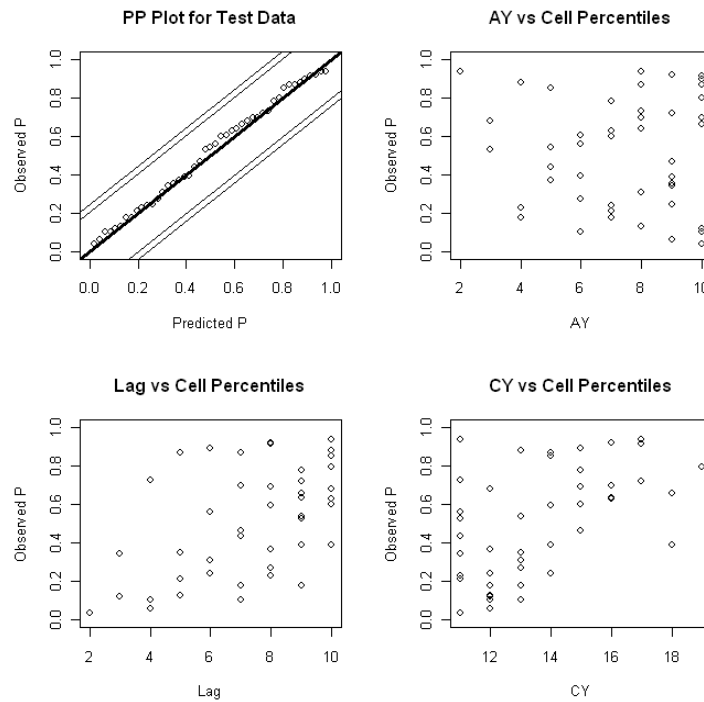


Figure 17 – BAT Model for Insurer 914 – Training Data

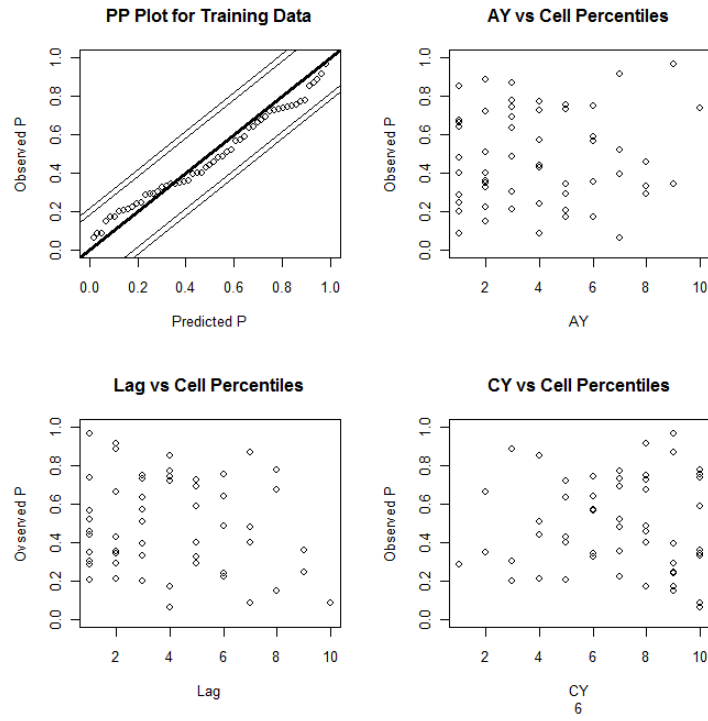
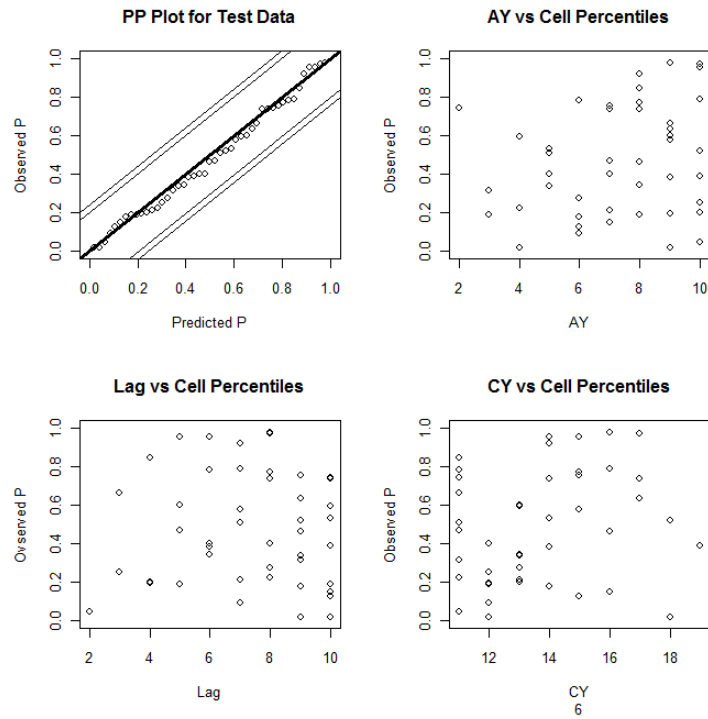


