

# Revision of EIOPA Guidelines April 2022



## Introduction

During the Solvency II 2020 Review process, the European Insurance and Occupational Pensions Authority (EIOPA) identified divergent practices in relation to the valuation of technical provisions and contract boundaries across Europe. In response, EIOPA has recently provided additional guidance to provide clarification in these areas.

EIOPA opened a consultation period in July 2021 for stakeholders to provide their feedback to the proposed Guidelines. The consultation period closed in November 2021, and EIOPA published its finalised reports<sup>1</sup> on the revision of the Guidelines on Contract Boundaries, and the Guidelines on the Valuation of Technical Provisions, in April 2022. The revised Guidelines will apply from 1 January 2023.

In this note, we describe the most material aspects of these revised Guidelines.

## Revision of the Guidelines on the Valuation of Technical Provisions

### OVERVIEW

In its consultation paper, EIOPA targeted the following divergent areas regarding the valuation of technical provisions:

- The proportionality principle
- Assumption-setting considerations
- Investment management expenses, and the apportionment of expenses
- Financial guarantees and contractual options
- Future management actions
- Role of the actuarial function on Expected Profit in Future Premium (EPIFP) calculation

After taking feedback from the industry, EIOPA has refined its initial proposal and has introduced the following new Guidelines:

- Guideline 0: Proportionality
- Guideline 24a-24e: Assumptions Setting
- Guideline 28a: Investment Management Expenses
- Guideline 37a-37c: Financial Guarantees and Options

- Guideline 40a-40b: Management Actions
- Guideline 53a: Use of Stochastic Valuation
- Guideline 57a: Market Risk Factors Needed to Deliver Appropriate Results
- Guideline 77a: Alternative Approach to Calculate EPIFP

The following Guidelines were also amended:

- Guideline 25: Modelling Biometric Risk Factors
- Guideline 30: Apportionment of Expenses
- Guideline 33: Changes in Expenses
- Guideline 77: Assumptions Used to Calculate EPIFP

No Guidelines were removed as part of the review process.

### THE PROPORTIONALITY PRINCIPLE

EIOPA has introduced a new Guideline which explicitly provides for the consideration of the proportionality principle in the valuation of the Solvency II technical provisions. This Guideline also influences the advice provided later in the report, particularly in relation to the use of stochastic valuation methods.

### ASSUMPTION-SETTING CONSIDERATIONS

EIOPA has introduced a number of new Guidelines to enhance the consistency of the assumption-setting process. These new Guidelines state that quantitative and qualitative indicators should be used to assess the materiality in assumption setting, including consideration of extreme binary events, such as global warming and legislative or political changes that might impact the sustainability of the business model.

Additional guidance is provided explicitly in relation to modelling biometric risk factors, specifically in relation to using a deterministic or stochastic approach, liability duration considerations and biometric risk factor independence and correlation.

A number of new Guidelines on this topic focus on enhancing governance, communication of uncertainty, documentation (including documentation of expert judgement in assumption setting) and validation in assumption setting.

<sup>1</sup> EIOPA (21 April 2022). EIOPA finalises the revision of Guidelines on Contract Boundaries and Guidelines on the Valuation of Technical Provisions. Retrieved 2 June 2022 from

[https://www.eiopa.europa.eu/media/news/eiopa-finalises-revision-of-eiopa%E2%80%99s-guidelines-contract-boundaries-and-guidelines\\_en](https://www.eiopa.europa.eu/media/news/eiopa-finalises-revision-of-eiopa%E2%80%99s-guidelines-contract-boundaries-and-guidelines_en).

## INVESTMENT MANAGEMENT EXPENSES, AND THE APPORTIONMENT OF EXPENSES

In its initial proposal, EIOPA noted the wide range of different approaches that companies were using to model investment expenses in the valuation of technical provisions, such as:

- Including all investment expenses
- Including investment expenses related to the Solvency II best estimate liability
- Including investment expenses related to the Solvency II technical provisions
- Including investment expenses related to the Solvency II technical provisions plus the Solvency Capital Requirement (SCR)
- Including investment expenses related to the local financial statements or GAAP technical provisions
- Excluding investment expenses

Initially in the consultation paper,<sup>2</sup> EIOPA had proposed the following new Guideline:

*Insurance and reinsurance undertakings should take into account administrative and trading expenses related to [an] amount of investments at least equal to Solvency II technical provisions plus the Solvency Capital Requirement.*

In the final report, EIOPA has considered stakeholder feedback and has amended the proposed Guideline above to be less prescriptive. The new Guidelines states that investment expenses included in the technical provisions should be based on “*the investments needed to service insurance and reinsurance contracts.*”

The new Guideline specifically delineates between contracts for which there is a clear link between the contract and backing assets (e.g., unit-linked business, ring-fenced funds) and other contracts. It also includes a paragraph stating that:

*Reimbursements of investment management expenses that the fund manager pays to the undertaking should be taken into account as other incoming cash flows. Where these reimbursements are shared with the policyholders or other third parties, the corresponding cash out flows should also be considered.*

It is unclear whether the same treatment should also be applied to investment expenses passed from an undertaking to the policyholder. Companies will need to consider whether this updated Guideline has a subsequent impact on the calculation of the Expense SCR, and how cash flows would pass between fund managers, companies and policyholders under an expense stress.

