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20 June 2011

**Report
of the
Task Force on Expected Profits arising from Future Premiums**

Table of contents

Executive summary

A definition and methodology for determining the amount of expected profits in future premiums (hereafter: EPIFP) has been tested in QIS5.

General concerns or objections have been raised by the industry as to the initial purpose of identifying this element

EIOPA has observed a limited incentive from undertakings to calculate EPIFP during QIS5; a wide variation in data resulted from this. Nevertheless, expected profits arising from future premiums may be a significant component of the excess of assets over liabilities under Solvency II. Based on QIS5 results, it appeared that EPIFP could contribute on average for 20 % of the Tier 1 own funds, and in some cases the amount could represent up to 50% or even more of own funds.

EIOPA expressed the intention to analyze together with the industry and the Commission the outcome of this test in a joint Task Force, with the aim to clarify the concept of EPIFP.[1]

EIOPA invited stakeholders to join the Task Force. CRO/CFO Forum, CEA, Groupe Consultatif, AMICE as well as a member of academia, were invited to discuss this issue with a small group of EIOPA Members. Commission services were invited as observers to the discussions, too. The Task Force has met three times in May 2011.

The work on the definition and calculation of EPIFP is closely linked to the possible purpose of the identification. Nevertheless, pre-judging the purpose would undermine the effort put in the work undertaken as well as the quality of the results.

The main aim of the Task Force has therefore been to develop a common understanding of the element of EPIFP. Based on this, the discussion continued to identify possible methodologies for a harmonized calculation of EPIFP under Solvency II.

There is disagreement amongst the members of the Task Force.

Generally speaking, industry representatives believe that:
- the whole report is not necessary to clarify the discussions;
- EPIFP are not to be calculated separately;
- the concept of EPIFP is not a relevant one for Solvency II.

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[1] See the letter from EIOPA to the European Commission from 14 March 2011 at
https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/submissionstotheec/QIS5_Cover_Note.pdf,

With particular regard to the concept itself, industry representatives do not agree on the use of the term "EPIFP" but propose an alternative terminology as set out in the section on definitions. Moreover, they do not agree on the inclusion in an annex to the report of the outcome of some side discussion held during the meetings of the task force, since they find it beyond the mandate of the TF itself.

On the other hand, representatives of supervisory authorities believe that:
- the report provides valuable insight on the definition of EPIFP;
- EPIFP may represent a material item in the Solvency II balance sheet and its separate quantification may be desirable for the purpose of risk assessment;
- the identification of EPIFP, and their eventual treatment, is very significant to Solvency II and does not undermine its economic approach.

Supervisory representatives see merits in the inclusion in an annex to the report of the outcome of the side discussions held during the meetings of the task force, as valuable and factual information on the arguments in favour and against the assessment of the tiering principles to the amount of EPIFP: therefore.

A. Nature and definition of Expected Profits arising from Future Premiums

Part of the difficulty in the discussion on EPIFP stems from the use of different concepts in the public debate. The mix between Solvency I and Solvency II concepts, as well as regulatory solvency principles and shareholder value notions is not helpful in understanding Solvency II and the concept of EPIFP: many of the terms would not necessarily be valid or meaningful in the upcoming framework of Solvency II. Therefore, a major aim of the Task Force is to clarify the meaning of EPIFP in a Solvency II context.

Only once a common understanding of the element has been achieved, informed decisions can be made with regard to its relevance in Solvency II and, eventually, its treatment for prudential purposes.

It is useful to remind readers of some key basic concepts of Solvency II:
- The Solvency II balance sheet includes the economic valuation of technical provisions, where all future cash flows (in and out) relating to existing business are included in the calculation of the Best Estimate. The Best Estimate takes into account the expected future cash-flows within the boundaries of the contract.
- The SCR is intended to reflect the unexpected risks that undertakings are exposed to. It does so by means of measuring possible adverse

changes to the Solvency II balance sheet in the event that various risks eventuate.
- Both technical provisions and SCR are being calculated on a going concern basis (Recital 55, Articles 75 and 101 of the Directive).
- The SCR should be covered by a sufficient quantity and quality of own funds, on a going concern and winding-up basis (Article 93).

The abovementioned key basic Solvency II concepts are known by supervisors and industry, but the implications of these concepts still need to be clarified to allow for them to be fully taken into account in the risk management practices of undertakings. In light of the importance of the Pillar II requirements in Solvency II, which place an important emphasis on the risk management practices of undertakings, the administrative, management or supervisory body of undertakings must fully understand the Solvency II framework in order to make informed decisions about risk management.

EPIFP are derived from the calculation of the Best Estimate and form part of the own funds, by being included in the reconciliation reserve. The reconciliation reserve is the amount of excess of assets over liabilities that remains once all identified elements of the own funds have been deducted. In this sense, the reconciliation reserve is a balancing item.

1. Definition of EPIFP

Based on QIS5, the following definition of EPIFP has been put forward:

*"Expected profits included in future premiums (EPIFP) are **profits** which result from the inclusion in technical provisions of **premiums** on **existing (in-force) business** that will be received in the future, but that have not yet been received."*

where highlighted concepts have the following meaning:

- **Existing business**: Existing business as defined by contract boundaries. The valuation of technical provisions will include all cash flows related to commitments arising from existing business. The width of the contract boundary can have a significant impact on the amount of the EPIFP. The contract boundary definition is being clarified in the implementing measures and by a future technical standard.

- **Future premiums**: Premiums of insurance contracts[2] that are expected to be received, i.e. future inflows of premium, not yet paid-

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[2] This report builds on a definition of premium of insurance contract in the context of Solvency II. Premiums on insurance contracts exclude asset management charges on savings-style contracts and similar other expected in-flows.

in[3] pursuant to the terms of the insurance contracts. The reference is made to an amount resulting from those expected premiums, which are being considered as probable future inflows in the calculation of the technical provisions. Future premiums are to be distinguished from already paid-in premiums, such as single premium contracts where the premium has already been paid, or multi-premium contracts where some premiums have already been received.

- **Profit:** The excess of expected future inflows over expected future cash outflows[4] related to insurance contracts, i.e. the expected (positive) margin of the insurance undertaking entailed in insurance contracts. An insurance contract could instead entail a loss, which does not imply a situation of loss making business but may be due to e.g. initial design, marketing reasons, or circumstances that materialize during the life of the contracts but not yet known at its launch; however the expectation of a loss should not usually be the case at inception of a contract since insurers expect to write profitable business.

Industry representatives in the Task Force proposed an alternative definition (and hence a re-stated acronym) to avoid the use of the word "profits" given that it is net cash flows which should be taken into account, and because of the baggage that such a word carries in the context of the public debate, and the associated confusion created. The industry proposes the following alternative definition of ENCFAFP:

"*Expected net cash flows attributable to future premiums (ENCFAFP) are **net cash flows** which result from the inclusion in technical provisions of premiums on existing (in-force) business that are expected to be received in the future, but that have not yet been received*."

where "net cash flows" has the meaning of:

- **Net cash flows:** The excess of expected future cash inflows over expected future cash outflows, taken at a particular point in time. This amount could be either positive or negative. Where the amount is negative, it does not necessarily imply a situation of loss making business but may be an expected occurrence based on the design and cash flow pattern of the product portfolio for these selectively isolated amounts of future cash in-flows which are expected future premiums,

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[3] For the sake of simplicity, consistently with definition used for the calculation of best estimates within the context of Solvency II, we refer in this paper to "paid-in" premiums to indicate both the premiums "paid" as well as those that "already become due" but were not effectively paid by the policyholders, so that a credit towards policyholders is recognized in the balance sheet. "Future premiums" therefore are other than those "paid in".
[4] These cash flows should be net of reinsurance as well as shareholders tax. See chapter on calculation methods.

while the meaning of "existing business" and "future premiums" would be the same as above.

Example to illustrate EPIFP

The following simplified example may help to clarify the notion of EPIFP:

An undertaking underwrites an insurance contract: the amount of premium(s) to be received over time is 18, with a net present value of future cash inflows of 15 and an estimated liability towards the policyholder (i.e. net present value of future cash outflows) of 10; there is no initial payment (i.e. all premiums are "future premiums") so the amount of assets is zero.
In Solvency II, the Best Estimate takes into account the cash in-flows and out-flows of the insurance contract. In this case the best estimate would be 10-15= -5 giving rise to a negative Best Estimate. The own funds, valued by the excess of assets (=0) over liabilities (=-5) is in this case 5 = [(0-(-5))].