Figure 18 – BAT Model for Insurer 914 – Test Data



The Retrospective Testing of Stochastic Loss Reserve Models

Figure 19 – BCL Model for Insurer 2674 – Training Data

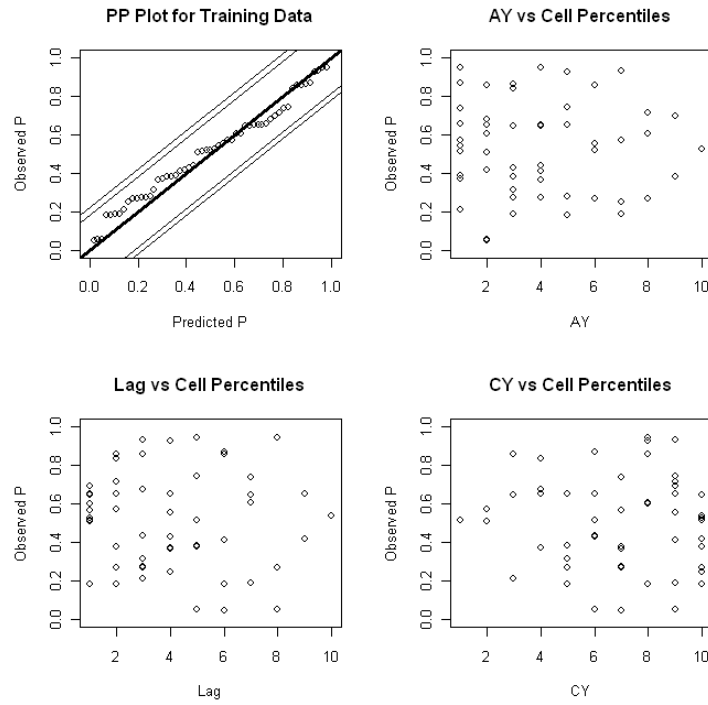


Figure 20 – BCL Model for Insurer 2674 – Test Data

