

Final Report on the Public Consultation on the revision of the Guidelines on Contract Boundaries

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1. EXECUTIVE SUMMARY

1.1. INTRODUCTION

- 1.1 During the 2020 review of Solvency II EIOPA identified several divergent practices regarding contract boundaries assessment, as presented in the analysis background document¹ to EIOPA's Opinion on the 2020 review of Solvency II. Divergent practices require additional guidance to ensure a convergent application of the existing regulation on contract boundaries.
- 1.2 In accordance with Article 16 of Regulation (EU) No 1094/2010² EIOPA issues these revised Guidelines to provide guidance on how insurance and reinsurance undertakings should apply the requirements of Directive 2009/138/EC³ ("Solvency II Directive") and in Commission Delegated Regulation (EU) No 2015/35⁴ ("Delegated Regulation"), on the boundaries of insurance and reinsurance contracts.
- 1.3 This revision introduces new Guidelines and amends current Guidelines on topics that are relevant for the determination of contract boundaries, in particular regarding the assessment whether a cover or financial guarantee has a discernible effect on the economics of the contract and the identification of the contracts which can be unbundled.

1.2. CONTENT

¹ https://www.eiopa.europa.eu/content/opinion-2020-review-of-solvency-ii_en

² Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pension Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

³ Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

⁴ Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

- 1.4 This Final Report includes the feedback statement to the consultation paper (EIOPA-BoS-21/301), the revised Guidelines, their Explanatory Text and the Impact Assessment. The Resolution of comments is published on EIOPA's [website](#).
- 1.5 The revised Guidelines are addressed to competent authorities as defined in Article 4(2) of Regulation (EU) No 1094/2010.
- 1.6 The revised Guidelines apply to both individual undertakings and mutatis mutandis at the level of the group⁵.
- 1.7 These revised Guidelines should be read in conjunction with and without prejudice to the Solvency II Directive, the Delegated Regulation and EIOPA's Guidelines on contract boundaries. Unless otherwise stated in this document, the current guidelines of EIOPA's Guidelines on contract boundaries remain unchanged and continue to be applicable.
- 1.8 If not defined in these revised Guidelines, the terms have the meaning defined in the Solvency II Directive.
- 1.9 These revised Guidelines do not deviate from the previous Guidelines and only add additional details compatible with the high-level guidance included in the previous Guidelines. For this reason, the applicability of these revised Guidelines should not lead to a reassessment of the contract boundaries of existing contracts. However, according to the revised Guidelines a reassessment is to be performed in case there is indication that the outcome would be different. Therefore, a reassessment of contract boundaries when these revised Guidelines enter into force is necessary in case the previous assessment significantly differs from the approach envisaged in these revised Guidelines. In addition, any reassessment of contract boundaries that is necessary according to these revised Guidelines should be performed according to the new Guidelines regardless whether the contract was underwritten before these revised Guidelines become applicable.
- 1.10 These revised Guidelines shall apply from 01-01-2023.

1.3. NEXT STEPS

- 1.11 A translated consolidated version of the Guidelines on contract boundaries will be published on EIOPA's website. In addition, EIOPA will publish an Explanatory note including a compilation in English of the Guidelines on contract boundaries and the Explanatory text.

⁵ As defined in Article 212 (1) of the Solvency II Directive.

- 1.12 This document contains guidelines issued under Article 16 of Regulation (EU) No 1094/2010. In accordance with Article 16(3) of that Regulation, competent authorities and financial institutions are required to make every effort to comply with guidelines and recommendations.
- 1.13 Competent authorities that comply or intend to comply with these revised Guidelines should incorporate them into their regulatory or supervisory framework in an appropriate manner.
- 1.14 Competent authorities are to confirm to EIOPA whether they comply or intend to comply with these revised Guidelines, with reasons for non-compliance, within two months after the issuance of the translated versions.
- 1.15 In the absence of a response by this deadline, competent authorities will be considered as non-compliant to the reporting and reported as such.
- 1.16 EIOPA will publish the fact that a competent authority does not comply or does not intend to comply with these revised guidelines. The reasons for non-compliance may also be decided on a case-by-case basis to be published by EIOPA. The competent authority will receive advanced notice of such publication.
- 1.17 EIOPA will, in its annual report, inform the European Parliament, the Council and the European Commission of the guidelines issued, stating which competent authority has not complied with them, and outlining how EIOPA intends to ensure that concerned competent authorities follow its guidelines in the future.
- 1.18 These revised Guidelines will be subject to a review by EIOPA