The Solvency II undertaking's balance sheet in this simplified example looks as follows:

Assets	Liabilities/Own Funds	
0	5	*Own Funds:* (EPIFP)
	-5	*Liabilities:* Best estimate (10-15)

It is important to underline that the theoretical example as above has the sole purpose of clarifying the point. In particular:

- an insurance undertaking would normally have underwritten more than one contract;

- an insurance undertaking would normally hold some assets in relation to its activity;

- EPIFP do not identify negative best estimates per se. See also section on calculation methods.

Level of aggregation

A further point with regards to this definition relates to the aggregation level at which the "profits" (or positive net cash flows) should be calculated.

The amount of profits referred to in EPIFP may vary significantly according to the level of granularity of the calculation – potentially also giving rise to a

loss. Depending on the increasing level of granularity of the calculation (i.e. at single contract level, at homogeneous group of risks level, at legal entity level, at group level) an increasing range of offsetting between in- and outflows is being allowed.

Annex 1 shows an example to illustrate the impact of the level of granularity of the calculation: the amount of EPIFP calculated for the two different contracts 1 and 2 varies from 15 to 20 depending on whether the two contracts belong to the same homogeneous risk group or belong to two different homogeneous risk groups.

In QIS5 the calculation of EPIFP was performed at homogeneous risk group level, in line with the calculation of Best Estimates according to Article 80 of the Solvency II Directive. This was considered as a viable solution both for materiality reason as well as for consistency of calculation, whereas in principle the calculation should have been carried out at contract level.

Industry representatives in the TF agreed that the calculation itself should be done at the level of the homogeneous risk group but the total EPIFP / ENCFAFP should be the sum of all homogeneous risk groups, allowing for a wide offsetting of positive and negative cash flows (legal entity level/group level).

2. Conceptual clarifications on EPIFP, MCEV, VIF and profit at inception

To understand the definition of EPIFP in the Solvency II framework, it is useful to compare the notion of EPIFP to other existing concepts and to distinguish the concepts and their purpose. This should help also avoiding further confusion resulting from the use of different concepts as it happened in several past discussions and publications.

In general, it can be pointed out that under current accounting practices (local GAAP, IFRS), traditions and model design differ and usually no such amount is identified separately by the undertakings (i.e. the whole future profits relating to both past and future premiums are identified, not specifically the profits related to future premiums).

"EPIFP is not EV/EEV/MCEV[5] because…"

EV/EEV/MCEV[6] (Embedded Value/European Embedded Value/Market Consistent Embedded Value) is being calculated by undertakings to express

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[5] EV, EEV and MCEV refer to the same concept, but they differ for some financial assumptions not relevant for the purpose of this paper.

the shareholder value of the entire insurance business, this is the insurance company/group, including all its legal entities. The value is limited to the existing business; this is excluding the value of the potential to write new business.

MCEV is being calculated as the sum of ANAV and VIF, with ANAV (Adjusted Net Asset Value) being valued under the accounting framework in a given country and VIF, which is being described hereunder.

Direct comparison between EV/EEV/MCEV and EPIFP is difficult, as the former are shareholder value concepts, whereas EPIFP does not attempt to attribute the value it measures.

However, ignoring the issue of attribution, the current concept of EV/EEV/MCEV is **much broader** than the concept of EPIFP, due to the difference between EPIFP and VIF as mentioned hereunder, as well as the ANAV; in addition, the EV/MCEV includes the value of terminated contracts not yet paid out to shareholders via dividends, which are not included in VIF nor in EPIFP.

"EPIFP is not VIF because…"

VIF[7] (Value In Force) reflects the difference between the economic value of the in force insurance business to the shareholder and its net asset value under the accounting framework (in particular with regard to the technical provisions), in relation to all existing business of an undertaking (i.e. it arises from expected future premiums as well as from premium that are already paid in).

VIF illustrates the release of prudent margins currently held within the liabilities in the statutory accounts, for whatever reasons they are due to. For

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[6] The definition of MCEV (according to the CFO Forum Market Consistent Embedded Value Principles) is as follows:
MCEV represents the present value of shareholders' interests in the earnings distributable from assets allocated to the covered business after sufficient allowance for the aggregate risks in the covered business. The allowance for risk should be calibrated to match the market price for risk where reliably observable. The MCEV consists of the following components:
- Free surplus allocated to the covered business
- Required capital; and
- Value of in-force covered business (VIF).
"The value of future new business is excluded from the MCEV."
[7] The CFO Forum Market Consistent Embedded Value Principles defines VIF as follows:
"The value of in-force covered business (VIF) consists of the following components:
- Present value of future profits (where profits are post taxation shareholder cash flows from the in-force covered business and the assets backing the associated liabilities) (PVFP)
- Time value of financial options and guarantees
- Frictional costs of required capital
- Cost of residual non hedgeable risks as defined in Principle 9."

example VIF might arise for future profits or because local technical provisions are not being discounted.

The value of VIF depends therefore on the accounting framework in force in a country and on the related valuation criteria of technical provisions: VIF can therefore be particularly significant in those countries where technical provisions are currently calculated according to local GAAP based on historical cost (not market consistent).

Solvency II introduces a best estimate calculation of the technical provisions which means that, should methodology and assumptions between the calculation of VIF and Solvency II be the same, the amount of VIF should in theory be eliminated since no additional prudence would be being built-in into the calculation of the technical provisions.

The concept of VIF however will remain where accounting frameworks adopt a more prudent calculation of the technical provisions than the calculation used under an economic, or best estimate, approach[8].

Allowing for the possible differences in attribution described above, the concept of VIF is therefore by definition **much broader** than the concept of EPIFP, since EPIFP may arise <u>only from</u>:
- future premiums, and not from premiums that are already paid in;
- future premiums within the contract boundary as set in Solvency II, which may be narrower than the future premiums included in VIF;
- profits inherent to the future premiums. Other possible sources of VIF such as the discounting of technical provisions, do not give rise to EPIFP.

Whilst the concept of VIF is by definition much broader than EPIFP, the amount of VIF might not be as such. The amount of VIF is dependant on the amount of prudence included within the accounting technical provisions (which varies in different countries) whilst the amount of EPIFP is not.

"EPIFP is not Profit at Inception because…"

Accounting rules (IAS/IFRS) are likely to require the calculation of an item which is similar in concept to that of expected profits, however as a whole: a "residual margin" is being added to the Best Estimate and Risk Margin (to compose altogether the technical provisions).

It should be noted that the IAS/IFRS accounting framework related to insurance contract has been under construction (Phase 2) since several years, so some concepts in the time have changed name and nature,

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[8] In this regard, it has to be noted that the calculation of VIF might not be affected by the entry into force of Solvency II, since Solvency II will not affect the accounting framework applicable in Member States.

sometimes substantially. What was known vividly as "profit at inception"[9] has turned into a "residual margin"[10]. The Task Force thinks it is more useful to speak about "residual margin" since this is the most up-to-date concept; possible refinements in the definitions in IAS/IFRS framework should require further investigation.

A residual margin arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows[11].

The residual margin under IAS/IFRS is meant to eliminate any gain at inception of the contract. Should any loss arise from the abovementioned difference (i.e. expected present value of the future cash outflows plus the risk adjustment exceeds the amount the expected present value of the future cash inflows), the amount should <u>not</u> be considered as a negative residual margin within technical provisions but should immediately be considered as a loss/expense in the profit & loss account.

The main differences with EPIFP are the following:

- The IFRS 4 (Phase 2) Exposure Draft does not require differentiation in profits coming from past written premiums and those coming from future premiums, so it is a whole profit, that can be related also to paid-in premiums. For instance, according to the Exposure Draft, an insurer shall recognise the residual margin locked-in at initial recognition as income in profit or loss over the coverage period in a systematic way that is not linked to the changes in the amount of future premiums;

- According to the IFRS 4 (Phase 2) Exposure Draft, the residual margin relative to future premiums would not be recalculated in the subsequent years: the amount would be "locked-in", i.e. it is calculated at the inception of the contract and it is amortized over the coverage period of the products and the remaining future profit relative to future premiums is not separately identified and isolated. The amortisation would be done on the basis of the passage of time or on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

EPIFP and the IFRS residual margin can be seen as similar in concept. As per the amounts, EPIFP and IFRS residual margins would be expected to be similar figures at time zero prior to any premiums being received, i.e. the amount of the EPIFP would be equal to profit at inception/residual margin only at the inception, before any premium is paid-in, assuming that the same premiums are included, that no premiums are yet paid-in and that the same

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[9] IASB, insurance contract Discussion Paper, dated May 2007
[10] IASB, insurance contract Exposure Draft dated July 2010
[11] This might happen also in case of a single premium contract already paid in.

contract boundaries would apply, and the same assumptions would apply both under IFRS and in Solvency II. Then, while the residual margin is amortized (not recalculated) the current QIS5 methodology for the calculation of EPIFP links the amount to the future premiums not yet paid in, so it envisages that EPIFP are identified and recalculated at each closing date depending on the estimate of the future premiums, which can vary over time.