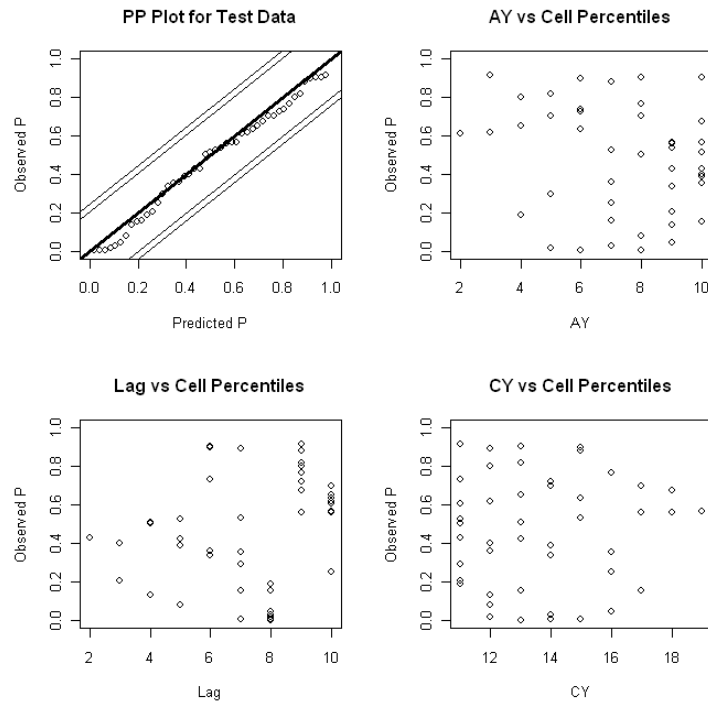




Figure 21 – BAT Model for Insurer 2674 – Training Data

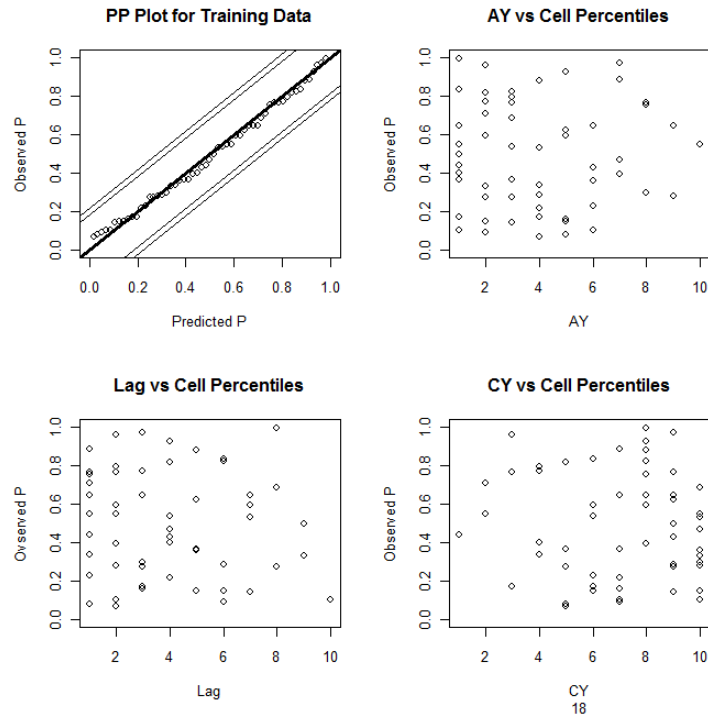


Figure 22 – BAT Model for Insurer 2674 – Test Data

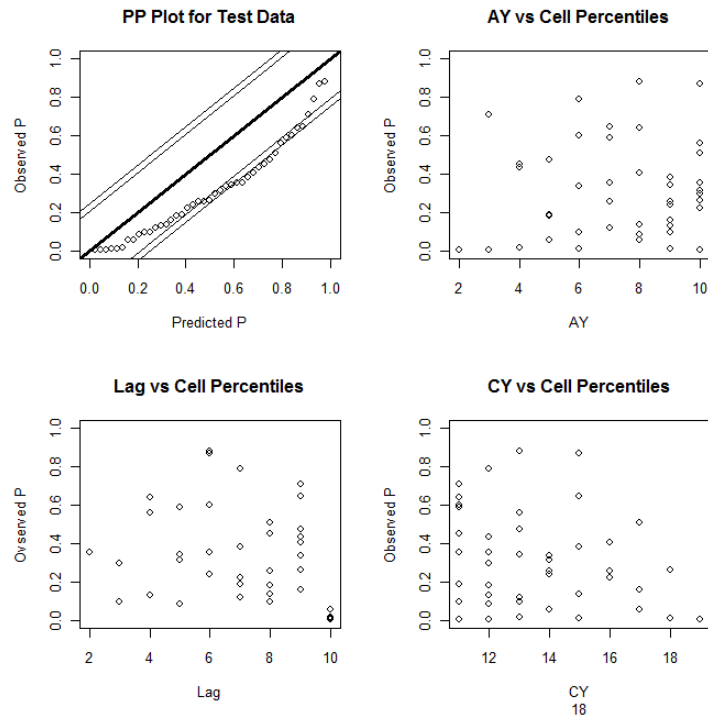


Figure 23 – BCL Model for Insurer 310 – Training Data