2. FEEDBACK STATEMENT

2.1. GENERAL COMMENTS

- 2.1. EIOPA would like to thank the Insurance and Reinsurance Stakeholder Group (IRSG) and all the participants to the Public Consultation for their comments on the revised guidelines. The responses received have provided important guidance to EIOPA in preparing a final version of these guidelines. All the comments made were given careful consideration by EIOPA. A summary of the main comments received and EIOPA's response to them can be found in the sections below. The full list of all the comments provided and EIOPA's responses to them is published on EIOPA's website.
- 2.2. EIOPA received comments from the Insurance and Reinsurance Stakeholder Group (IRSG) and eighteen responses from other stakeholders to the public consultation. All the comments received and labelled as public by the stakeholder have been published on EIOPA's website with an individual resolution.
- 2.3. Respondents can be classified into three main categories: European trade, insurance, or actuarial associations; national insurance or actuarial associations; and other parties such as consultants, lawyers or insurance and reinsurance undertakings.
- 2.4. The comments on contract boundaries mainly focus on the application date and the assessment whether a cover or financial guarantee have a discernible effect on the economics of the contract.
- 2.5. The Consultation Paper also included an Impact Assessment and was accompanied by an information request to complement it. Where the need for reviewing the Impact Assessment has arisen following comments on the revised Guidelines, the Impact Assessment has been revised accordingly.

2.2. APPLICATION DATE

- 2.6. The main concerns from stakeholders are about the resources need to adapt their systems to the revised Guidelines, the need to revise the existing portfolio of contracts when the revised Guidelines become applicable and the potential overlap with the entry into force of IFRS 17.

- 2.7. Regarding the burden for undertakings to perform a full revision of contract boundaries when the revised Guidelines become applicable, EIOPA has also clarified that these revised Guidelines do not deviate from the previous Guidelines and only add additional details compatible with the high-level guidance included in the previous version of the Guidelines. For this reason, the applicability of these revised Guidelines should not automatically lead to a reassessment of the contract boundaries of all existing contracts. However, Guidelines 5 and 6c require a reassessment in case there is indication that it may lead to different contract boundaries. Therefore, those insurance and reinsurance undertakings currently following practices that clearly deviate from the guidance included in Guidelines 5, 6a and 6b should perform a reassessment when these revised Guidelines become applicable.
- 2.8. In terms of the burden for undertakings to adapt the contract boundaries assessment process, and given the considerations in the previous paragraph, EIOPA considers that implementation should be possible by the 1 January 2023 in almost all cases. However, EIOPA acknowledges that this can be a challenge in the specific cases of IFRS 17 users if they are also significantly impacted by these revised Guidelines. In these specific cases, EIOPA recommends the national competent authorities to follow a flexible approach for the first application of these revised Guidelines.
- 2.9. Finally, it should be noted that Guidelines only support the interpretation of the existing regulation and therefore cannot create new transitional measures to smooth their initial application. In any case, the information request showed that the expected impact of this revision of the Guidelines is expected to be low, so EIOPA considers that transitional measures are not needed.

2.3. DISCERNIBLE EFFECT OF A COVER OR FINANCIAL GUARANTEE ON THE ECONOMICS OF THE CONTRACT

- 2.10. Stakeholders have raised three main concerns regarding discernible effect. First, about the expectation of supervisors on the quantitative assessment and the role of supervisors on the process. The second, on status of the example included in the Explanatory Text of Guidelines 6a and 6b, in particular whether it should be understood as a threshold. Finally, the third one, regarding the frequency of the reassessment of discernible effect after changes in the economic environment and its potential impact.
- 2.11. A core element of the determination of contract boundaries is the assessment of whether the restrictions to undertakings' unilateral rights, limitations of the extent to which

premiums and benefits can be amended, covers for a specified uncertain events and financial guarantees have a discernible effect on the economics of the contract. Divergent approaches have been identified, in particular regarding covers and discernible effect. EIOPA therefore considers it is necessary to ensure convergence in this regard.

- 2.12. Regarding the role of the supervisors, EIOPA agrees with stakeholders that contract boundaries are not subject to any kind of approval. EIOPA does not consider that the text of the revised Guidelines 6a and 6b introduced such notion, but only structured the different approaches described to assess the discernible effect, clarifying that the quantitative approach is expected to be used in cases where the qualitative approach is not conclusive, e.g. when the undertaking and the supervisor reach different conclusions. However, to avoid any misinterpretation, EIOPA has removed the controversial reference to the role of NCAs from the Guideline, as this is embedded in their usual supervisory activities.
- 2.13. On the example in the Explanatory text of Guidelines 6a and 6b, EIOPA wishes to further clarify that it is only an example and the percentages used should not be considered to be a threshold. The percentages only reflect EIOPA expectations in terms of order of magnitude for the ad-hoc threshold that should be defined for each product in case a quantitative assessment is performed. In particular, it should also be noted that this example is only relevant for the purposes of contract boundaries assessment, but it should not be used as a reference for any other purpose (e.g. to determine whether a contract should qualify as insurance contract).
- 2.14. About the frequency of the reassessment, EIOPA considered the comments and believes that after extreme changes in the economic environment, a reassessment is necessary to ensure a market consistent valuation. However, EIOPA understands the concerns about the reassessments being performed too frequently. For this reason, EIOPA has clarified that the reassessment should only be performed after extreme changes in the economic environment and that, in any case, contract boundaries are expected to remain constant in most of the cases.