B. Calculation method for EPIFP

The methodology should reflect the definition of EPIFP while allowing for a straightforward calculation. The calculation method should reflect a market consistent approach, but at the same time will necessarily be an approximation to ensure that Solvency II is not unduly complex in this respect.

A sufficiently simple calculation method should be found to ensure the proportionality of the calculation method.

The Task Force investigated several possible methodologies, including related proxies. The starting point was the QIS5 methodology in order to deal with, and possibly overcome, the difficulties that were highlighted during the QIS5 exercise.

1. QIS5 Calculation method

Description of the methodology

The QIS5 methodology aimed at estimating EPIFP as the difference between two technical provisions through a simplified process composed of three steps, i.e.

> **Step 1)** taking into account the Best Estimate calculation already computed;

> **Step 2)** calculating a new Best Estimate under the assumption that no more premiums were to be received in the future, assuming that other assumptions would be unchanged. In this calculation, policies were to be treated as paid-up (i.e. no more premiums are received but policies continue to be in force) rather than being considered as surrendered (i.e. policies lapsed, no longer in force);

> **Step 3)** Making the difference between amounts calculated in step 2 and in step 1 for homogeneous risk groups (level of granularity) as in Best Estimate, and taking into account the positive differences only (i.e. only

profitable homogeneous risk groups, those where the difference was positive).

For the purpose of the calculation of the Best Estimate, and the computation of the EPIFP, contracts are being grouped on a homogeneous risk basis according to the Level 1 principles, which allows for an off-setting of expected profit and losses in future premiums within homogeneous risk groups, but not across the whole portfolio of contracts.

The methodology was applicable to life and non-life business.

The methodology was intended to be a simplified calculation – a proxy[12] - based on existing/similar calculations already in place for QIS5 purposes.

In order to clarify this point, the following notation may be helpful:

(1) *Best estimate = Present value outflows – Present value future premiums*

where we might split:

(2) *Best estimate = PV_outflows_due_to_paid_in_premiums + PV_outflows_future_premiums - PV_future premiums*

and then
Best estimate - PV_outflows_due_to_paid_in_premiums = PV_outflows_future_premiums - PV_future premiums

where the second part of the expression *(PV_ outflows_future_premiums – PV_future_premiums)* reflects the accurate calculation of EPIFP, while the first part of the expression *(Best estimate - PV_outflows_due_to_paid_in_premiums)* is precisely the formulaic reflection of QIS5 method.

Then, one can conclude that the paid-in method is a proxy which delivers fully consistent results to estimate EPIFP.

The aim of the methodology is to quantify the amount of expected profits (i.e. positive amounts only, as in step 3) arising from the inclusion of future premiums (i.e. those not already paid in) within the contract boundary. This is why it was considered appropriate to apply the paid-up scenario in Step 2 to all contracts including those where a paid up assumption is not possible.

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[12] It is essential to clarify that the method applied in QIS5 to calculate EPIFP **is a proxy** that provides quite approximate results to a full calculation of EPIFP. Since QIS5 method is a shortcut then it should not be analyzed as if it faithfully reproduced the overall conceptual framework and assumptions underlying the calculation of EPIFP. In other words, an analysis limited to the shortcut and its underlying methodology lacks sense, if not completed with an adequate focus on the real final target.

Feedback to the methodology arising from QIS5

Feedback from QIS5 showed that the calculation method was not fully clear and the calculation was considered to be burdensome by industry participants.

The Task Force acknowledges that during QIS5, identifying this component was challenging and the significance of the amount, as a percentage of own funds, varied between companies. To ensure that Solvency II is not unduly complex, this needs to be addressed.

When Solvency II enters into force it is expected that the undertakings would have adapted their systems to produce these numbers more accurately, so the burden for industry should be materially reduced. Simplifications in the calculation method for identifying EPIFP in order to address issues which arose during QIS5 (or possible alternative methods) could contribute to reducing the burden for industry.

Furthermore, the industry pointed out that if EPIFP were to be calculated, it must be representative of the realities of the insurance business. It must be possible to apply the methodology consistently across all Member States.

The overarching concern raised by industry participants in QIS5 was based on the statement that the calculation method should reflect the economic reality of the business. Hereunder, the main objections are being summarized, whereas a more detailed explanation is illustrated in Annex 2.

- *"The paid-up assumptions are artificial"*
- *"The additional calculation of the Technical Provision (see step 2) is burdensome"*
- *"The distinction between life and non-life business is not sufficiently captured"*
- *"The calculation should not consider profitable business only (step 3)."*
- *"The impact of reinsurance and of net deferred taxes is not appropriately taken into account."*

2. Proposals for revising the methodology of calculation of EPIFP

Proposal 1: improvement of QIS5 method based on paid-up assumption

There were a number of practical difficulties raised with the QIS5 methodology for the calculation EPIFP as outlined in the QIS5 technical

specification. The QIS5 Q&A attempted to deal with some of these issues and the task force has built on this to provide some possible solutions to the key practical issues raised. The points mentioned below refer to step 2 of the calculation, where it is felt there is a wide range of available simplifications to streamline the calculation required in this step:

- For short term contracts, such as short term assurance contracts, or short term non-life contracts in the calculation of the EPIFP it may be reasonable to assume that the contracts lapse rather than become paid up, provided that lapse values do not contain material reduction or penalties that may exaggerate the amount of EPIFP. This could also be the case for contracts under which a paid-up scenario is not contractually possible.

- A change in reinsurance asset should be captured in a comprehensive assessment of the Expected Profits in Future Premiums. This reflects the fact that the reinsurer's profit margins do not form part of the direct insurer's Solvency II balance sheet.

- A simplification (where the paid up assumption is not possible) to determine the correct allocation of profits to future premiums could be to allocate profits to premiums on a pro-rata basis based on the proportion of premiums received. In some cases this could be simplified to merely changing the present value of benefits by pro-rating down in relation the premiums received.

- For SLT (Similar To Life) health insurance business, EPIFP could be calculated by applying the following steps: assume a change of all policyholders to a tariff with reduced benefits where all future benefits are paid by the provisions that have been accrued. This approach would exclude exactly the amount of future profits that are related to future premiums but would consider those relating to past premiums.

- A change in deferred shareholder taxes should be captured in a comprehensive assessment of the Expected Profits in Future Premiums. In particular, in the case that technical provisions increase in a scenario of no future premiums, the deferred tax liability would be expected to reduce (or equivalently deferred tax asset increase).This reflects the fact that the amount of tax paid is dependent on the receipt of the profits in the future premiums.

- With respect to charges on savings contracts, the paid-up scenario refers to excluding future premiums rather than future charges , and as such future charges should not form part of EPIFP except those future charges that were earned on future premiums

- Some further simplifications may be required for the EPIFP calculation for participating business. Further guidance may be provided in the Level 3 guidelines.

PROs:

- The methodology is simple, and clearer than in QIS5.

- The methodology is dynamic

- The methodology captures an amount close to the QIS 5 definition of EPIFP

- Current concerns related to models not being able to calculate the paid up amount could be overcome in the future: when Solvency II enters into force it is expected that the undertakings would have adapted their systems to produce these numbers more accurately

CONs:

- Even though the methodology does not aim at assessing the change in basic own funds under a "paid-up scenario" (but only to determine the amount of future profit included in cash-flow), the point on artificiality might still be an issue. Some contracts actually are not subject to paid-up; so currently some models might not allow for this calculation. This might be particularly relevant form some kind products/countries (German/Swiss products with significant profit-sharing mechanism).

Proposal 2: based on SCR mass lapse risk scenario

A similar methodology as set in QIS5 (i.e. EPIFP = differences between two different BE calculations, one Best Estimate and the other under stressed circumstances) but instead setting up a different scenario to be used in step 2 of the calculation, so to ease the burden of calculation.

A new stressed scenario for the proposed methodology could be elaborated on the basis of the same methodology used for the SCR mass lapse risk submodule, with an adapted calibration.