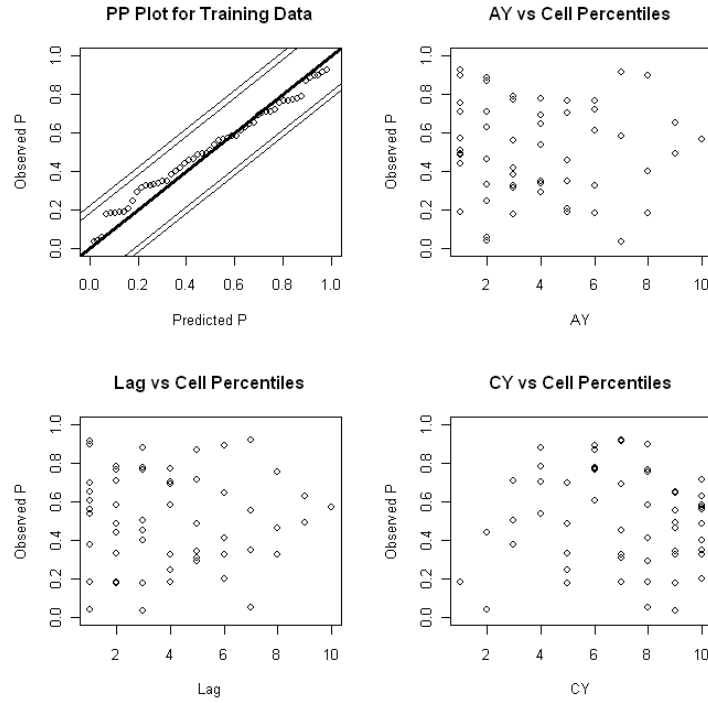


Figure 24 – BCL Model for Insurer 310 – Test Data

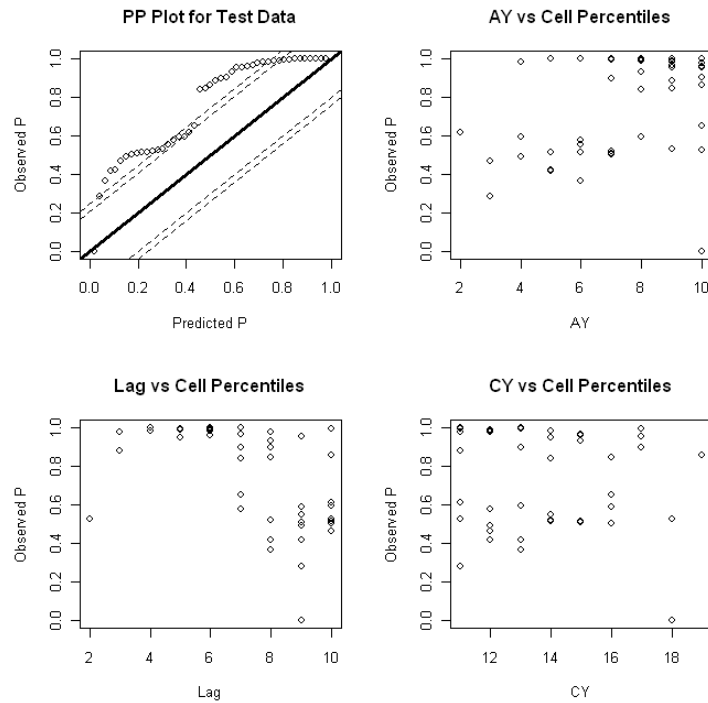


Figure 25 – BAT Model for Insurer 310 – Training Data

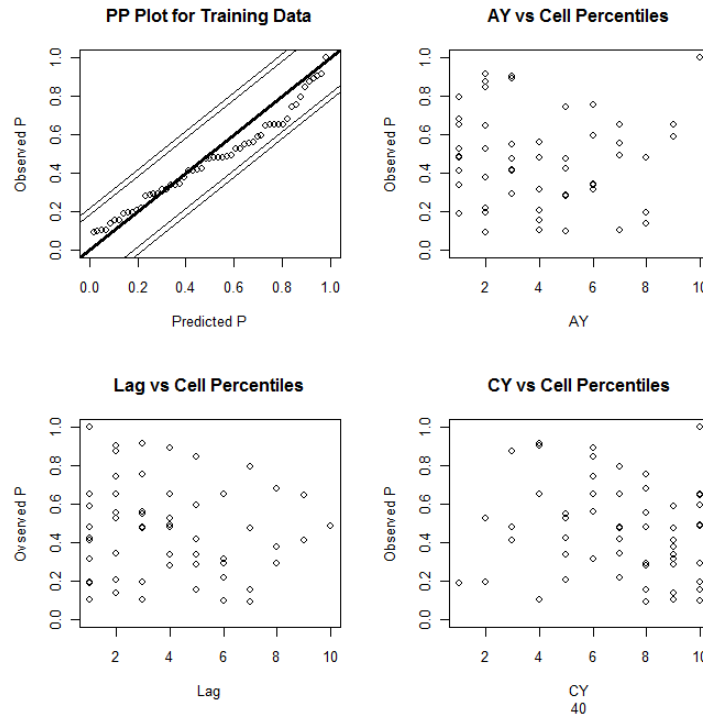
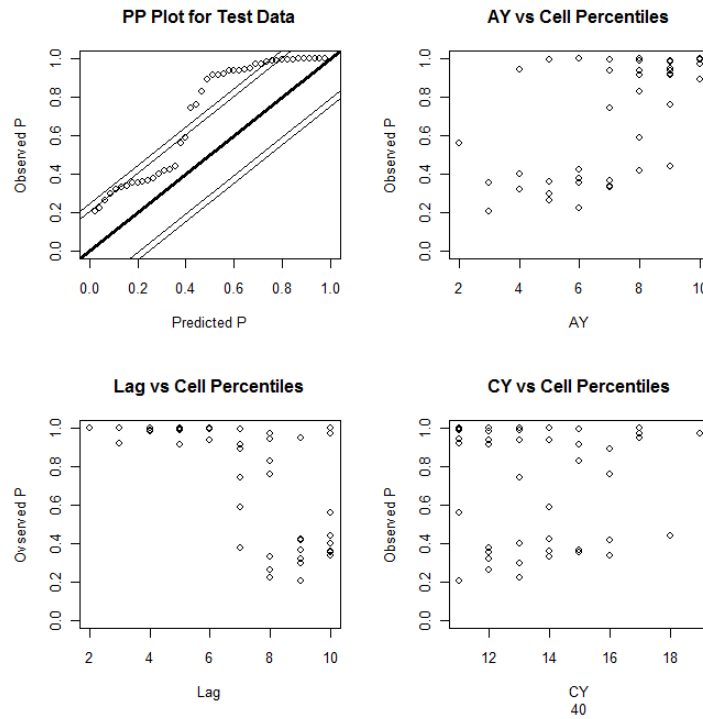


