

**APN 113 ESTIMATED FUTURE EXPENSE CASH FLOWS - CONSIDERATIONS FOR LIFE INSURANCE MEMBERS
CALCULATING TECHNICAL PROVISIONS AND SOLVENCY CAPITAL REQUIREMENTS****Classification**

This Advisory Practice Note (APN) provides guidance for Life Insurance Members calculating or reviewing *Technical Provisions* and/or *Solvency Capital Requirements* under the Prudential Standards required by the Insurance Act (2017).

Abstract

This Advisory Practice Note outlines considerations with respect to expenses for members calculating or reviewing life insurance *Technical Provisions* and *Solvency Capital Requirements* for regulatory reporting under the Prudential Standards required by the Insurance Act (2017).

Purpose

The purpose of this APN is to provide guidance to *members* of the Actuarial Society of South Africa in determining the expenses to be included in the calculation of *TPs* and their treatment in the calculation of the *SCR*.

Legislation or Authority

Actuarial Society of South Africa Life Assurance Committee.

Application

Members calculating or reviewing *Technical Provisions* and *Solvency Capital Requirements* for life insurance regulatory reporting under the Prudential Standards required by the Insurance Act (2017).

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Status

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Definitions

<i>AUM</i>	Assets Under Management
<i>BOF</i>	Basic Own Funds as defined in FSI 1.
<i>BEL</i>	Best Estimate Liabilities forming part of the Technical Provisions and calculated in accordance with the requirements in FSI 2.2.
<i>FSI</i>	Financial Soundness Standards for Insurers as issued by the Prudential Authority.
<i>IFRS 17</i>	International Financial Reporting Standards 17 – Insurance Contracts.
<i>Insurer</i>	A person licensed to conduct insurance business under the Insurance Act.
<i>Insurance Act</i>	Insurance Act (18 of 2017), including relevant amendments, Prudential Standards, regulations, Prudential Authority directives and guidance notes.
<i>Member</i>	A member of the Actuarial Society of South Africa as defined in the Code of Professional Conduct, or a member of another recognised actuarial association to whom this APN applies.
<i>PA</i>	The Prudential Authority established in terms of the Financial Sector Regulation Act (9 of 2017).
<i>Prudential Standards</i>	The Prudential Standards issued by the Prudential Authority as enabled by the Insurance Act
<i>SCR</i>	The Solvency Capital Requirement of the Insurer defined in the Prudential Standards
<i>TPs</i>	Technical Provisions defined in FSI 1.

1 Introduction

1.1 Background

The Prudential Standards are principles-based and as a result interpretation of some of the requirements contained in the Prudential Standards are subjective. Further to this, all the principles are not always explicitly laid out, which results in more room for interpretation.

The treatment of expenses, and which of these to include in the *TPs* that underlie the *SCR* calculation, is one such example. This was identified as such by the then Financial Services Board ("FSB") while the Prudential Standards were still in draft form. The FSB performed a thematic review of the treatment of expenses and released a report in December 2015. Consequently, adjustments were made to the draft Prudential Standard.

The *PA* issued guidance on *TPs*, "Guidance Note FSI GN 2.2 Valuation of Technical Provisions" ("FSI GN 2.2"). Chapter 9 covers expenses to be used in assumptions.

Despite the clarifications provided in FSI GN 2.2, there are still areas that are open to interpretation. Further guidance regarding the principles is therefore required. In addition, some of the expense related requirements can be interpreted as being inconsistent with other parts of the Prudential Standards.

Lastly, there is lack of clarity with regard to the treatment of expenses in some of the shocked scenarios for the purposes of calculating the *SCR*, where consistency across the market may be improved with further guidance.

1.2 Inconsistencies with IFRS 17

IFRS 17 states that expenses should be included in the fulfilment cash-flows only if they are directly attributable to the underlying product. This can result in the exclusion of certain expenses in the *IFRS 17* liability calculation compared to the *BEL* under the Prudential Standards.