The adapted calibration should take into account:

- the purposes of the calculation (i.e. quantify EPIFP, not increasing SCR lapse)

  The SCR lapse risk charge under QIS5 is not meant to calculate EPIFP but instead to reflect the risk related to the receipt of future premiums if contracts were to lapse, i.e. in the holistic Solvency II Framework, uncertainty around the mean relating to the cash-inflow of expected future premiums. The calibration as tested in QIS5 aims to represent a 1 in 200 scenario for this specific risk. So, for the limited purpose of approximating EPIFP, the % used in QIS5 SCR mass lapse charge could be appropriately scaled up.

- an adjustment, for SCR lapse methodology takes into account also premiums already received and not only future premiums, as for the definition of EPIFP. So, for the limited purpose of approximating EPIFP, the % used in QIS5 SCR mass lapse charge could be appropriately diminished.

Under the approach, the amount of the SCR mass lapse risk charge is used as a proxy of EPIFP, subject to the application of a "k" factor, where "k" could either be set at a fixed level or could be a parameter set on the basis of the portfolio structure of the undertaking/group. In the latter case, the assumptions for setting the parameter should be explained to (and challenged by) supervisors.

The fixed level could be for example k = 2, which would mean that the 30% mass lapse module (for retail business) would instead be replaced by a 60% mass lapse module. Note that in the special case where k = 1, the estimated amount will be the exact amount of the SCR mass lapse module.

Possibilities for setting an appropriate value of "k" could be examined.

PROs:
- The methodology is simple
- The methodology is consistent with Solvency II SCR calculation (not new)
- The methodology is dynamic
- Contrary to the paid-up scenario, the methodology takes into account not only premiums but also related claims and variable expenses

CONs
- There is a need for setting a "k" factor: if "k" s a fixed parameter, it needs to be developed at EU level either in % or as a formula; if it is entity specific, this would require supervisory assessment in a way as other parameters: need for L3 guidelines or for standards.
- The methodology might be interpreted as increasing the SCR lapse charge. This should require clear explanation on the purposes of the calculation, i.e. the quantification of EPIFP, which is not to be confused with quantification of SCR lapse which is done somewhere else.
- The methodology is weakly related to the QIS5 definition of EPIFP

Proposal 3: based on profit margin percentage

Future profits are estimated as whole on the basis of a profit margin percentage applied at the inception of the insurance contract, likely on the basis of the profit test that insurance undertakings perform before the launch of a new product. The amount of future profits calculated as a whole at the inception of the contract is then released over time, further to premiums being paid-in as well as to other movements in the contracts.

A full assessment of how the amount is released over time would require considerable effort in calculation. The methodology hereby envisages a simplified method to release profit over time (see formulae 3 or 4 in annex 3). The method for ensuring the release might be further tailored, for example by sophisticating the "speed" of the release of profits. However it is to be noted that there is a trade-off between accuracy and simplicity of application.

Since the methodology would be applicable to new products only (i.e. the amount is calculated at inception), the methodology would require as well a sort of "first time adoption" calculation of future profits embedded in premiums to be received related to already existing contracts at the moment of the switch to Solvency II. Once this amount is quantified, it should then be considered for further release together with the amount related to new contracts as described above. The methodology envisages a simplified "first time adoption" calculation (see annex 3, formula 1), which would be done differently according to the valuation of Technical Provisions under Solvency I.

This approach presents some similarities - but is not equal - to the accounting treatment of residual margin based on the IFRS, which is still under development further to the issuance of the Exposure Draft in 2010 (see relevant section in this paper).

It is to be noted that releasing over time a whole profit calculated in advance is a way of approaching the same issue of EPIFP but in quite a different way than in QIS5. Therefore, if this method is to be adopted, there might be a need to refine the definition of EPIFP as it was set in QIS5 or to set an appropriate % to have it referred to future premiums only.

PROs
- The methodology is quite simple
- The methodology would not be an incentive/disincentive for some kind of business (single premium v. regular premiums). This because the methodology does not distinguish between the two and so it would not

create additional burden even if a specific prudential treatment (be it Pillar 1 either Pillar 2 either Pillar 3) is given to EPIFP..

CONs

- The amount calculated is static, i.e. is in principle related to the moment of the launch of the product. Further degrees of sophistication in the release of profits might be reached at the cost of a more difficult calculation

- The methodology is weakly related to the QIS 5 definition of EPIFP, i.e. it starts calculating profits at inception which are then to be adapted to those premiums not yet paid-in by way of releasing profits over time

Proposal 4: based on surrender values

This method is based on the comparison of the surrender value with the value of the best estimate liability, either at a policy level or at homogenous risk group level. This gives a very simple way of calculating an approximation to EPIFP as a difference between the two Best Estimates amounts by looking at the amount of future profits that could not be recovered if a policy was discontinued immediately.

It is to be noted that there is a view that this approach would not introduce a surrender value floor on the best estimate liability or a winding-up valuation (Solvency II valuation is based on a going concern basis), since the approach, should it be adopted, would only serve the purpose of approximating the amount of EPIFP.

PROs

- The methodology is simple

- The methodology would not be an incentive/disincentive for some kind of business (single premium v. regular premiums). This because the methodology does not distinguish between the two and so it would not create additional burden even if a specific prudential treatment (be it Pillar 1 either Pillar 2 either Pillar 3) is given to EPIFP.

CONs

- The methodology might give the wrong idea that surrender value is introduced in the best estimate. This should require clear explanation on the purposes of the calculation, i.e. the quantification of EPIFP, which is not to be confused with the calculation of best estimate. This because otherwise the approach would conflict with the assumptions for the evaluation of technical provisions in the Level 1 text (i.e. transfer value).

- The methodology does not restrict EPIFP to profits earned on future premiums, but includes future profits on premiums previously paid

- The methodology is weakly related to the QIS 5 definition of EPIFP

Proposal 5: based on negative best estimates

This method starts from the assumption that the best estimate can be decomposed between:

- The present value of future cash inflows (premiums); and
- The present value of future cash outflows (e.g. claims, expenses).

The value of EPIFP would be approximated as the difference, where positive, between the former component and the latter, either at a policy level or at homogenous risk group level. This gives a very simple way of calculating an approximation to EPIFP in a more realistic manner, i.e. without making assumptions regarding the lapsation of policies.

Note that, for contracts whose period of coverage has not started, the EPIFP will reflect the amount of profit at inception (which is equal to the negative amount of its best estimate). On the other hand, contracts where the full premium has already been paid will correspond to an amount of EPIFP of zero, acknowledging that the remaining obligations will not yield any additional expected future profit to the undertaking.

This method will give a similar outcome as if one were comparing the best estimate of the real policy with that of a 'profit zero' policy (i.e. one where the amount of premiums received will correspond exactly to the amount of cash outflows[13]), both under a going-concern perspective.

PROs

- The methodology is simple and does not require extra calculations from the undertaking
- The methodology would not be an incentive/disincentive for some kind of business (single premium v. regular premiums). This because the methodology does not distinguish between the two and so it would not create additional burden even if a specific prudential treatment (be it Pillar 1 either Pillar 2 either Pillar 3) is given to EPIFP.

CONs

- Conceptually, the methodology does not capture EPIFP to its full extent, but only the residual part which is not netted by any expected losses. It will exclude policies with positive best estimate liabilities which could still have a best estimate liability that would otherwise be higher if the policy were to stop paying premiums.
- The methodology does not restrict EPIFP to profits earned on future premiums, but includes future profits on premiums previously paid
- The methodology is weakly related to the QIS 5 definition of EPIFP

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[13] Note that, for contracts whose period of coverage has not started, the best estimate of a 'profit zero' policy would be zero.

Conclusions on methodology of calculation

The Task Force would retain proposal 1 as a practicable approach based on a proxy simple to understand.

The Task Force however sees merits also in exploring the possibility to allow the use of alternative methods as set above for the calculation of EPIFP based on the application of a proportionality principle as well as on the pros/cons of methodologies illustrated above. The choice of methodology would be supported by adequate reasoning.

This flexible approach might provide a better treatment depending on the nature and characteristics of each portfolio and would minimize the burden of the calculation, to the extent that each undertaking will benefit from the method better fitted, for example, to the manner it calculates its technical provisions.

ANNEX 1 – Illustration of Expected Profit In Future Premiums (EPIFP) item

This illustration includes a number of simplifications to make the example easy to understand. For example, there is no discounting or risk margin included in the example.

Contract 1 is a profit making contract (EPIFP =20) while contract 2 is a loss making contract (EPIFP=5) .