Figure 26 – BAT Model for Insurer 310 – Test Data



## 5. Retrospective Tests for Multiple Insurers

The retrospective test could be performed for a portfolio of insurers as well. At portfolio level, the retrospective test helps detect the potential under or over reserving issue if one single stochastic method is applied to all insurers in the portfolio. The same idea could be generalized to the industry level. Considering a portfolio of  $N$  property-casualty insurers, we implement the test using total reserves. Specifically, for the  $k^{\text{th}}$  ( $k = 1, \dots, N$ ) insurer in the portfolio, we calculate the percentiles of realized total unpaid losses in the lower triangle  $p_k^{\text{Tot}} = F(r_k^{\text{Tot}})$ . Here  $F(\cdot)$  and  $r_k$  indicate the corresponding predictive distribution and realized unpaid losses, respectively. Whether the stochastic reserving method is suitable for the insurer portfolio could be answered by examining the uniformity of  $p_k^{\text{Tot}}$ .

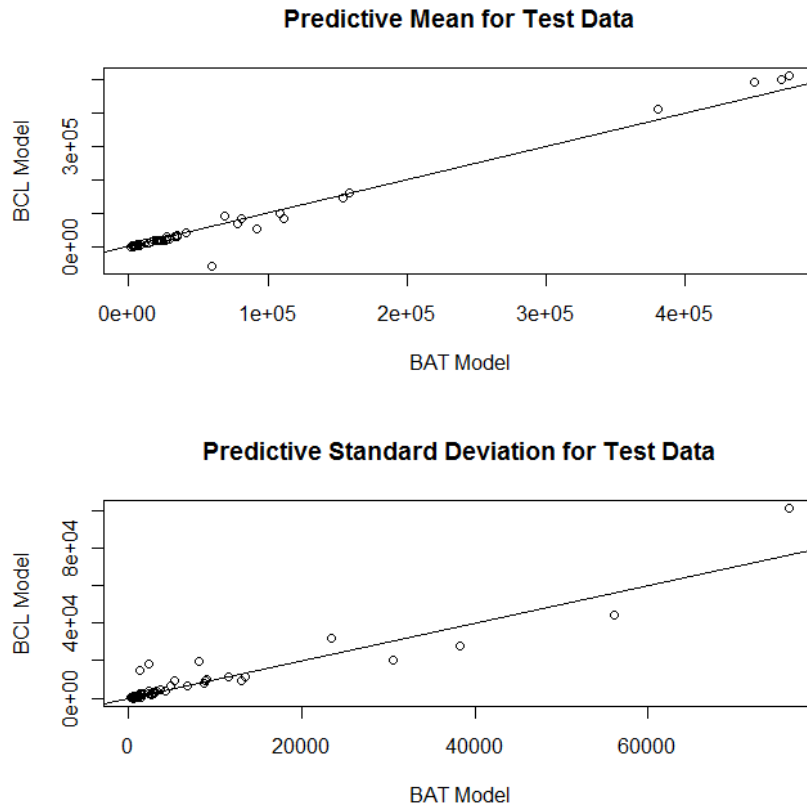
This section compares the predictions of the Bayesian Autoregressive Tweedie (BAT) model and the Bootstrap Chain Ladder (BCL) model. Our data also includes the reserve that each insurer posted in the 1997 Annual Statement. The reserves posted by the insurer differ from the models in that they are not tied to any particular method or model and can reflect insurer judgment. Also, it is not difficult to imagine the various incentives that can influence the judgments in either direction.

Figure 27 compares the predictive means and standard deviations of the total outstanding losses using the BAT and BCL methods. This figure indicates that for the most part, the predictive means are fairly close<sup>5</sup>. There are a noticeable number of instances where the predictive standard deviation is smaller for the BAT model.

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<sup>5</sup> In one case the mechanical application of the BCL model produced a negative mean because of a negative incremental paid loss. Any actuary would reject this result, in practice. The BAT model dropped any cell that contained a negative incremental paid loss.