The possible inconsistencies between the Prudential Standards and *IFRS 17* should be noted. However, these differences may occur considering the different purposes of the balance sheets under *IFRS 17* and the Prudential Standards. These differences should be analysed and be reconciled.

1.3 Scope

This note covers the treatment of all expenses under the Framework for *FSIs* of the Prudential Standards for insurers writing life insurance business.

The considerations apply to all expenses that an *insurer* might encounter or might expect to encounter for which allowance needs to be made in the *TPs* and *SCR*.

2 General Principles

2.1 Allocation and categorisation of expenses

The Prudential Standard FSI 2.2 and FSI GN 2.2 refer to the allocation, categorisation or apportioning of expenses between initial, renewal, and once-off. Although these documents do not discuss allocating expenses across business units and products, this is also usually necessary.

2.1.1 Allocation of expenses across initial, renewal, and once-off expenses

According to FSI GN 2.2, the categorisation of expenses may distinguish between Direct versus Indirect expenses and may further be split according to the three-bucket approach:

- Initial;
- Renewal; and
- Once-off expenses.

In performing the categorisation of expenses across these buckets, the following principles may be considered:

- Direct expenses that are clearly attributable to any single expense category should be categorised accordingly.
- Direct and indirect expenses attributable to more than one category should be allocated in a realistic and objectively justifiable manner. There is usually no single correct answer, and therefore pragmatism may be required.
- The approach (reasoning and methodology) should be documented and monitored to ensure consistent application over time.

2.1.2 Allocations of expenses across business units and products

Not all expenses can be directly and unequivocally attributed to a specific business unit and even less to an individual product level.

Various approaches can be adopted to allocate indirect expenses across business units and products. The allocations are normally based either on a top-down or bottom-up approach.

Whatever the specific approach adopted, the outcome should:

- Be internally consistent such that the total expenses are completely allocated without material double counting or omission.
- Be rational in generally allocating more expenses for more operational effort, higher policy volumes, more complex policies or customer servicing requirements, and/or more transactions whether this is based on a detailed activity-based costing exercise or not.
- Be documented to ensure consistent application over time and between business units and products.

In estimating future expense cash flows, the *member* should consider the impact of changing allocations of expenses in future.

2.2 Deriving unit expense assumptions and drivers

In estimating future expense cash flows, expenses are usually modelled as some form of “unit expense” multiplied by an expected number of units in each future projection period. Units could be number of policies or benefits, premiums, *AUM*, or other suitable drivers. Where possible, the unit chosen should reflect the driver of expenses. For example, some expenses will have a direct link to the number of policies, while others will be a function of *AUM*.

In setting unit expense assumptions, prior actual expenses and expected or budgeted future expenses should be considered alongside prior actual units and expected future units.

When using units such as number of benefits or policies, past and expected future inflation should be considered, alongside how future expected inflation is allowed for in the cash flow projection models.

Where expenses are modelled as a percentage of premiums or *AUM*, appropriate allowance should be made for the impact of expense inflation and consideration should be given to the impact thereof within the shocked scenarios for the purposes of calculating the SCR.

2.3 Expenses should be company specific where possible

Expense assumptions should reflect the best estimate expectation of *insurer*-specific expenses; however, industry expense experience, where available, may be informative under certain circumstances. This industry information should ideally be relevant, considering the appropriate class of business and allowing for different complexity levels and operational models.

2.4 Probability-weighted approach and approximations and simplifications thereof

The FSIs require a probability-weighted expected value of future cash-flows. In most scenarios, the *BEL* can be well approximated using a single best estimate scenario, in other words a deterministic approach. However, there are certain cases, e.g., option and guarantee related expenses, where this approach would not be appropriate.

Members should consider whether a single scenario is adequate to capture the potential variability in outcomes in order to substantiate whether a deterministic approach is appropriate.