The new Guideline also explicitly states that (re)insurers can consider modelling all investment management expenses as a simplification.

The explanatory text provides a bit more colour on what “expenses to service the contracts” means in practice:

- *In some cases, insurance and reinsurance undertakings may still be able to clearly identify the investments related to a product or obligation as part of their [Asset-Liability Matching] policy, but in other cases it may be necessary to use drivers to estimate the amount of investments related to a product as if the product were a ring fenced fund.*
- *The appropriate driver to be used depends on the product or obligation, but since Solvency II framework follows an economic valuation, the Best Estimate might not be an accurate driver (due to EPIFP among others). In some cases, local GAAP technical provisions may be used as drivers, e.g. for with profits products where the profit sharing mechanism is linked to local GAAP technical provisions.*

Regarding inflation, EIOPA does not prescribe a specific methodology but provides explanatory text in relation to the use of market data, correlation between inflation rates and interest rates, cases where expenses may not be subject to inflation and proportionality.

## FINANCIAL GUARANTEES AND CONTRACTUAL OPTIONS

EIOPA has introduced three new Guidelines in relation to the treatment of financial guarantees and options. The first of these, Guideline 37a, states that companies should base assumptions on option take-up rates on:

- Statistical and empirical evidence, where it is representative of future conduct
- Expert judgement on sound rationale and with clear documentation

It also notes that a lack of data in extreme scenarios should not be sufficient justification to avoid modelling dynamic policyholder behaviour. The explanatory text adds that companies should consider that policyholders may not actively manage their products, and so their behaviour may not be motivated purely from an economic perspective.

New Guidelines have also been added stating that both increases and decreases in exercise rates should be considered as part of setting dynamic assumptions, and that companies should allow for the option of policyholders to pay additional premiums or vary their premiums in their modelling.

Regarding valuation methodologies for material options and guarantees, EIOPA has stated that these should be valued

<sup>2</sup> EIOPA (14 July 2021). Consultation on the revision of the Guidelines on Valuation of Technical Provisions. Retrieved 2 June 2022 from <https://www.eiopa.europa.eu/document->

[library/consultation/consultation-revision-of-guidelines-valuation-of-technical-provisions\\_en](https://www.eiopa.europa.eu/document-library/consultation/consultation-revision-of-guidelines-valuation-of-technical-provisions_en).

stochastically, and has provided some considerations which (re)insurers should include in their materiality assessment of these options and guarantees.

Regarding Economic Scenario Generators (ESGs), EIOPA has specified that companies should be able to demonstrate that their modelling reflects the volatility of their underlying assets, and that the models used should allow for the modelling of negative interest rates.

#### FUTURE MANAGEMENT ACTIONS

EIOPA has communicated that a board-approved “comprehensive management plan” is to be required by (re)insurers. As described in Guideline 40a, this should consist of either:

- *a single document listing all assumptions relating to future management actions used in the best estimate calculation; or*
- *a set of documents, accompanied by an inventory, that clearly provide a complete view of all assumptions relating to future management actions used in [the] best estimate calculation.*

EIOPA has also clarified that companies should consider the effect of new business in setting future management actions and consider the consequences of new business on other related assumptions.

#### ROLE OF THE ACTUARIAL FUNCTION ON EPIFP CALCULATION

EIOPA has stated that it considers EPIFP validation by the actuarial function to be a best practice but acknowledges that other approaches would still be compliant with the Solvency II framework. In any case, the calculation is expected to be performed by staff with adequate actuarial knowledge to ensure consistency with the best estimate valuation.

In addition to the two additional Guidelines on EPIFP calculation, EIOPA highlighted the following considerations in its explanatory text:

- *expenses directly related to future premiums should be excluded since the underlying assumption is that no future premiums will be received (e.g. some acquisition expenses);*
- *fixed costs should remain unchanged (e.g. no hypothesis on lower costs – such as salaries – should be used because no future premiums will be received);*
- *variable expenses should be influenced only indirectly because without future premiums, the invested reserve will not increase as planned (e.g. for investment management expenses, using the same management fee percentage as in the official technical provisions without risk margin but applied to lower amounts).*

## Revision of the Guidelines on Contract Boundaries

### OVERVIEW

This revision by EIOPA has introduced a number of new Guidelines, amended existing Guidelines and removed previous Guidelines.