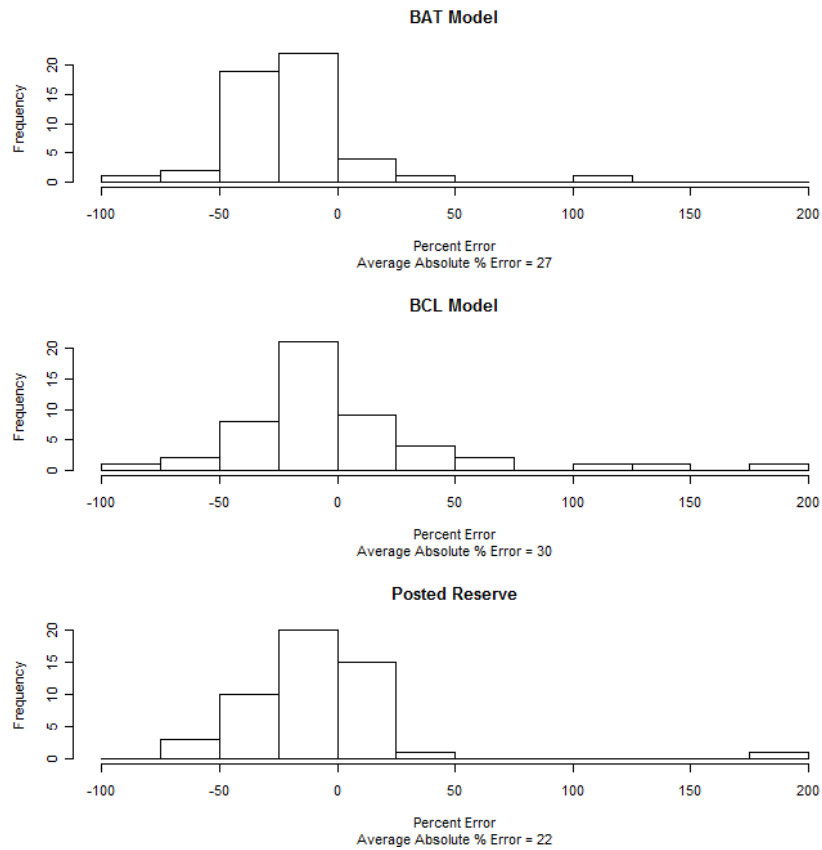
Figure 27



Next, we compare the accuracy of the predictions of the BAT and BCL models with the posted reserves. For both models, we use the predictive means for the test data. Figure 28 compares the percentage error of the three predictions<sup>6</sup> from the actual outcomes. The mean absolute percentage error was largest for the BCL model, and smallest for the posted reserve. It is worth noting that in most cases, all three estimates predicted losses that were high. It is also worth noting that a previous study of this sort on different data (Meyers 2007c) found that a Bayesian model produced smaller errors than the posted reserve.

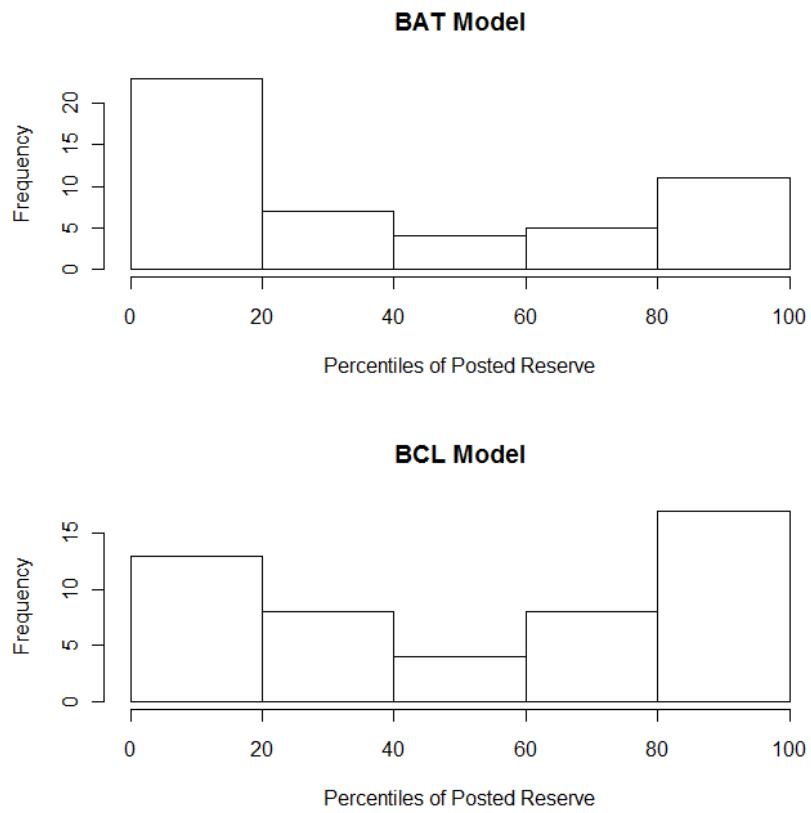
<sup>6</sup> The BCL model produced one negative and one zero predicted mean. We set the percentage absolute percentage error at -100% and 200% respectively.