2.5 Targeting zero expense variances

FSI GN 2.2 Chapter 9, paragraphs 4, 9 and 10 state:

- 4 *In order to ensure that the cost universe to be included in the cash-flow projections is complete, insurers are encouraged to reconcile the cost universe to the costs reflected in the IFRS annual financial statements of the insurer and also the group if applicable.*
- 9 *The technical provisions should include all on-going maintenance expenses as part of the best estimate expense assumption.*
- 10 *The approach when setting the best estimate expense assumption should be guided by the principle that the overarching objective of an insurer is to provide benefits to policyholders. Therefore, any decision to exclude on-going maintenance expenses should be able to be justified by the insurer with this overarching objective in mind.*

Estimates of future expense cash flows should be an unbiased, best estimate view of all future expense cash flows, including direct and an appropriate allocation of indirect expenses. *Members* should generally apply the assumption that all expenses are incurred in the overarching objective of the *insurer* to provide benefits to policyholders. Exclusion of expenses should be by exception, with careful consideration, clear reasoning, and adequate documentation on the reasons for excluding the expenses.

Expense assumptions and the allowance for expenses within the *BEL* should be set with the target of achieving zero expense variances, after allowing for once-off expenses, in future years.

2.6 Application of contract boundaries to expenses

Expenses beyond the contract boundary do not need to be modelled as part of the *BEL*; however, all expenses required to service obligations must be modelled.

Where short contract boundary contracts are assumed to lapse, consideration should be given to whether the remaining expenses need to be allocated to the policies that have not lapsed.

- Should the *member* have a realistic expectation that the *insurer* will replace lapsed contracts or contracts that have reached their contract boundaries with new contracts, there is no need to consider these expenses in the *BEL* or the *SCR*.

- Where business is in runoff, the full expense base needs to be carried by the policies in force at each point in time.

2.7 Application of expert judgement

Members are reminded that FSI 2.2 permits, but places restrictions on, the use of expert judgement.

6.41. *In certain circumstances, expert judgement may be used in the valuation of the best estimate. Expert judgement may be used in relation to the data, assumptions and techniques used to value the best estimate.*

6.42. *The use of expert judgement must be well-founded, documented, transparent and subject to validation. Insurers should document the processes leading to the use of expert judgement, allowing an external party to account for and verify the judgements made.*

Setting expense assumptions will likely involve expert judgement. These judgements should meet the criteria from FSI 2.2.

3 Additional considerations on types of expenses

The sub sections below provide additional perspectives on specific types of expenses.

3.1 Once-off / project expenses

FSI GN 2.2 Chapter 9, paragraph 7 states:

7. *Once-off expenses, and particularly project costs, should be analysed to ensure that these are appropriately reflected in the cash-flow projections:*

- a) *Once off and project costs that clearly relate to future initiatives that have no benefit to the existing in-force book need not be included;*
- b) *Large project costs may be capitalised as intangible assets for IFRS purposes. In these cases it may be appropriate to include the future depreciation charges associated with these capitalised projects; and*
- c) *Costs associated with all projects that will not be capitalised for IFRS purposes need to be taken into account in the cash-flow projections. These projects potentially could run over more than one financial year in which case an appropriate duration needs to be assigned to these costs in the cash-flow projections.*

In analysing once-off expenses, the *members* should also consider the following:

- Some project costs may be recurring in nature, even though concrete project plans are only in place over the shorter term. For example, *insurers* may expect a fairly consistent level of expenditure on IT maintenance and IT renewal costs. If this type of recurring expense is not included in ongoing maintenance expenses, then the company should allow for the recurring nature of these projects in their projections of once-off expenses. This allowance should be assessed over the full projection term, although allowance may be made for:

- The extent to which expenses fall outside the contract boundaries of the insurer's in-force book and can therefore be disregarded (see section 2.6), and
- For the contribution to once-off expenses that new business is expected to make (similar to unit expenses applied to ongoing maintenance expenses).
- Prior expenses that are not expected to recur may be excluded from the estimate of future expenses. However, there must be reasonable certainty that these or similar expenses will not be incurred in the future.