3. ANNEX I: GUIDELINES WITH EXPLANATORY TEXT

NEW: GUIDELINE 0 – CONTRACT BOUNDARIES

- 3.1. Insurance and reinsurance undertakings should not consider contract boundaries as a single point in time, but as a boundary between the premiums and obligations that belong to the contract and the premiums and obligations that do not belong to the contract. Cash flows related to premiums and obligations that belong to the contract should be projected using realistic assumptions, which means that the projection of cash flows might go beyond any of the dates referred to in Article 18(3) of the Delegated Regulation.

Explanatory text:

- 3.2. Contract boundaries determine the premiums and obligations that belong to the contract considering the rights and risks for the undertakings. 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.
- 3.3. 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.
- 3.4. However, under very specific circumstances, this may not be the case. For example, in case of a contract with a paid-in premium where either party can cancel the contract during a limited period of time, e.g. a few days after entering into it. In such a case, the undertaking does not have the right to keep the premium nor the obligation to cover the risk and, therefore, the premium and the related obligations do not belong to the contract. However, these cases will usually have an immaterial impact on the value of the best estimate liability of the undertaking, among others, due to the short period where both rights coexist. In such

a case, undertakings might still consider that these obligations related to paid-in premiums belong to the contract.

3.5. In any case, contract boundaries only limit the premiums and obligations that belong to the contract, but do not limit the projection horizon of the cash flows steaming from these premiums and obligations. The following example illustrates this point:

3.6. Example: The contract covers the risk of the following year for premiums paid during the year (e.g. paid on the 31st of December). If an insured event occurs, the actual payments (cash flows) may occur spread across three years. The undertaking has the right to amend any future premium so it fully reflects the risk. Valuation date: end of year t.

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

3.7. The horizon of projection of future cash flows is not affected by the contract boundaries. Even if obligations from premiums received in t+1 do not belong to the contract, cash flows related to previous obligations should be projected beyond t+1.

AMENDED: GUIDELINE 5 – UNBUNDLING OF THE CONTRACT

- 3.8. Insurance and reinsurance undertakings should assess whether at recognition date it is possible to unbundle a contract and, at each valuation date, consider whether there has been any change, which would affect the previous assessment.
- 3.9. Insurance and reinsurance undertakings should consider that a contract can be unbundled for the purpose of contract boundaries if and only if two (or more) parts of the contract are equivalent in terms of risk to two (or more) contracts that could be sold separately. For the purposes of this Guideline, two contracts should be considered to be equivalent in terms of risk if there are no discernible differences in the economics of the contracts regarding the insurance or financial risk borne by the undertaking.
- 3.10. Notwithstanding the previous point, where all the parts of a contract have the same contract boundary, as a simplified approach undertakings may consider not to unbundle the contract for the purpose of setting contract boundaries.
- 3.11. When an option or guarantee covers more than one part of the contract, insurance and reinsurance undertakings should determine whether it is possible to unbundle it or whether it should be attributed to the relevant part of the contract.
- 3.12. If a contract is considered an insurance contract under Solvency II Directive, insurance and reinsurance undertakings should consider all unbundled parts of the contract to give rise to insurance or reinsurance obligations.
- 3.13. If a contract is unbundled for the purposes of assessing contract boundaries, each part should be treated as an independent contract.

Explanatory text:

- 3.14. Unbundling can be performed at two different levels or stages of the valuation process:
- a) Unbundling for cash flow projection purposes: The first step for best estimate valuation is the projection of cash flows. Where a contract has different parts, the cash flows of each part may be independent, the cash flows of one part may depend on the other (dependency) or the cash flows of each part may depend on the other parts (interdependency). Where material (inter)dependency exists, unbundling for cash flow projection purposes is not possible: in case of unbundling, the dependency among cash

flows would be lost. Therefore, in such a case, cash flows should be projected for the whole contract altogether.

- b) Unbundling for valuation purposes: The second step for best estimate valuation is to determine which cash flows belong to the contract, i.e. which cash flows will be included in the best estimate. The key criteria for that purpose is Article 18 of the Delegated Regulation.

- 3.15. In most of the cases, where unbundling for cash-flow projection purposes is not possible, undertakings should not unbundle the contract for valuation purposes. However, in some cases a contract may be equivalent in terms of risk to the sum of two independent contracts that could be sold independently. In such a case, not unbundling the contract could lead to different contract boundaries compared to two independent contracts, while in terms of risk no discernible differences exist.
- 3.16. Therefore, any contract that is equivalent in terms of risk to two (or more) parts of the contract could be sold independently should be unbundled. Conversely, dependencies in terms of risk should prevent a contract from being unbundled unless they are not discernible. To assess such equivalence, only insurance and financial risk should be considered and non-discernible differences should not prevent the contract from being unbundled.
- 3.17. For example, a unit-linked contract with a mortality cover where the payout in case of death is equal to the sum of a fixed amount (sum insured) plus the value of the fund should be unbundled as there is no connection between the risks of each part. The first part would be a unit-linked component to be paid in any case (death or survival), and the second component would be the mortality cover guaranteeing an additional sum insured in case of death. Conversely, in case of a unit-linked contract with a mortality cover where the payout in case of death is equal to the maximum between a fixed amount (sum insured) and the value of the unit-linked fund, the risk of the mortality cover depends on the unit-linked fund, so this contract should not be unbundled.
- 3.18. In some cases, cash flows are projected for a group of contracts altogether but contract boundaries may be different for some of them. For example, for products with profit sharing features, the cash flow projection may be done globally for several guarantees, but cash flows are allocated at a later step (unbundled) for valuation purposes and even different contract boundaries may exist for contracts with different financial guarantees.
- 3.19. Dependencies at the level of premiums or reserves should also be considered to determine whether a contract should be unbundled. In particular, these dependencies may prevent a