Figure 28



When a stochastic loss reserve analysis is performed, a question commonly asked by actuaries is “What percentile should one post a reserve.” While we do not intend to answer that question, we can use the BAT and the BCL models to estimate the percentiles of the actual posted reserve. Figure 29 provides the results. It appears that many insurers post conservative estimates, while many others (correctly as it turns out) posted lower than expected reserves.

Figure 29



*The Retrospective Testing of Stochastic Loss Reserve Models*

If a loss reserve model is appropriate for all insurers, the predicted percentiles of the data should be uniformly distributed. Figure 30 provides histograms for both models with the training data and Figure 31 provides histograms for both models on the test data. All four histograms indicate non-uniformity of the predicted percentiles. It should come as no surprise that the percentiles tend to be around the middle ranges on the training. Because of the high parameter to data point ratio, we attribute this to overfitting. We interpret the results for the test data as an indication that either: (1) something changed in the environment that resulted in lower claim settlements; or (2) no single model should be expected to apply for all insurers. It appears that, for whatever reason, the BCL did a better job of picking up that environmental change.

Figure 30

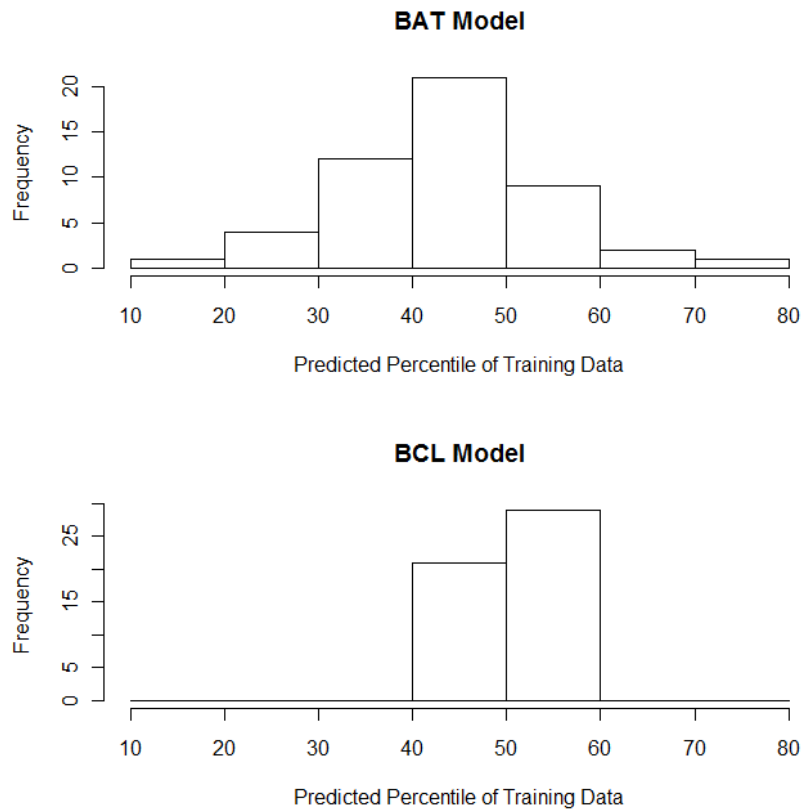
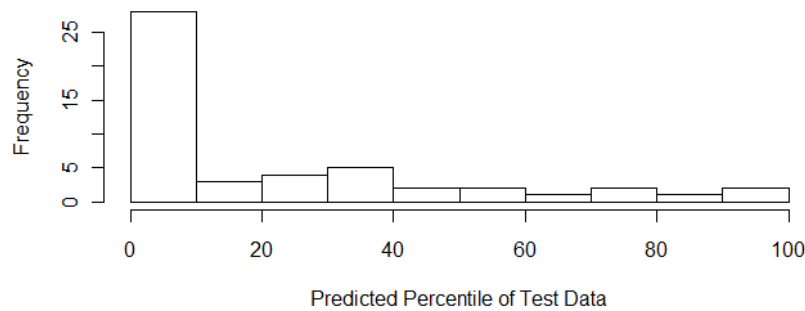