3.2 Expenses incurred elsewhere in the group

FSI GN 2.2 Chapter 9, paragraph 3 states that:

3. *For insurance groups where functions are performed by other entities in the group, the costs associated with these functions as they relate to the insurer should be included in the cash-flow projections of the insurer. Also, where an insurer comprises a large part of the group, group costs (such as boards of directors, investor relations, etc.) should be analysed and allocated to the insurer on an appropriate basis.*

Often, the expenses incurred elsewhere in the group, but in respect of the insurance entity, will be charged back to the insurer as an intra-group transaction, and these expenses will be recognised in the insurer's standalone IFRS accounts. These expenses must be included in the estimates of future cash flows for the insurer.

Where expenses are incurred elsewhere within the group, but an appropriate charge for these expenses is not made to the insurer's income statement for the IFRS results, *members* should consider to what extent this distorts the adequacy of TPs, and the solvency and sustainability of the insurer. Where the expenses charged to the insurer for IFRS purposes do not reflect the economic reality, the expenses used for regulatory reporting purposes should be adjusted to allocate expenses to the insurer on an appropriate basis. Otherwise, the TPs and SCR will not accurately reflect the insurer's true expense base.

3.3 Expenses incurred within the life insurer in respect of another entity

Some insurers may incur expenses for another entity, typically within the group. To the extent these expenses are recovered from the other entity, the net expenses will usually be the appropriate amount to include in the insurer's expense assumptions.

In calculating the net expenses, *members* should consider whether there may be any future departure from full recovery of these expenses, including possible tax impacts.

3.4 "Shareholder" expenses

For some insurers, certain expenses are categorised as "shareholder" expenses as they are not directly related to administration of policies or policyholders.

In line with the principles from 2.5, exclusion of shareholder expenses from expected future cash flows should be by exception, with careful consideration, clear reasoning, and adequate documentation on the reasons for excluding the expenses.

In terms of projecting these expenses, it could be that per policy modelling is not appropriate, but *members* should ensure that they are ultimately represented in the BEL and shocked accordingly for the SCR.

3.5 Investment expenses

FSI GN 2.2 (Chapter 9, paragraph 6b) explicitly mentions that investment management expenses must be included where relevant. The following should also be considered.

Assets on which management expenses should be included.

- Investment management expenses should be based on all assets that are projected in the valuation models. Where assets are not explicitly modelled, it should be assumed that assets will at least equal *TPs*.

Assumed asset allocation

- Investment management expenses should be based on the long-term strategic asset allocation, even if the actual asset allocations at the valuation date differs from the long-term strategic asset allocation.
- As the expected investment expenses and tax payable will be derived from the future asset allocation, expected changes in the future asset allocation should be allowed for.
- The agreed long-term strategic asset allocation should be the best indication of what actual assets will be held in the future. Should there be significant deviations from the long-term strategic asset allocation, which cannot be attributed to short-term market fluctuations, consideration should be given to adjusting the long-term strategic asset allocation and reflecting this in the investment management expenses.

Treatment of investment expenses for negative *BEL*

- Care should be taken in how negative *BEL* is considered when deriving the investment expenses in practice. Total invested assets cannot be assumed to reduce due to negative liabilities, leading to lower investment management expenses, since negative *BEL* might still have related investment expenses depending on the overall investment strategy of the business.
- The costs of any hedging strategies implemented to cover the negative *BEL* should be allowed for in the investment expenses.
- Where the *BEL* goes from negative to positive over the projection period, care needs to be taken to ensure that the projected investment management expenses look reasonable over the whole projection term, keeping in mind the principle of proportionality.

3.6 Investment performance expenses

Typically, investment performance fees will not be payable if the return achieved is risk-free. A single best estimate scenario with a risk-free discount rate might therefore suggest that no performance fees need be modelled to be consistent with this assumed return.

However, under a probability weighted valuation, there may be several scenarios where investment management fees will be due. This should be calculated in line with the structure of a best estimate APN110 calculation, and the probability weighted average of the investment fees used in the determination of investment expenses.