contract from being unbundled in case they create a discernible dependency in terms of insurance or financial risk.

- 3.20. In particular, in case of a product including two savings components where the policyholder decides the allocation of the premium or existing reserves between the two components or where this is predetermined (e.g. changing the percentage of each premium allocated to each component depending on the age of the policyholder). In this case, there is no connection between the risk of both savings components and this behaviour could be easily replicated with two independent products.
- 3.21. For example, in a contract with two parts, general account plus unit linked, where the policyholder may choose the percentage of premium allocated to each part, the dependency exists only at the level of the premium and there is no discernible difference in terms of insurance or financial risk compared to two independent contracts (general account and unit linked). Therefore, this contract should be unbundled.
- 3.22. However, in case there are dynamic reallocations (i.e. not controlled by the policyholder nor predefined), the risk between both parts is connected as the premium/reserve represents the risk exposure for savings products and the reallocations depend on the evolution of the financial risk. Therefore, dynamic reallocations usually prevent from unbundling.
- 3.23. In case of a combination of a savings product with a rider, if the premium for the rider is predefined (e.g. the undertaking cannot amend it), then there is no connection between the risks as the premium for the savings component can be determined beforehand. In case the premium for the mortality cover is not predefined (e.g. the undertaking can amend it), there is a dependency from the savings component on the rider, i.e. if the mortality risk changes, this would impact the savings component. Therefore, in this case unbundling would not be possible provided this dependency has a discernible effect on the economics of the contract.
- 3.24. Similarly, when the rider is covered through periodical charges from the savings component, the product may still be unbundled in case these charges are predefined. It should be noted that if the product is not unbundled, these charges should be considered to be part of the benefits agreed within the contract. Conversely, in case the contract can be unbundled, both parts should be treated as independent contracts. This means that the periodical charges should be considered to be equivalent to premiums that should be projected only within contract boundaries.
- 3.25. For example, a whole life unit-linked product with a rider (e.g. mortality cover) that has a single premium paid at the beginning of the contract were costs are deducted periodically from the market value of the fund to cover the rider. In this case, if the contract cannot be

unbundled, the periodical charges should not be considered to be equivalent to premiums so they are to be projected regardless of contract boundaries.

DELETED: GUIDELINE 6 - IDENTIFICATION OF A DISCERNIBLE EFFECT ON THE ECONOMICS OF A CONTRACT

NEW: GUIDELINE 6A – IDENTIFICATION OF A FINANCIAL GUARANTEE OF BENEFITS WITH A DISCERNIBLE EFFECT ON THE ECONOMICS OF A CONTRACT

- 3.26. When determining whether a financial guarantee has no discernible effect on the economics of a contract, insurance and reinsurance undertakings should take into account all potential future cash flows, which may arise from the contract.
- 3.27. Insurance and reinsurance undertakings should consider a financial guarantee of benefits as having a discernible effect on the economics of a contract only if the financial guarantee is linked to the payment of the future premiums and provides the policyholder with a discernible financial advantage.
- 3.28. When determining whether a financial guarantee provides for a discernible financial advantage, insurance and reinsurance undertakings should consider the extent to which the whole set of future cash flows is expected to discernibly change if the financial guarantee did not exist. Undertakings can assess this on qualitative or quantitative basis.
- 3.29. The qualitative assessment should consider whether the configuration (risk, timing and amount) of the cash flows of the contract with the financial guarantee discernibly differs from the configuration of the contract without the financial guarantee.
- 3.30. The quantitative assessment should be based on whether the relative difference in the value of all future obligations related to the contract with and without the financial guarantee (“value of the financial guarantee”) on an expected present value basis is discernible. When calculating the value of the obligations without the financial guarantee, insurance and reinsurance undertakings should assume cash flows equal to

the amount that would be paid if the financial guarantee did not exist. For contracts where the benefits depend on market returns undertakings should assume benefits that are consistent with relevant risk-free interest rate term structure used to calculate the best estimate as referred to in Article 77(2) of Solvency II Directive, without volatility adjustment and matching adjustment. When calculating the value of the obligations with the financial guarantee, insurance and reinsurance undertakings should consider in the valuation any form of guaranteed benefits stemming from the financial guarantee. Proper consideration of the time value of options and guarantees is relevant for this assessment.