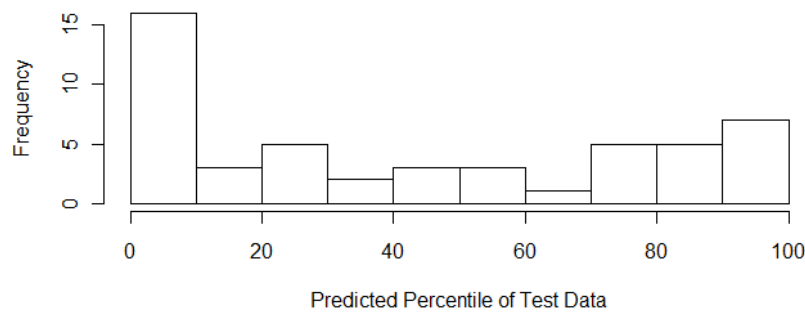


Figure 31

**BAT Model**



**BCL Model**



**6. Concluding Remarks**

The primary purpose of this paper was to introduce a new database that can be used to test predictive distributions from different stochastic loss reserve models. We emphasized the retrospective tests based on realized payments in the projecting periods. We then performed some tests on an established model, bootstrap chain ladder (BCL) model, and a proposed new model, Bayesian Autoregressive Tweedie (BAT) model. At this point in time, we are not ready to declare a winner. These models, and perhaps other models, should be tested on other lines of insurance. And the database is there that will permit further testing.

This particular study suggests that there might be environmental changes that no single model can identify. If this continues to hold, the actuarial profession cannot rely solely on stochastic loss reserve models to manage its reserve risk. We need to develop other risk management strategies that do deal with unforeseen environmental changes.

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## **Appendix**

This appendix describes the data set of loss triangles that we prepared for claims reserving studies. The data cover major personal and commercial lines of business from U.S. property casualty insurers. We extract the claims data from Schedule P – Analysis of Losses and Loss Expenses in the National Association of Insurance Commissioners (NAIC) database.

### **A.1 Schedule P**

NAIC Schedule P contains information on claims for major personal and commercial lines for all property-casualty insurers that write business in U.S. Some parts have sections that separate occurrence from claims made coverages. We focus on the following six lines: (1) private passenger auto liability/medical; (2) commercial auto/truck liability/medical; (3) worker's compensation; (4) medical malpractice – claims made; (5) other liability – occurrence; (6) product liability – occurrence.

For each of the above six lines, the variables to be included in the dataset are pulled from three different parts in Schedule P, including:

Part 1 - Earned premium and some summary loss data

Part 2 - Incurred net loss triangles

Part 3 - Paid net loss triangles

Part 4 - Bulk and IBNR Reserves

### **A.2 Data Preparation**

The triangles consist of losses net of reinsurance, and quite often insurer groups have mutual reinsurance arrangements between the companies within the group. Consequently, we focus on records for single entities in the data preparation, be they insurer groups or true single insurers. The process of data preparation takes three steps:

Step I: Pull triangle data from Schedule P of year 1997. Each triangle includes claims of 10 accident years (1988-1997) and 10 development lags. This data was the training data used for model development.

### *The Retrospective Testing of Stochastic Loss Reserve Models*

Step II: Square the triangles from Schedule P of year 1997 with outcomes from Schedule P of subsequent years. Specifically, the data for accident year 1989 was pulled from Schedule P of year 1998, the data for accident year 1990 was pulled from Schedule P of year 1999, ....., the data for accident year 1997 was pulled from Schedule P of year 2006. The data in the lower triangles could be used for model validation purposes.

Step III: We performed a preliminary analysis to ensure the quality of the dataset. An insurer is retained in the final dataset if all following criteria are satisfied: (1) the insurer is available in both Schedule P of year 1997 and subsequent years; (2) the observations (10 accident years and 10 development lags) are complete for the insurer; (3) the claims from Schedule P of year 1997 match those from subsequent years.

### A.3 Final Dataset

As a final product, we provide a dataset that contains run-off triangles of six lines of business for all U.S. property casualty insurers. The triangle data correspond to claims of accident year 1988 – 1997 with 10 years development lag. Both upper and lower triangles are included so that one could use the data to develop a model and then test its performance retrospectively. A list of variables in the data is as follows:

Table A.1. Description of Variables

Variable	Description
GRCODE	NAIC company code (including insurer groups and single insurers)
GRNAME	NAIC company name (including insurer groups and single insurers)
AccidentYear	Accident year (calendar year)
DevelopmentYear	Development year (calendar year)
DevelopmentLag	Development year - Incurral year + 1
IncurLoss_	Incurred losses and allocated expenses reported at year end
CumPaidLoss_	Cumulative and paid losses and allocated expenses at year end
EarnedPremD_	Premiums earned at incurral year - direct and assumed
EarnedPremC_	Premiums earned at incurral year - ceded
EarnedPremN_	Premiums earned at incurral year - net
Single	1 indicates a single entity, 0 indicates a group insurer
"_ "	Refers to lines of business
B	Private passenger auto liability/medical
C	Commercial auto/truck liability/medical
D	Workers' compensation
F2	Medical malpractice - Claims made
H1	Other liability - Occurrence
R1	Products liability - Occurrence