EIOPA consultation: Revision of the guidelines on contract boundaries

Highlights and implications for the insurance sector

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On 11 July 2021, the European Insurance and Occupational Pensions Authority (EIOPA) published a consultation paper on the revision of the guidelines on contract boundaries for technical provisions. The consultation aims to reduce divergent practices across Europe concerning contract boundaries by providing additional guidance on the topic. In this paper we highlight the most important proposed changes and its implications for insurers.

Introduction

As defined in Article 18(3) of the Delegated Regulation, a contract boundary is the future date where the insurer has a unilateral right to terminate the contract, reject premiums payable under the contract or amend premiums or benefits such that the premium fully reflects the risk in the contract. The interpretation of the regulation on contract boundaries has been a topic of debate since the start of Solvency II.

During the Solvency II 2020 Review, EIOPA identified divergent practices in the application of contract boundaries across the industry. To ensure consistent industry-wide application, EIOPA proposes updated guidance related to contract boundaries.

The proposed amendments to the guidelines include clarification on definitions of "contract boundaries" and "unbundling." Further, the assessment of whether a cover or financial guarantee has an observable effect on the economics of the contract is clarified.

Proposed guidelines on contract boundaries

This section presents a summary of each of the changes to the current guidelines. Guideline 0 is introduced to provide a clear definition for contract boundaries. Guideline 5 is amended to clarify the definition of unbundling of insurance contracts. Guideline 6 is expanded to provide clarity on the identification of an observable effect on the economics of a contract.

GUIDELINE 0 – CLARIFICATION OF CONTRACT BOUNDARY DEFINITION

The contract boundary is the boundary separating the premiums and obligations belonging to the contract, and those not belonging to the contract. Given this distinction, cash flows belonging to the contract are projected. This implies that the projection of cash flows may extend beyond any of the dates referred to in Article 18(3).

Contract boundaries limit only the premiums and obligations that belong to the contract, but do not limit the projection horizon of the cash flows stemming from these premiums and obligations. Where contracts are expected to be renewed, a realistic projection of future cash flows is required for the valuation of a product, which must include assumptions on future renewals after the maturity date.

Two examples are provided to clarify the text.

EXAMPLE 1 – SINGLE YEAR COVER

Product description: An insurance contract covering the risk for the following year given premiums paid during the year. Where the insured event occurs, the actual payments may spread across three years. The insurer has the right to amend future premiums to reflect the risk.

Contract boundaries: The time horizon of the projection of future cash flows is not affected by the contract boundaries. For valuation at the end of year *t*, cash flows related to previous obligations should be projected beyond year *t+1*. Obligations from premiums received in year *t+1* do not belong to the contract.

Date	t-3	t-2	t-1	t	t+1	t+4	t+3	t+4
Premium	100	100	100	100	100			
Obligation		Cover	Cover	Cover	Cover	Cover		
Cash flow projection		32	48	16				
			32	48	16			
				32	48	16		
					32	48	16	
						32	48	16
BE discounted				176				

EXAMPLE 2 – PROFIT SHARING GENERAL ACCOUNT COVER

Product description: An insurance product with profit sharing, maturing after eight years. At maturity, the contract will be renewed annually. The insurer or the policyholder may cancel the contract one month before the renewal date.

Contract boundaries: A realistic projection of future cash flows is required, including assumptions on future renewals after the maturity date. Insurers may assume a simplified approach where the contract is terminated after eight years with a lump sum payment where this approach does not lead to an underestimation of the best estimate.

In Example 1, each premium received relates to a different period of coverage. In Example 2, the expected renewals relate to the same cover. Thus, the expected renewals related to the present cover are taken into account and included in the contract boundary for Example 2.

GUIDELINE 5 – UNBUNDLING OF THE CONTRACT

EIOPA aims to clarify the different interpretations of what is considered a different part of a contract and when these parts should be considered separately. The proposal thus provides clarity on the definition of "unbundling."

The amended definition states that a contract may be unbundled for the purpose of contract boundaries if and only if component parts of the contract are equivalent in terms of risk to separate contracts that could be sold separately. Contracts are considered equivalent in terms of risk where there are no observable differences in the economics of the contracts in terms of the insurance or financial risk.

It is expected that the impact of this option will not be material in most cases as this is the current approach followed in most jurisdictions.

A simplified approach is also provided by EIOPA, where insurers may elect not to unbundle the contract for the purpose of setting contract boundaries where the components of a contract have the same contract boundary.

GUIDELINE 6 – IDENTIFICATION OF AN OBSERVABLE EFFECT ON THE ECONOMICS OF THE CONTRACT

Covers and guarantees that do not have an observable effect on the economics of the contract are not considered for the assessment of the contract boundaries. While the current guidelines provide some guidance on the assessment of an observable effect on the economics of a contract, EIOPA has identified divergent practices in this regard, including different interpretations for some features of an insurance contract.

To promote a convergent approach, EIOPA proposes to replace "Guideline 6 – Identification of an observable effect on the economics of a contract" with the following guidelines:

- **Guideline 6a:** Identification of a financial guarantee of benefits with an observable effect on the economics of a contract.
- **Guideline 6b:** Identification of a coverage for a specified uncertain event that adversely affects the insured person with an observable effect on the economics of a contract.
- **Guideline 6c:** Reassessment of the observable effect of a cover or financial guarantee.

A financial guarantee or a coverage has an *observable effect* where it is linked to the payment of future premiums, providing the policyholder with a distinct financial advantage. A *financial advantage* is assessed by the extent to which the set of future cash flows would be expected to change if the financial guarantee or cover did not exist.

The assessment of a financial advantage may be determined qualitatively or quantitatively, with Guidelines 6a and 6b providing guidance for both the qualitative and quantitative assessment of financial guarantees and coverages, respectively. Insurers are not expected to perform these assessments on a contract level but should consider the average features at product level.

GUIDELINE 6C – REASSESSMENT OF THE DISCERNIBLE EFFECT OF A COVER OR FINANCIAL GUARANTEE

This guideline is introduced to formalise the approach across market participants to the reassessment of contract boundaries.

Changes in the external environment may change the contract boundaries of an insurance contract. Insurers must reassess and update contract boundaries where this leads to an amendment of the current contract boundary. Insurers are not expected to reassess at each valuation date, but only where the change in the external environment implies a change in the contract boundary.

The proposed guideline aims to ensure that equivalent contracts are treated similarly under Solvency II. Consequently, this may potentially result in more frequent changes to contract boundaries, which would increase the volatility of technical provisions and own funds, as well as the burden on insurers and supervisory authorities.

EIOPA concludes that the impact of this proposed revision is not material, as contract boundaries are expected to remain constant in most cases.

Conclusions

The revised guidelines provide a common understanding of contract boundaries, resulting in a more common approach across Europe. With this proposal, EIOPA aims to better reflect the approach followed in most cases in Europe and bring the Solvency II treatment of contract boundaries and unbundling closer to that of IFRS 17.

Certain insurers and supervisors will require adjustments in their approaches to comply with the revised guidelines. This is unavoidable, and expected, when addressing divergent practices. Depending on the approach currently taken, the revised guidelines may have an impact on the valuation and balance sheets of insurers offering certain products. Additionally, the revised guidelines have a potential impact on the effectiveness of internal and external reinsurance transactions implemented with a primary objective to release contract boundaries.

The impact analyses provided by EIOPA for the amendments regarding unbundling and the reassessment of contract boundaries is based on information from Quantitative Reporting Templates (QRTs). It is acknowledged that a deeper analysis is required, with EIOPA requesting input from stakeholders by 12 November 2021.

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