Explanatory text:

- 3.31. The qualitative assessment may be based on any relevant considerations that provide evidence whether the financial guarantee provides a discernible effect on the economics of the contract. For example, undertakings may consider whether the financial guarantee is deeply in or out of the money or whether the price of the guarantee represents only a small percentage of the annual investment management fees charged to the policyholder. Other alternative approaches could be based on previous quantitative assessments or quantitative assessments performed for similar products. This means that new business is expected to rely on a past quantitative analysis for the same product if available, notwithstanding the potential need, at some point in time, to repeat the assessment based on Guideline 6c.
- 3.32. The quantitative assessment should be based on all future obligations related to the contract, including expenses, as guarantees on the level of expenses may have a discernible effect on the economics of the contract. This means that the calculation should include obligations related to paid-in and future premiums. This also means that, for the purposes of the assessment, all obligations related to the contract should be considered regardless of contract boundaries. For example, for a 10 year contract offering an financial guarantee of benefits revised annually with a minimum of 0%, the assessment whether the 0% minimum guarantee provides a discernible effect should consider all premiums and the related obligations within the contractual period (10 years) regardless whether in the end the final conclusion is that contract boundaries are shorter.
- 3.33. In order to properly consider the time value of the financial guarantee stochastic valuation is usually necessary. This could be achieved using simulation methods based on probability-weighted potential future scenarios, as well as with some closed-formula approaches for simple cases.

- 3.34. The assessment, in particular where quantitative, may depend on contract-specific features (e.g. age of the policyholder). Insurance and reinsurance undertakings are not expected to perform the analysis on a contract-by-contract basis and the analysis should consider average features at a higher level.
- 3.35. In some cases the outcome of the quantitative assessment will require additional considerations. For example, an undertaking may determine that for a specific product in case the stochastic value of the financial guarantee over the value of all future obligations is only 0.5%, the financial guarantee does not have a discernible effect on the economics of the contract, but if the ratio were 2% it would be considered to have a discernible effect on the economics of the contract. However, in some cases (e.g. 1%, which falls within the range 0.5% - 2%) further qualitative considerations may be needed, e.g. whether the effect of the financial guarantee is increasing, decreasing or constant through the life of the contract. In any case, undertakings are expected to use recommendations by NSAs, or in case of no recommendations, set their own ranges after consulting NSAs, which may be wider or narrower depending on the contract under assessment. It should also be noted that the value of the financial guarantee using deterministic valuation will usually be lower than its stochastic value.
- 3.36. In some cases, benefits may not depend on market returns at all. In such a case, it may be reasonable to use a benchmark that is not linked to the market, e.g. constant capital.
- 3.37. For the purpose of this assessment, the expected payments linked to future discretionary benefits whose allocation is absolutely voluntary for the undertaking should not be considered as they do not create any insurance nor financial risk for the undertaking. For this purposes, allocation of future discretionary benefits is absolutely voluntary where there is no legal nor contractual obligation to specifically allocate profits to one policyholder or group of policyholders or to unspecifically reserve profits for a future specific allocation to policyholders. Any other future discretionary benefit should be considered in the assessment.

NEW: 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

- 3.38. When determining whether the coverage for a specified uncertain event that adversely affects the insured person (cover) has no discernible effect on the economics of a

contract, insurance and reinsurance undertakings should take into account all potential future cash flows, which may arise from the contract.

- 3.39. Insurance and reinsurance undertakings should consider a cover as having a discernible effect on the economics of a contract only if the cover is linked to the payment of the future premiums and provides the policyholder with a discernible financial advantage.
- 3.40. When determining whether a cover provides a discernible financial advantage, insurance and reinsurance undertakings should consider the extent to which the whole set of future cash flows is expected to discernibly change if the cover did not exist. Insurance and reinsurance undertakings can assess this on qualitative or quantitative basis.
- 3.41. The qualitative assessment should consider whether the configuration (risk, timing and amount) of the cash flows of the contract with the cover discernibly differs from the configuration of the contract without the cover.
- 3.42. The quantitative assessment should be based on whether the relative difference in the value of all future obligations related to the contract with and without the cover (“value of the cover”) on an expected present value basis is discernible. When calculating the value of the obligations without the cover insurance and reinsurance undertakings should assume that the cover does not exist. When calculating the value of the obligations with the cover insurance and reinsurance undertakings should consider all obligations. Considering potential future scenarios in some cases is relevant for this assessment.

Explanatory text:

- 3.43. The qualitative assessment may be based on any relevant considerations that provide evidence whether the cover provides a discernible effect on the economics of the contract. For example, for contracts combining a savings part and a cover undertakings may consider whether the sum insured for the cover is very low in comparison to the principal of the contract or whether the price of the cover represents only a small percentage of the annual investment management fees charged to the policyholder. Other alternative approaches could be based on previous quantitative assessments or quantitative assessments performed for similar products. This means that new business is expected to rely on a past quantitative analysis for the same product if available, notwithstanding the potential need, at some point in time, to repeat the assessment based on Guideline 6c.