This is likely an onerous requirement and may not be appropriate given the principle of proportionality. However, the *member* should assess the materiality thereof and determine whether a zero-performance fee estimate is a reasonable approximation, or whether some other, positive, expense figure is more appropriate.

3.7 Bonuses and incentives expenses

Variable and discretionary expenses should be allowed for at the best estimate of the future experience.

To the extent that these expenses could reasonably and realistically be reduced in a stressed scenario by management actions, the *member* can allow for this when calculating the *SCR*. The clearer, the direct link between the shock and the ensuing management action, the simpler the justification for the reduction in expenses. For example, an incentive pool that is calculated as an explicit percentage of premiums could clearly be reduced for reduction in premiums collected.

3.8 Amortisation of intangibles

FSI GN 2.2 Chapter 9, paragraph 7 b states:

Large project costs may be capitalised as intangible assets for IFRS purposes. In these cases it may be appropriate to include the future depreciation charges associated with these capitalised projects

The overwhelming majority of intangibles on an insurer's IFRS balance sheet will not be recognised on the Prudential balance sheet. Large project costs capitalised into an intangible asset will almost invariably not meet the criteria to be included for Prudential Standard reporting.

However, there can be scenarios where intangibles are still recognised on the Prudential balance sheet. The depreciation charges must be included at least insofar as the intangible asset is included in the asset side in determining the Basic Own Funds. When analysing expense variances using IFRS expenses (which will include amortisation of intangibles), the member should remove these expenses and document the reasoning and impact of the adjustment.

4 Changes in expenses over time

4.1 Expense inflation

Prudential Standard FSI 2.2 Valuation of Technical Provisions (Attachment 2, Paragraph B.8) states:

Expense assumptions must include an allowance for expected future cost increases. The allowance for cost inflation must be consistent with the economic assumptions made in the cash-flow projections, and must take into account the types of cost involved. Where insurers make assumptions about expected cost reductions in their cash-flow projections, such assumptions must be supported by realistic and objective analysis, and based on verifiable data and information.

A member should consider the following in setting these assumptions:

- The starting point will usually be the implied break-even inflation¹ based on the Nominal and Real yield curves used in discounting the liabilities.
- Adjustments can then be made to these rates based on other sources of inflation expectations, recognition of supply and demand imbalances in the nominal and real bond markets, and differences in past and expected future insurer expense inflation compared to CPI inflation.
- The core principle is that where a company expects a stable state between in-force and new business, CPI inflation can be a reasonable assumption for expense growth; however:

¹ Break even inflation is the difference between the nominal spot rate and the real spot rate. It is a market consistent estimate of expected future inflation PLUS an inflation risk margin, which can be positive or negative depending on the supply and demand for nominal and real bonds.

- Where faster business growth is assumed, assuming unit expense inflation lower than CPI inflation might be justified.
- Where slower business growth is likely, the extent of fixed expenses within the operations of the insurer might result in actual unit expense inflation being higher than CPI inflation. In this case, an explicit increase in the expense inflation assumption over CPI inflation may be necessary.
- Where *members* make assumptions about expected cost reductions or expenses that increase at a rate lower than inflation in their cash-flow projections, such assumptions must be supported by realistic and objective analysis and based on verifiable data and information.
- In the case of expected cost reductions, reliable and verifiable management plans, that are specific rather than generic, should be in place to realise these. This holds especially for costs that are not outsourced. As for all future management actions, this must be approved by an appropriate governance forum within the insurer as required by FSI 1.
- Where costs are outsourced, cost reductions can only be allowed for insofar it has been contractually confirmed. A cost reduction experienced in any one year does not imply lower costs can be assumed in future, as this could in fact result in higher increases under the contract in future years. Further to this, where costs are outsourced, *members* should consider the possibility of default of outsource partners and the cost of finding new partners to fulfil the requirements.
- Estimation of expected expense inflation in countries other than South Africa should follow similar principles and be consistent with the overall economic basis.
- Where expenses are modelled as a percentage of premiums, members need to consider whether this allows adequately for future expense inflation, since premium growth might not be sufficient as an implied inflation adjustment.