The following new Guidelines have been introduced:

- Guideline 0: Contract Boundaries
- Guideline 6a: Identification of a Financial Guarantee of Benefits With a Discernible 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 a Discernible Effect on the Economics of a Contract
- Guideline 6c: Reassessment of the Discernible Effect of a Cover or Financial Guarantee

The following existing Guidelines have been amended:

- Guideline 5: Unbundling of the Contract

The following existing Guidelines have been removed:

- Guideline 6: Identification of a Discernible Effect on the Economics of a Contract

While these Guidelines have been brought in to align identified divergent practices regarding contract boundaries, EIOPA has acknowledged that these new Guidelines are intended to provide clarification rather than changing the underlying criteria for determining contract boundaries. Therefore, the introduction of these Guidelines is not expected to result in a material change in approach across the industry.

### GENERAL GUIDELINES ON CONTRACT BOUNDARIES

The introduction of Guideline 0 provides additional clarification on contract boundaries. The explanatory text then gives the following examples in determining the contract boundary for an insurance obligation:

- *Where the undertaking can compel the policyholder to pay the premium, the premium and the related obligations belong to the contract because the undertaking has the right to request and keep the premium.*
- *Where the undertaking has the obligation to accept new premiums and cover the related obligations, but does not hold the unilateral right to amend the premiums/benefits so that the premiums fully reflect the risk, these premiums and the related obligations belong to the contract because the undertaking has the obligation to cover the risks.*

- *In most of the cases, paid-in premiums and the related obligations reflect a right and an obligation for the undertaking, i.e. the right to keep the premium and the obligation to cover the risk. Therefore, the premium and the related obligations belong to the contract.*

The explanatory text also clarifies that, while a contract boundary limits the premiums on an obligation, the cash flows stemming from these premiums and obligations are not limited by the boundary and therefore should be projected accordingly.

#### GUIDELINES ON CONTRACT UNBUNDLING

The amendment of Guideline 5 and the new Guideline 6a, 6b and 6c provide additional clarity on contract unbundling. EIOPA has stated that the applicability of these revised Guidelines should not automatically lead to a reassessment of the contract boundaries of all existing contracts. However, if companies are using practices that clearly deviate from the new Guidelines, they should perform reassessments when these Guidelines become applicable.

EIOPA has reiterated in its feedback statement that contract boundary assumptions still do not require any kind of formal approval. In its explanatory text, EIOPA has provided a number of examples of whether or not to unbundle an insurance contract to accompany the amendment of Guideline 5.

The new Guideline 6a and 6b on identification of financial guarantees and coverage of specified events recommends the use of qualitative or quantitative assessments. Analysis should be performed at a suitably high level, and contract-by-contract assessments are not required. The quantitative assessment should be based on all future obligations related to the contract, including expenses, and all obligations related to the contract should be considered regardless of contract boundaries.

Regarding the assessment of discernible effects of financial options and guarantees on contracts, EIOPA has stated that companies are expected to use recommendations by national supervisory authorities. In the case where no recommendations are available, they can derive their own ranges in consultation with national supervisory authorities.

EIOPA states that after extreme changes in the economic environment, a reassessment of contract boundaries will be necessary. Specifically regarding extreme movements in the risk-free interest rate, EIOPA clarified:

*Changes in the relevant risk-free rate since the date when the assessment used to define the current contract boundaries was performed that are lower than the interest rate stress in the Standard Formula should not be considered to be extreme. This does not necessarily mean that any change in*

*the risk-free rate term structure beyond the interest rate stress in the Standard Formula should be considered to be extreme.*

EIOPA notes that the time when the reassessment takes place may have an impact on the outcome. To overcome this, it suggests performing the reassessment as if the contracts were issued at the valuation date, or to base the reassessment for existing contracts on the assessment for similar new contracts.

EIOPA has clarified that contract boundaries should not be reassessed in the calculation of the SCR scenarios or scenarios in a stochastic valuation, even though these may represent an extreme change in the external environment which, if experienced, would trigger a reassessment.

## Summary

The scale of the impact of the introduction of the revised Guidelines will obviously depend on the nature of the individual company. There are some actions that most companies will need to consider in light of the Guidelines:

- Review assumption-setting process
- Review the treatment of investment expenses
- Review dynamic policyholder behaviour, and consider modelling this behaviour if it is not currently in the basis
- Prepare a board-approved comprehensive management plan, or ensure that the current process and documentation of management actions meet the requirements to be classified as a comprehensive management plan
- Review calculation and governance of the EPIFP
- Review contract boundary methodology to ensure compliance with new Guidelines



## How Milliman can help

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