- 3.44. The quantitative assessment should be based on all future obligations related to the contract, including expenses. This means that the calculation should include obligations related to paid-in and future premiums. This also means that, for the purposes of the assessment, all obligations related to the contract should be considered regardless of contract boundaries.
- 3.45. To properly consider the value of the guarantee, probability-weighted potential future scenarios should be considered where relevant. This may include, for example, cases where the cover (e.g. mortality cover) is providing a financial guarantee (e.g. minimum return in case of death). For the quantitative assessment, stochastic valuation allows such consideration.
- 3.46. The assessment, in particular where quantitative, may depend on contract-specific features (e.g. age of the policyholder). Insurance and reinsurance undertakings are not expected to perform the analysis on a contract-by-contract basis and the analysis should consider average features at a higher level.
- 3.47. In some cases the outcome of the quantitative assessment will require additional considerations. For example, an undertaking may determine that for a specific product in case the value of the cover over the value of all future obligations is only 0.5%, the cover does not have a discernible effect on the economics of the contract, but if the ratio were 2% it would be considered to have a discernible effect on the economics of the contract. However, in some cases (e.g. 1%, which falls within the range 0.5% - 2%) further qualitative considerations may be needed, e.g. whether the effect of the cover is increasing, decreasing or constant through the life of the contract. In any case, undertakings are expected to use recommendations by NSAs, or in case of no recommendations, set their own ranges after consulting NSAs, which may be wider or narrower depending on the contract under assessment.

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

- 3.48. Insurance and reinsurance undertakings should keep contract boundaries constant through the whole life of a contract in almost all cases. However, due to changes of the external environment as defined in Article 29 of the Delegated Regulation as well as changes in the terms of the contract, contract boundaries may need to be amended.

- 3.49. Insurance and reinsurance undertakings are not expected to reassess whether a cover or financial guarantee has a discernible effect at each valuation date. However, insurance and reinsurance undertakings should perform this reassessment if there is indication that it may lead to a different conclusion. In particular, to assess changes in the economic environment undertakings should compare the current economic environment to the economic environment existing when the assessment used to define the current contract boundaries was performed and do a reassessment only in case these changes are extreme. For this purpose, the changes on the relevant risk-free interest rate term structure used to calculate the best estimate as referred to in Article 77(2) of the Solvency II Directive that are less extreme than the interest rate stress of the Standard Formula should not be considered to be extreme.
- 3.50. Insurance and reinsurance undertakings should change contract boundaries after this reassessment only if the reassessment leads to a clearly different conclusion than the assessment performed to define the current contract boundaries.
- 3.51. When the reassessment of the discernible effect of a cover or financial guarantee led to a change in contract boundaries resulting on a material impact on the valuation of technical provisions and the solvency of the undertaking, insurance and reinsurance undertakings should immediately report this change to the supervisory authority. In addition, insurance and reinsurance undertakings should consider this as a material change as referred to in Article 312(3) of the Delegated Regulation and include it in the annual report mentioned in that Article, including a detailed description of the reassessment and its impact on the solvency position of the undertaking.
- 3.52. Otherwise, the assessment whether a cover or financial guarantee has a discernible effect on the economics of the contract should not change.
- 3.53. Insurance and reinsurance undertakings should not reassess contract boundaries for the different scenarios used to calculate the best estimate using simulation methods nor for the stressed scenarios used to calculate the SCR.

Explanatory text:

- 3.54. Changes in the economic environment may have an impact on the assessment whether a cover or, in particular, a financial guarantee has a discernible effect on the economics of the contract.

- 3.55. While Guidelines 6a and 6b already envisage the consideration of potential future scenarios (e.g. using stochastic valuation in the quantitative assessment), changes in the economic environment may require a reassessment to ensure that contract boundaries properly reflect the risk borne by the undertaking.
- 3.56. Changes in the economic environment should only lead to a reassessment when they are extreme, i.e. the probability of changing back to the original situation in the mid-term is low. 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.
- 3.57. To determine whether the change in the risk-free rate is extreme or not, undertakings may use simplified indicators as long as they suit the nature and risk of the relevant obligations. For example, undertakings may base the assessment on the term of the risk-free rate term structure that matches the current Macaulay duration of the relevant obligations. If the difference between the current value of the term and its value when the last assessment was performed is lower than the interest rate stress of the Standard Formula for that term, the change in the risk-free rate term structure would not be considered to be extreme.
- 3.58. The outcome of a quantitative assessment has clearly changed only in case there has been a material change in the ratio compared to the outcome at when the assessment used to define the current contract boundaries was performed. Following the example in paragraph 3.35 or 3.47, if the undertaking concluded at inception that a ratio of 1.5% in that particular case does not create a discernible effect on the economics of the contract, the undertaking is not expected to change contract boundaries in case a reassessment leads to a 2% ratio, as it does not lead to clearly different conclusion compared to the previous assessment.
- 3.59. The point in time when the reassessment is performed may have an impact on the outcome, regardless of the economic conditions (e.g. assessment performed at inception vs. reassessment performed at year t). If undertakings do not properly consider this effect, the possibility to conclude that there is no discernible effect might increase with time for some contracts. One alternative to overcome this effect is to perform the reassessment as if the contracts were issued at valuation date or base the reassessment for existing contracts on the assessment for similar new contracts.
- 3.60. Where the reassessment leads to a change in the contract boundaries, this should be considered to be a material change as describe in Article 312(3) of the Delegated Regulation. Therefore, the undertaking should include a detailed description of the reassessment and its impact on the solvency position of the undertaking in the annual