The QIS5 methodology was based on the methodology of adding together the EPIFP's of contracts within the same Homogeneous Risk Groups and setting this to 0 at this level of aggregation if the EPIFP is less than 0.

If we assumed that the contracts in example 1 and example 2 are in the same Homogeneous Risk Group then the EPIFP = 20 – 5 = 15. If the contracts are assumed to belong to different Homogeneous Risk Groups then the EPIFP = 20 + 0 = 20.

The level of aggregation has been debated within the Task force and the views vary from assuming no cross subsidizing of profits and losses between individual policies to cross-subsidizing to the level of the entity.

**Example 1 – A contract that is expected to be profitable**

The key features of this contract are:
- 3 premiums still to be paid of 50 each
- a benefit payment at maturity of the contract of 130

Contract 1 - Cash flows
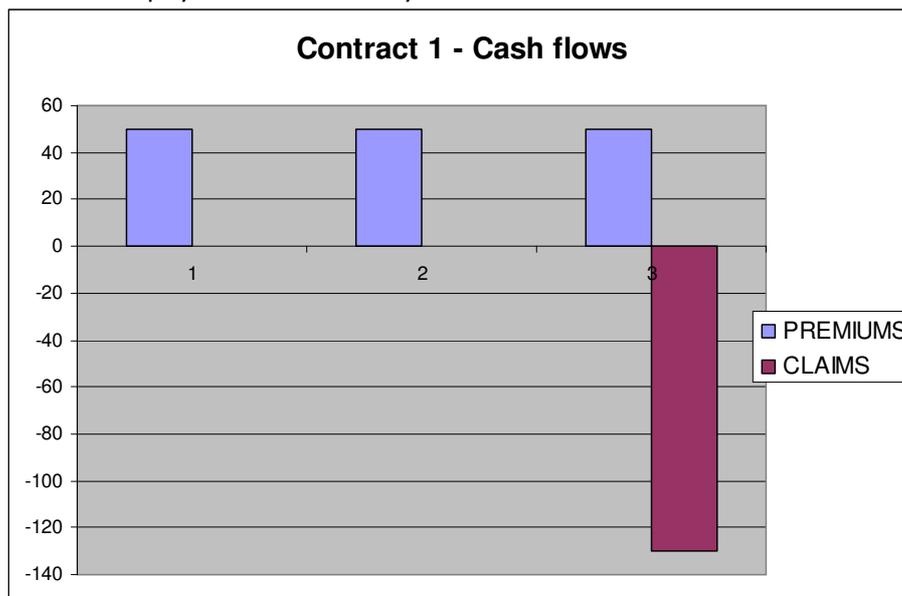
Stage 1 is to determine the Technical Provision of the contract. The Best Estimate of the technical provision for this contract is 130-50-50-50= -20

Stage 2 is to consider an alternative scenario for the contract under which no future premiums are paid. Excluding the premiums is likely to have an impact on the benefit to be paid. We observe that if no future premiums are paid, a benefit of 20 is paid on maturity, built up based on premiums already paid.


Contract 1 - Cash flows excluding future premiums
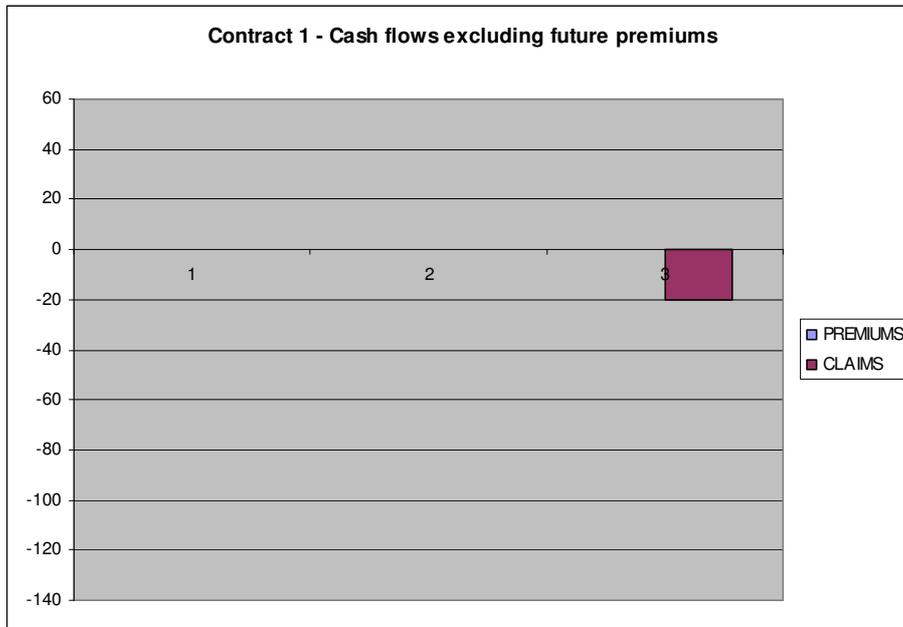
The Technical Provision = 20.

Stage 3 is to use the information from Stage 1 and Stage 2 to determine the EPIFP. This is determined as 20 – (-20) = 40.

One possible illustration of the allocation of the profit to individual premiums is shown in the graph below:

Contract 1 - Cash flows with profit allocated to premiums
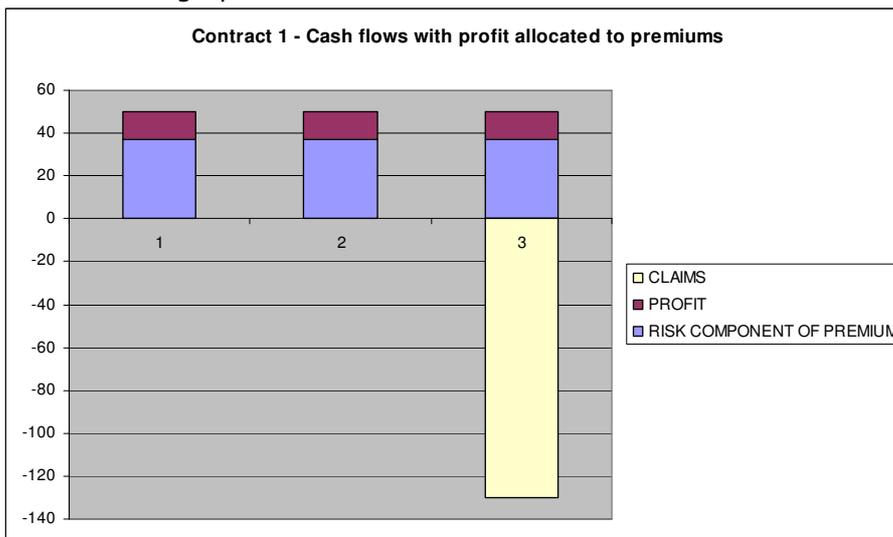
For background information it is also useful to consider how the technical provision for this contract would develop over time. For the purpose of this example, we take the technical provisions as the net present value of future cash flows at the valuation date. This shows that the net present value does not give an indication of profit itself, but shows if there is a net inflow of net outflow from the future cash flows.

**Contract 1 - Development of technical provisions**
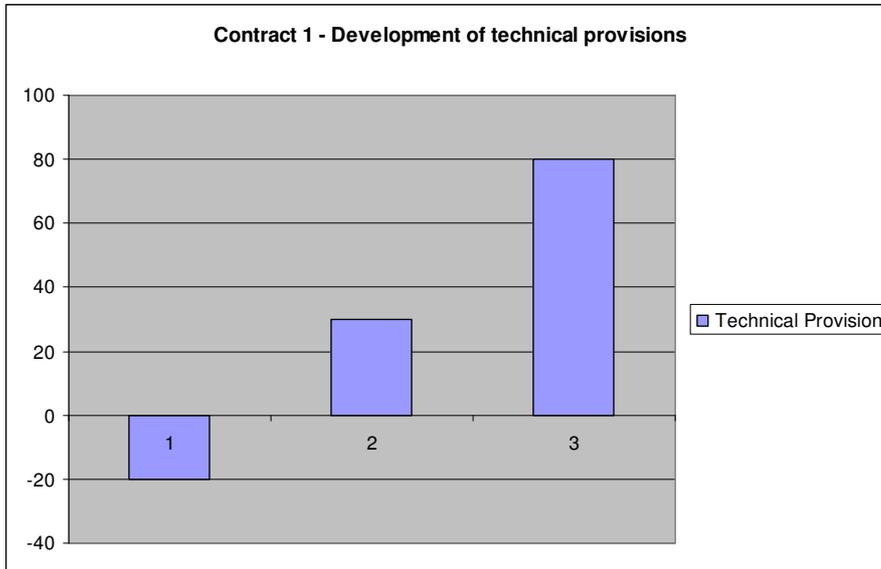
Now we can consider the technical provisions under the scenario without future premiums. We have not shown the development of the technical provisions under the scenario without premiums, because the cash flows of the scenario will depend on the valuation date. For example once the current premium of 50 due is paid, then the future benefit payment under the scenario without future premiums is unlikely to change. For the purpose of this example we are interested in the Expected Profits in Future Premiums at the valuation date.