5 Treatment of Expenses in the SCR shocks

5.1 Expense shock

All future expenses must be included in expense shocks within the *SCR*. Good practice would be to reconcile all expenses modelled to expenses shocked to ensure that no omission or double counting has inadvertently taken place. This is advisable whether or not the expenses are modelled as unit expenses within a typical policy-by-policy cash-flow model or via a separate manual calculation.

Expenses that are modelled as a percentage of premiums but are not driven directly (contractually or otherwise) by premiums, should be shocked as if they were set in nominal terms. A modelling choice to express them as a percentage of premiums does not immunise them against expense level and expense inflation shocks. Any changes to expenses resulting from management actions should be subject to the requirements for management actions.

For claims expenses included in claims provisions:

- As with any other expense experience, claims expenses experience are at risk of being higher than expected. The claims expense component in claims provisions should therefore in principle be shocked alongside all other expenses in the Expense Risk module.
- *Claims provision* durations are generally short and shocking the expense inflation assumption might therefore not have a material impact on the *SCR*. It might be appropriate to disregard the impact of an increase in inflation in this context, both in the Expense Risk and Interest Rate Risk components. However, where the *claims provisions* cover longer periods, consideration should be given to the impact of inflation and appropriate allowance should be made.

5.2 Expense treatment for non-expense SCR shocks

In most circumstances, the SCR shocks will be applied in a modular fashion and adjustments to the expense assumption will not be required. Possible exceptions include the lapse shocks which imply a change in volumes. For these shocks, the *member* should consider:

- Whether the change in volumes materially influences the assumption that future new business can at least replace lapsed policies;
- The extent to which expenses are directly related to business volumes;
- What management actions could reasonably be assumed to reduce expenses in future;
- The application of the principle of proportionality; and
- Therefore, what change in unit expense assumptions or expense overrun provision may be required.

In general, it is likely that the level lapse shocks will not require an expense adjustment (considering management actions and/or reasonable assumptions around replacement of lapsing policies with new business). On the other hand, it will be more common that an adjustment to expenses may be required for the mass lapse shock. The *member* must apply their mind to the specific circumstances of the insurer.

The insurer is not required to specify the exact course of management action that would be applied in specific events. Rather, the insurer should be comfortable that the reduction in expenses would be achieved in the relevant shock.

5.3 Expense treatment for the mass lapse SCR shock

Under the Mass lapse shock, the standard requires (FSI 4.2 paragraph 8.5):

A requirement for total expenses (excluding variable acquisition costs and variable costs directly linked to assets under management) to remain constant for one year after the mass lapse event.

Although expenses other than those linked to AUM could in practice be completely variable in relation to policy volumes, the FSI wording is clear that except for the specific expenses mentioned, total expenses must remain constant.

The following principles therefore apply in calculating the expense component of the mass lapse shock:

- Total expenses must be assumed to remain unchanged for the full year except for variable acquisition costs or where it is directly linked to the AUM in respect of policies that are assumed to lapse.
- Expense assumptions applied in the BEL for policies remaining after the mass lapse event may need to be re-estimated to allow for the lower volumes of business assumed to be in force after the mass lapse event as outlined in section 5.2 above.
- Using x to denote the percentage of policies that are assumed to lapse under the mass lapse scenario, then the expense assumption for the policies assumed not to lapse could be derived by scaling the original expense assumption up by $1/(1-x)$.
- If applicable, this can be adjusted for variable acquisition expenses or expenses directly linked to AUM.
- Management actions can be used to reduce assumed future expenses, but not until after the first 12 months.