report mentioned in that article. If the undertaking was already issuing that annual report, this information should be included within the same report. If no other material change triggered the need to issue that annual report, the undertaking should specifically issue it to cover this information.

- 3.61. Even if contract boundaries may be reassessed after changes in the economic environment, contract boundaries should not be reassessed in the calculation of the SCR scenarios, even for those that are stressing the economic environment, i.e. contract boundaries do not change in SCR calculations. The objective of the SCR is to assess the losses that the undertaking would face in extreme (1 in 200) scenarios. However, changes in contract boundaries do not reflect losses for the undertaking but only changes in the scope of the valuation of best estimate, so they should not be considered.
- 3.62. Similarly, while performing stochastic valuation, some scenarios considered within the valuation process could trigger a reassessment of contract boundaries. This should not be considered within the stochastic valuation process since changes in contract boundaries do not reflect a change in the expected cash flows but a change in the scope of obligations to be included in best estimate. Therefore, contract boundaries should remain constant through all the scenarios in the stochastic valuation to ensure that the valuation is consistent with the contract boundaries determined at the valuation date.

4. ANNEX II: IMPACT ASSESSMENT

4.1. PROCEDURAL ISSUES

- 4.1. In accordance with Article 16 of EIOPA Regulation, EIOPA has conducted analyses of costs and benefits during the policy development process. The analysis of costs and benefits is undertaken according to an impact assessment methodology.
- 4.2. This impact assessment covers the two main topics revised: unbundling of different parts of a contract and the assessment whether a cover or financial guarantee have a discernible effect on the economics of the contract. It is based on the qualitative assessment of the potential impacts done by EIOPA with some quantitative analysis based on prudential reporting data (QRTs) and specific information gathered through an information request launched simultaneously with Consultation Paper on the revision of the Guidelines on Contract Boundaries.

4.2. PROBLEM DEFINITION

- 4.3. Following the entry into force of the Solvency II Directive, especially the publication of the Delegated Regulation, EIOPA has adopted several sets of Guidelines that aim at clarifying expectations of the supervisors towards a correct implementation of the regulation by insurers. However, those Guidelines were not issued after a review of actual practices, as the time between application and implementation of Solvency II was not sufficiently long to study the industry's practices and the industry's understanding of the regulation.
- 4.4. During the preparation of EIOPA Opinion on the 2020 review of Solvency II, EIOPA has identified several divergent practices among insurers and supervisors regarding the assessment of contract boundaries. Those issues have been presented in the consultation paper, published in October 2019 and were especially explained in the Annex 3 of that document.
- 4.5. Globally, those divergent practices were mainly due to lack of clear explanations regarding the appropriate application of some provisions of the Delegated Regulation, mainly regarding unbundling of different obligations and the assessment whether a cover or financial guarantee has a discernible effect on the economics of the contract.

- 4.6. Some insurance contracts include different obligations that should be unbundled to determine contract boundaries when they are clearly identifiable. However, there are different interpretation when two parts of a contract are clearly identifiable. This interpretation can be grouped in two main approaches. The first one, unbundling a contract for contract boundary purposes only when it can be unbundled for cash-flow projection purposes, i.e. where there are no dependencies among each part of the contract. The second one, unbundling a contract when the cash flows of the contract can be allocated to each part of the contract. The second approach leads to unbundling more contracts than the first one, which in some cases has a material impact on contract boundaries and therefore on the best estimate and the own funds.
- 4.7. Regarding the discernible effect of covers and guarantees, the assessment significantly varies across different Member States. While it may be reasonable to use different assessments in some cases, the conclusions for similar products should be consistent and currently undertakings and NCAs are reaching different conclusions for similar financial guarantees and covers. Also related to this, in some markets the discernible effect assessment is only performed at inception while in other countries discernible effect is reassessed following relevant changes on the economic environment, which in the long run could lead to material differences on the treatment of the same products across Europe

4.3. OBJECTIVES PURSUED

- 4.8. The main objective of these Guidelines is to ensure a convergent approach regarding the assessment of contract boundaries across (re)insurance undertakings. This proposal sets out additional principle-based guidance complementing and amending the current guidelines in order to provide clarity on how the insurance and reinsurance undertakings should implement the requirements laid down in the Delegated Regulation. In particular, the concept of contract boundaries, the assessment whether a cover or financial guarantee has a discernible effect on the economics of the contract and unbundling a contract into different parts are addressed. This additional principle-based guidance aims at fostering convergence on practices within European Union.
- 4.9. The mentioned objective for the Guidelines are connected to the general objectives of the Solvency II framework (deepen the integration of the EU insurance market, enhance the protection of policyholders and beneficiaries and promote better regulation) and in particular they are connected to:
- ▶ improving the governance and risk management of insurance and reinsurance undertakings, and

- ▶ the convergence of supervisory methods.