Contract 1 - Technical provision at valuation date under scenario without future premiums
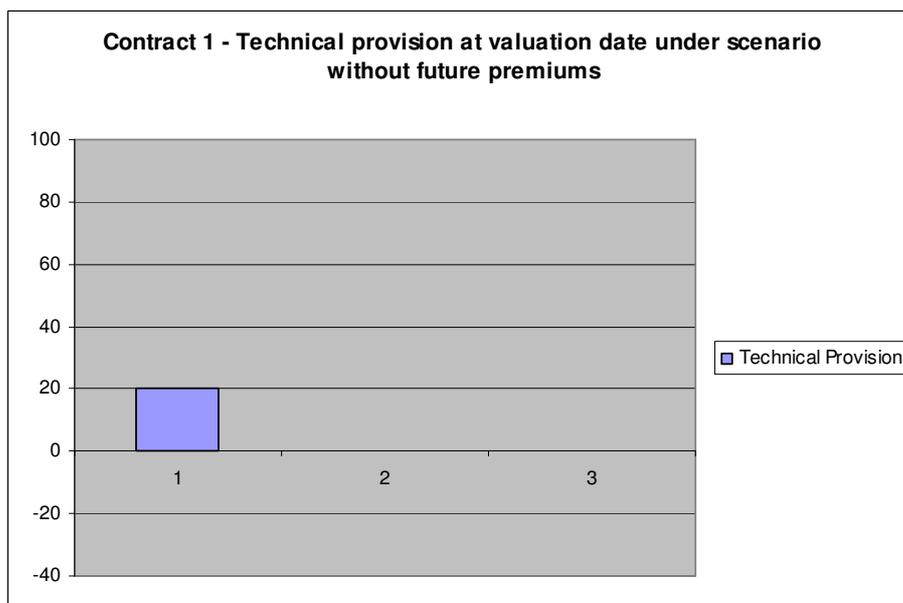
Example 2 – A contract that is expected to be loss making

The key features of this contract are:
- 3 premiums still to be paid of 30 each
- a benefit payment at maturity of the contract of 100
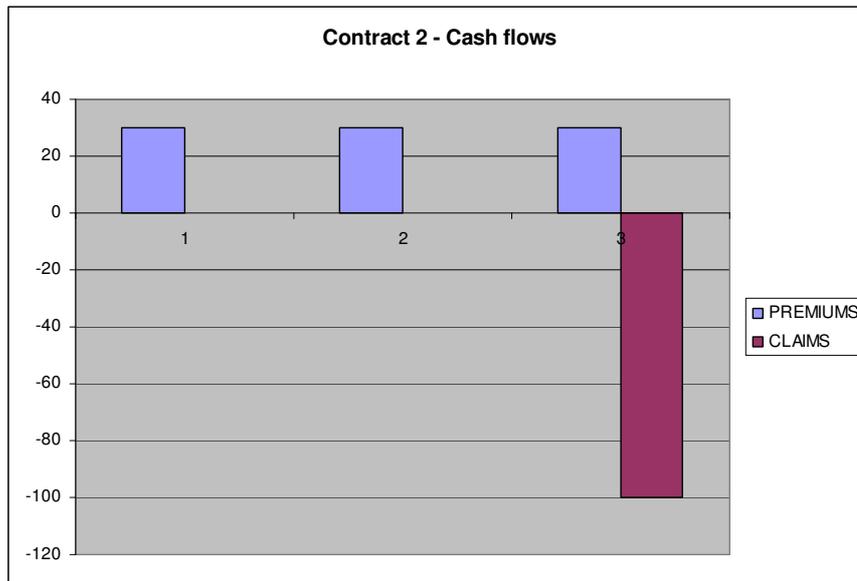
Stage 1, the Technical Provision is 100 – 30 – 30 – 30 = 10
In the scenario without Premiums the benefit is 5.
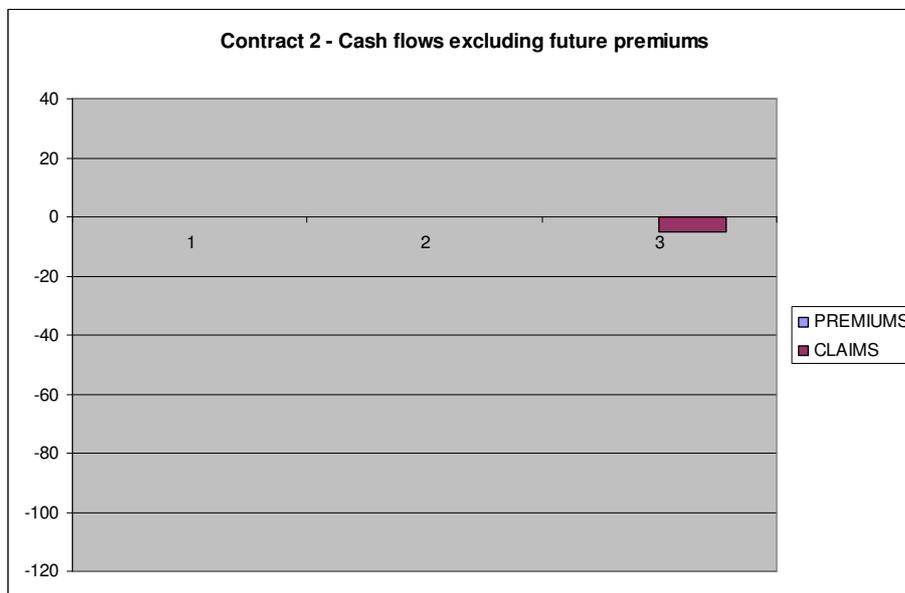
Stage 2, the Technical Provision under the scenario without Premiums is 5.
Stage 3, the Expected Profits in Future Premiums is 5 – 10 = -5

Annex 2 –main objections to the QIS5 methodology for assessing EPIFP and some related consideration

"The paid-up assumptions are artificial"

The use of paid-up assumptions was criticized to be very artificial by industry and, in some situations also impracticable due to the fact that models might currently not be designed to capture a full paid-up assumption, since contracts in place might not allow for paid-up situation or paid-ups might be immaterial in practice and therefore not modeled.

In addition, the scenario in step 2 (i.e. a paid-up assumption of premiums, with no other changes in other assumptions) was considered as not realistic/significant since assumptions about expenses/claims etc will also change in the scenario that no future premium are received. Profit sharing mechanisms were difficult to project out in an environment perceived as not realistic.

However, the issue of assumptions not being realistic should be carefully contextualized. Having in mind that this is a methodology used as a shortcut to assess EPIFP, actually the focus should be on the final outcome, considering whether such shortcut delivers an appropriately cost-accuracy balanced practical solution for the assessment of EPIFP.

"The additional calculation of the Technical Provision (see step 2) is burdensome"

The computation represents a full extra run in terms of regular computational requirements and also significant investment to adjust existing models to produce the required stresses. As a related point, the more contracts with regular premiums, the more burdensome the calculation will become. Moreover, should a different treatment be envisaged for EPIFP, this would create disincentives on business featuring recurrent/annual premiums, whilst creating incentives for business based on single premiums.

Also in this case, the issue of excessive burden should be appropriately contextualized. In most cases, the burden will depend on the state of the art of each insurer in its process of adaptation to Solvency II. Where such process has not been finalized, the addition of the calculation requested in step 2 does not seem to require a material additional burden above the general implementation of the whole project. Even for fully adapted systems, the implementation of QIS5 calculation methodology for EPIFP may require specific actions, but those actions will not likely have a huge scope and cost.

"The distinction between life and non-life business is not sufficiently captured"

The proposed methodology was not considered fit for non-life business, due to the different kind/structure of contracts and of premiums.