- It should not be assumed that expense reductions beyond 1 year will automatically be achieved. To the extent that management action is needed, the necessary steps in evaluating and approving it are required.
- Only cash flows up to the contract boundary must be considered. This applies to all cash flows, including expenses. For clarity, expenses are valued up to the contract boundary when determining whether there is a lapse strain but will be valued for at least the 12-month minimum period when determining the quantum of the mass lapse shock. For contracts with a zero-day boundary (and the zero day has been elected), there will be no lapse strain and therefore no mass lapse shock. Expenses related to such contracts do not, therefore, need to be included for the 12-month minimum period required in determining the quantum of the mass lapse shock.
- Per FSI 4.2, after applying the relevant mass lapse shock, best estimate lapse assumptions should continue to apply to each homogeneous group.
- The resultant increase in the BEL must be included in the mass lapse shock along with the change in *BOF* arising from the assumed lapse or surrender of policies with a positive surrender strain.

To the extent the mass lapse shock gives rise to additional losses beyond the contract boundary, these could be considered as part of an assessment of lapse and business volume risk within the Own Risk and Solvency Assessment.

6 Considerations for expense overruns and allocations for insurers at different stages of maturity

Where expense overruns truly should be borne by in-force business, liabilities should be set up that include the expense overruns until they are expected to become zero. This ensures that expected future expenses form part of the *BEL*, appreciating the expectation that the additional allowance over the long-term assumptions will likely decrease as volumes grow towards scale.

Additional requirements may apply for business that is growing rapidly, as in a start-up phase, run-off phase, or those that experience major business restructuring or changes. These items are considered in the following sections.

6.1 Start-up phase

All expected expenses required to meet the obligations to existing policyholders must be included in the *BEL*. This will likely be informed by the business plan and business projection. The *member* should consider whether the business plan is plausible. In their assessment, the *member* may need to consider multiple scenarios.

- For most insurers in the start-up phase, projecting an increasing unit expense assumption derived assuming no new business would not be appropriate. New business will generally carry an increasing proportion of projected expenses.
- It is often also not appropriate to use a unit expense assumption that assumes the insurer is at scale at the valuation date.
- In most cases, a projected unit expense that reduces as the business moves toward scale and grows with inflation beyond scale is most appropriate. Due to expenses reducing through time rather than already being at scale, start-ups will typically have a large positive BEL in the early years of the insurer.

For clarity, expenses associated with new business do not need to be included in the BEL. However, the member should exercise caution around the risk of optimistic or biased allocations of expenses to new business rather than existing business.

6.2 Rapid growth

For a business expected to grow rapidly, expense overruns may initially be expected and tolerated as those are expected to be rewarded for via future new business (not in-force or current new business). The expense efficiencies should be allowed for in the insurer's liabilities similar to those in a start-up phase (as discussed under 6.1 above), with appropriate governance.

6.3 Ongoing business with major business restructuring or changes

The following should be considered when the *member* is aware of substantial changes that may be occurring or have recently occurred, for example, when they anticipate a significantly adverse scenario, a merger or the launching of a significant new business line, such as when a life insurance group starts non-life business:

- The modelling of future expenses should allow for the anticipated impact of these substantial changes.
- The allowance could be included as an explicit adjustment or may be included implicitly by adjusting the per policy expenses.
- For a substantial new product line, similar considerations should be applied as to a start-up insurer, but with particular regard to allow appropriately for cross-subsidisation.

6.4 Run-off scenario

Members modelling insurers or portfolios that are in run-off are required to model all expenses for the run-off of existing portfolio. This will likely lead to a higher unit expense assumption as the fixed expenses will dominate as the size of the portfolio decreases over time.

Alternatively, the member may replace the modelling of unit expenses with a projection of total expected expenses.

If it is assumed that the book will be sold or transferred at some point, the member must be careful to confirm that this is reasonable and likely, that the timelines are reasonable, that all costs associated with this sale or transfer have been factored in, and that the purchase price is reasonable and realistic under the assumed conditions.

Based on a probability weighted approach, it is likely that management forecasts will not be the same as a single best estimate scenario, but rather may be optimistic. This needs to be considered and allowed for in the expense assumptions.

All expenses must still be shocked for the expense *SCR* shocks. All other shocks (especially lapse) should factor in potential increases expenses in that scenario. (See Section 5 Treatment of Expenses in the *SCR* shocks for the principles.)