In this respect it could be noted that Solvency II project in general does not set out a separate overall framework for life, non-life and health insurance.
In the particular case of EPIFP, it is expected that for a major part of non-life business (i.e. annually renewable contracts), insurers do not need to calculate EPIFP, simply because they are nil. In the case of long term non-life insurance business with regular premiums, the conceptual framework around EPFIP seems applicable in the same manner as to life or health business.

"The calculation should not consider profitable business only (step 3)."

This issue raised by industry is closely linked with the definition of profits and the extent to which offsetting between positive or negative cash-flows should be permitted (see relevant section on definition).

"The impact of reinsurance and of net deferred taxes is not appropriately taken into account."

Although there was a common agreement that EPIFP should be net of taxes and of reinsurance, the details in the methodology were not clearly specified.

ANNEX 3 – calculation related to profit percentage

Assume that we are at time zero and that at this date the switch from Solvency I to Solvency II takes place.

At time t let us assume:

V : technical provisions, i.e. market-consistent value of liabilities (benefits - premiums)
R : statutory reserve (according to Solvency I)

We observe that in Solvency II, the negative value of V cannot be excluded. In normal circumstances this cannot happen for single premium policies, while it is a typical feature for periodic premiums policies at their inception and also in the early years of their lifetime.

Using the notation $V^+ = \max(V;0)$, we can define as "*Notional Future Premiums*" the following value:

$$NFP_0 = \begin{cases} R - P - V, \text{ for existing policy} \\ V^+ - V, \text{ for a new policy} \end{cases}$$
(1)

For an existing policy the NFP_0 value is equal to the *VIF – P (ie VIF less annual premium)*; while for a policy newly issued the NFP_0 value is equal to the profits at inception. To be noted that for an existing policy the (*VIF – P*) value is lower for the policies nearly to the maturity (almost nil) vice versa is higher for the policies younger.
The statutory reserve (=R) under Solvency I for undertakings whose TP are calculated based on historical cost in Solvency I (not market consistent); whether R (is already calculated under the market consistent valuation, then the sum of the premiums already earned could be considered as proxy of R,.

Provided that, we can define the "notional premium" as:

$$N_0 = P - \frac{NFP_0}{\sum_{k=1}^{n} v(0,k)}$$
(2)

where P is the periodic/annual premium, n is the number of remaining premiums and $v(t; t + k)$ is the risk-free discount factor prevailing on the market at time t for the maturity $t + k$.

Once calculated N_0, the values that an undertakings could taken into account as EPIFP on yearly basis are:

$$EPIFP_t = NFP_0 \frac{\sum_{k=t+1}^{n} v(t,k)}{\sum_{k=1}^{n} v(0,k)}$$

(3)

Or, in very simplified way (proxy), the undertakings could taken into account the following formula:

$$EPIFP_t = NFP_0 \frac{n-t}{n}$$

(4)

This calculation could be carried out at the same level of granularity used in the calculation of technical provisions or a suitable basis which delivers a sufficiently equivalent result.

Nevertheless, considering that the EPIFP's values should be calculated until when there are premiums not yet earned, the undertakings could define the model points built up with policies characterized by the same maturity (ie with the same n). In the next graph, we show you the EPIFP's trend during the lifetime.

Example. *Endowment policy with annual premiums.*
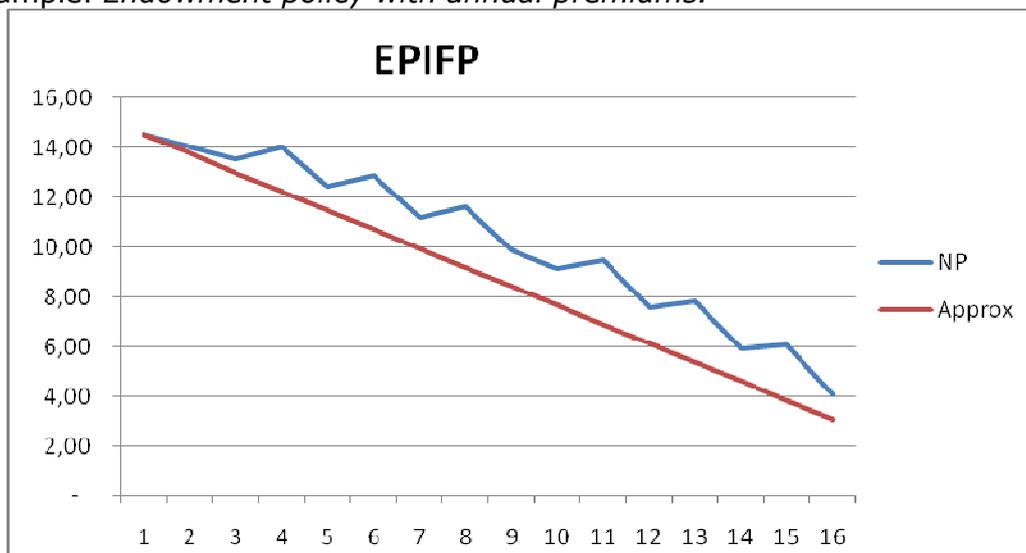
The graph shows the figures of an existing endowment policy with a positive VBIF at the valuation date. The EPIFP have been calculated with the method of "*Notional Future Premiums*" (formula 3) and with the proposed "Approximation" (formula 4).

Annex 4 – Why EPIFP should be calculated? Some considerations

Supervisors and industry disagree on the role of EPIFP, including its possible prudential treatment.

This annex tries to highlight the main concerns on the treatment of EPIFP in the context of Solvency II, with the purpose of clarifying as much as possible the different issues, in order to offer grounds for informed decisions to be taken in other fora.

Some Task Force members noted that there could be merits in including in the report also some elements that were discussed in the Task Force as side aspects; this, with the aim of addressing such issues for the purpose of enhancing common understanding of some related aspects to the core issue of EPIFP. Some other members considered this discussion as beyond the strict mandate of the TF and opposed to the inclusion in the final report.

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A simplified example for helping reasoning on the concerns

A simplified example may serve as an introduction. The example is based on the example explained in section B of the report:

Assets	Liabilities/Own Funds	
0	5	*Own Funds:* (EPIFP)
	-5	*Liabilities:* Best estimate (10-15)

In the example the SCR is set at 20. The undertaking issues shares (and receives 15 of cash) to cover this capital requirement. Below, the new balance sheet is depicted, which highlights the coverage of the SCR of 20 with a corresponding amount of Own Funds[14].

Assets	Liabilities/Own Funds	
15	20	Own funds
	-5	Liabilities

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[14] The example simplifies examples discussed during the meetings of the Task Force, for the purpose of ensuring the understanding.

If a 1-in-200 event would then happen affecting the contract written, the undertaking would find that it has a liability of 20, but finds it only has 15 of assets. In this example, the future premiums will not be received due to the occurrence of the event (this will be more true of life business as opposed to non-life).

However, it should be noted that insurance undertakings write large numbers of contracts as opposed to one. A key difference is that when the 1-in-200 event happens, not all future premiums are extinguished. Only those contracts directly related to the 1-in-200 event (especially those that terminate on pay-out) are affected.

The general concern in this situation is whether the SCR is being appropriately covered or not. This concern has been emphasized by CEIOPS position in its advice to the Commission on Level 2 implementing measures, where it was suggested to classify EPIFP as Tier 3 within Own Funds. That way – due to the limits with regard to the eligibility of Own Funds (Tier 2 as maximum 50% and Tier 3 as maximum 15% of Own Funds to cover the SCR) - any item included in Tier 2 or Tier 3 would not necessarily be fully allowed to cover the capital requirements.

Having set out the issue, some concerns and related arguments are listed below:

Potential for double counting of the risk related to future premiums

"The risk attached to EPIFP is taken into account through the probability weighted average of the Best Estimate and through the calculation of the SCR. Any attempt to address to limit the own funds arising due to EPIFP via tiering limits could result in a double counting of the risk. Either the SCR is calculated to cover for the unexpected risk related to a balance sheet item, or there is a tiering on the related Own Fund element, but both applied to the same elements would double-count the risk"

This concern is based on the general idea that under the economic approach of Solvency II, if there are risks associated with the valuation of an item in the balance sheet, then a capital requirement needs to be established via the SCR. The value of that item – which contributes to the value of Own Funds as all items do in an economic approach – should absorb losses relating to that specific item. If the value of the item is limited via the tiering in Own Funds, this could lead to a situation where a firm might be required to hold more own funds from holding that item than if that item would not exist , which might be counter-intuitive since the risk of any item is normally capped at its value.

This concern could be summarised as follows: either the SCR is calculated to cover for the unexpected risk related to a balance sheet item, or there is a tiering on the related Own Fund element. The two, combined with the idea

that future cash inflows have been appropriately valued in the calculation of best estimate, would lead to a so-called "double-counting" of the risk.

In the specific case of EPIFP, the risk inherent to future premiums would be that future premiums will not be received by the insurer. This risk would be addressed via the SCR, via lapse risk. Furthermore, if future premiums are not to be received, not only SCR lapse would be addressing the risk, but also there would be a side effect in the same direction, i.e. the value of the corresponding liability will generally reduce or in some cases be eliminated. The combination of these two factors should therefore mitigate the risk arising from non-receipt of future premiums just as other elements of the SCR address the risk that future liabilities might be understated. If the loss absorbency of EPIFP is being questioned because there is a future cash flow, then logically any item for which its current value is based on an expectation of future cash movement should be equally questioned. For example, for assets valued on the solvency II balance sheet which should be set at market value, the market value implicitly assumes future payments under that asset (rent, dividends, coupons, capital,...), however, these assets are stressed under the SCR, and there is no question that they should also be tiered. If this was the case, as for EPIFP, it would in turn mean that the whole basis of profit determination would need to shift to one that is based on ultimate cash settlement. This conflicts with the fundamental nature of insurance, where the discounting and recognition of future cash flows is part of the business model regardless of the introduction of Solvency II.
This is why there is widespread view that no tiering should be applied to EPIFP.

On the other hand, there are several arguments against the idea that the analysis of EPIFP issue should be reduced to the dilemma "either the SCR or a tiering should capture the risk". In this respect, reference can be made to the Directive, which explicitly requires that the classification of the excess of assets over liabilities should be carried out on the basis of the criteria used to classify own funds in accordance with Article 93 of the Directive. It should be reminded that the tiering of the own fund has also effects on the MCR coverage (i.e. the MCR could be fully covered with EPIFP, should they qualify as tier 1).

Furthermore, the abovementioned relation between EPIFP and SCR lapse (i.e. SCR lapse "already" addressing the risk in Future Premiums) only applies to a limited extent, as already mentioned in the section on calculation of EPIPF[15]. For example:

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[15] Among the "cons" of proposals 2, 4 and 5 they led to a result weakly linked to the QIS 5 definition of EPIFP. For the sake of a comprehensive understanding of this issue, it must be stated that calculations of EPIFP and SCR lapse risk present material differences, namely:
-   the calculation of the SCR lapse risk takes into account the surrender value resulting from the application of the relevant contractual or legal limitations to such value;
-   the calculation of EPIFP under QIS 5 is a notional calculation where no limitation to the lapse value is applied, i.e. the value of the contract ignoring future premiums.

- where EPIFP are nil but the undertaking bears lapse risk anyway (e.g. all single premium contracts where the best estimate is lower than the surrender value generate SCR lapse risk);

- where EPIFP can have a material value but the undertaking does not bear any lapse risk (e.g. regular premium contracts with no surrender value, and it is the case as well of most regular premium contracts where the surrender value is severely penalized according the contractual clauses);

- the design of the lapse module, both in life, non-life and health does not seem to capture adequately all the risks associated with future premiums. The mass lapse risk is only including a surrender scenario; paid-up situations are not dealt with in that absolute choc, while it is realistic to envisage that future premiums are massively not paid-in (e.g. a new contract has been created, more attractive than the already existent contract, and policyholder decide not to pay future premiums; or there is a fiscal advantage linked to a new contract);

- even where a part of the value of EPIFP and SCR can be considered to be related, the amount of the SCR charge and the amount of EPIFP can be very different: the former can be much lower than the latter, due to the material effects of diversification benefits and the loss absorbency capacity of deferred taxes in the calculation of the final SCR. To make an example based on QIS5 public aggregated result, an increase of one euro in the SCR lapse risk leads to an increase, on average, of 0,173 euro in the final SCR.

Finally, Own Funds stand ready "as a whole" to cover the SCR and are not directly linked to specific items. This means that by definition there cannot be a direct link between a SCR charge and the related value of the item being shocked for that SCR. For example, on the equity shock: if an equity shock was to happen, the value of the equity would fall and Own Funds corresponding to that equity would not be available for covering the loss stemming from that fall (i.e. there would be no point in selling equity to raise up capital to face losses since the value of equity would have fallen: those losses stemming from equities would be covered from other items whose value has not fallen).

Potential for EPIFP not being available permanently to absorb losses

As a general requirement in Solvency II (Article 93), Own Funds should be available permanently to absorb losses. A few arguments can be explained, in the view of bringing additional clarity to the debate.

There is a view that EPIFP are permanently available for absorbing losses. For instance, in the event of substantial insurance losses, the undertaking will need to revise upwards the amount of technical provisions in

its books. In such circumstance, the increase in technical provisions could be counterbalanced by a partial or full reduction in the amount of EPIFP counted as own funds. Thus, the EPIFP could provide loss absorbency. This view sees loss absorbency set in the context of whether the value of an own fund item can be written down, thereby reducing shareholders' share of the net asset value of the company.

As per the permanent availability of EPIFP, should it happen that cash is needed to face losses (for example financial losses which do not affect the level of technical provisions), the value of EPIFP would need to be materialized through the selling of the insurance portfolio or of a similar arrangement. In an economic approach of Solvency II, the economic value can in theory always be securitized and transferred in the market in going concern as well as in times of winding-up. The uncertainty related to the materialization of future cash-flows, being related either to EPIFP or to any other future items, is addressed via discounting and via the SCR capital charge.

On the other hand, it is quite intuitive that where cash is needed to absorb losses (to ensure the payment of liabilities as they fall due), the EPIFP would not be immediately usable for that purpose. The materialization of EPIFP through the selling of the insurance portfolio or of a similar arrangement would be possible but it is prone to difficulties and to timing issues, as there is a limited market for insurance contracts. And if market participants perceive the troubled condition of the undertaking, it is also likely that they will bid lower than the book value of EPIFP. Additionally, it could be argued that buyers of the insurance portfolio may not be easy to find quickly, especially in the event of a financial crash. Thus, EPIFP could be seen as not permanently available, particularly in stressed situations when the materialization of its value is most needed. In times of crisis, the transfer of insurance business is impeded and the transfer of future profits arising from future premiums is highly unlikely to happen at its full amount. In this sense, as the ability to realize cash is incorporated into the concept of full permanent availability to cover losses, EPIFP lack full permanent availability to cover losses.

As a side consideration in the same view, it might be noted that loss absorbency capacity of EPIFP is closely linked to the level of granularity in their calculation. For example: to what extent EPIFP in one related undertaking could be used to absorb losses of another related undertaking; to what extent EPIFP in one line of business could be used to absorb losses in other LoBs or losses due to the materialization of other risks, such as operational risk, market.

Concerns of this nature could be seen in a wider context of balanced stress on assets and liabilities, i.e. a stress on liabilities as above should be done similarly on assets, so not to run the risk of an asymmetric approach. To this regard, two different views are in place:

- on one side, one could argue that stress on assets (e.g. equity) does not envisage for an illiquid market following the 1-in-200 event nor the fact that the undertaking may become a forced seller of equities: in this view no similar stress should be carried out on the liability side;
- on the other hand, some other could argue that - to the extent that the calibration of (e.g.) equity risk does not distinguish falls in equity due to intrinsic causes (inherent to the equity itself), from those other falls due to extrinsic reasons (inherent to distressed markets) - SCR market risk captures both: in this view, a similar stress should be considered in the liability side as well.

Furthermore, the possible lack of liquidity of EPIFP should be dealt with in Pillar 2 risk management requirements. The Directive envisages that risks that are not being addressed through Pillar 1 capital requirements should be dealt with via Pillar 2. Therefore, EPIFP – as well as any other item - should be assessed for liquidity risk in the context of the ORSA (Own Risk and Solvency Assessment). Should liquidity risk arise with regard to EPIFP, the administrative, management or supervisory body of undertakings should take appropriate measures, including possibly also holding additional capital to cover SCR.

No need for EPIFP to be identified separately and calculated

There is a widespread view that, since EPIFP should be classified by default in Tier 1, there would be no point in making any effort/approximation for their separate identification and calculation.
On the other hand, there is an opposite view, that EPIFP should be quantified and calculated even though they are fully – or to the highest part - classified in Tier 1. This quantification would be done at least for Pillar 2 purposes (see above the point of EPIFP possible not being liquid) and Pillar 3 ones (reporting and disclosure).