4.10. The objective of the Guidelines are also consistent with the following objectives of EIOPA, as reflected in the founding Regulation of EIOPA:

- ▶ to ensure a sound, effective and consistent level of regulation and supervision;
- ▶ to ensure the transfer of risks related to (re)insurance activities is appropriately regulated and supervised; and
- ▶ to foster consumer protection.

4.4. POLICY OPTIONS

4.11. With the aim to meet the objectives to clarify the application of assumptions and management actions, as set out in the previous section, EIOPA has analysed different policy options throughout the policy development process.

4.12. The section below reflects the most relevant policy options that have been considered in relation to the different aspects of valuation of technical provisions. We have also listed relevant options which have been discarded in the policy development process.

4.4.1. POLICY ISSUE 1: INTRODUCTION OF ADDITIONAL GUIDELINES VS STATUS QUO

4.13. The following policy options have been identified:

1. **Policy option 1.1** Introduction of additional Guidelines to provide clarity on how contract boundaries are to be assessed by insurance and reinsurance undertakings.
2. **Policy option 1.2** Keeping the status quo of the current Guidelines.

Policy option 1.1. *Introduction of additional EIOPA Guidelines to provide clarity on contract boundaries are to be assessed by insurance and reinsurance undertakings.*

4.14. On the basis of the analysis performed by EIOPA during the preparation of the consultation paper on the Opinion on the 2020 Review of Solvency II, EIOPA has identified a lack of convergent practices among several topics regarding the calculation of technical provisions. Those divergent practices are described especially in Section 1 of the Annex 3 of the aforementioned document and mainly affect interpretation of the legal provisions regarding the concept of contract boundaries, unbundling and discernible effect.

- 4.15. The existence of those divergent practices is often due to the lack of clarity of the existing guidelines or the absence of guidelines explaining expectation of supervisory authorities when (re)insurance undertakings implement the principle-based regulatory requirements of technical provisions.
- 4.16. As a consequence, EIOPA has an opinion that the introduction of additional and amended Guidelines on contract boundaries:
- a) supports the (re)insurance undertakings in setting up contract boundaries, and therefore, ensures an enhanced level playing field among the undertakings; and
 - b) does not significantly modify the current expectations of supervisory authorities but provide more clarity and more transparency on the application of regulatory requirements.
- 4.17. The main purpose of this revision is to ensure a common understanding of contract boundaries that facilitates a convergent application across Europe without introducing any material change on the existing principles. Addressing divergent practices unavoidably requires slight adaptations from some stakeholders to ensure such convergence. Therefore, in terms of cost of compliance with the new Guidelines, it is reasonable to expect that some stakeholders may need to slightly adapt their processes to assess contract boundaries. However, considering that the new Guidelines intended to provide clarifications rather than changing any criteria, the cost at EU market level is not expected to be material.

Policy option 1.2 *Keeping the status quo of the current Guidelines.*

- 4.18. This option has the lowest impact since it does not require any change from stakeholders. However, it fails to address the existing divergent practices that hamper the level playing field. This could be particularly relevant in case of activities performed through freedom of establishment of freedom of services. Indeed expectations regarding contract boundaries might differ from the Home supervisory authority and the Host supervisory authority, which could lead to different own funds' assessment for the same insurance obligations.

Conclusion on Policy issue 1

- 4.19. EIOPA believes that, without the introduction of additional Guidelines, the current set of Guidelines on contract boundaries fail to provide a sufficient regulatory framework for the insurance and reinsurance undertakings and the national competent authorities as shown by the current divergent practices.

4.20. The following table shows the main costs and benefits for EIOPA stakeholders:

Policy issue 1: Introduction of new Guidelines vs status quo		
Option 1.1: Introduction of new Guidelines		
Costs	Policyholders	None
	Industry	Some undertakings may need to do some adjustments regarding best estimate valuation to comply with the revised Guidelines. However, this is unavoidable when addressing divergent practices.
	Supervisors	Some undertakings may need to do some adjustments regarding best estimate supervision to comply with the revised Guidelines. However, this is unavoidable when addressing divergent practices.
	Other	None
Benefits	Policyholders	More consistent level of protection across Europe.
	Industry	Enhanced level playing field and consistent supervision across Europe.
	Supervisors	Clearer guidance facilitating the level playing field and a common understanding with industry.
	Other	None
Option 1.2: No change		
Costs	Policyholders	Different level of protection depending on the interpretation of SII principles in each jurisdiction.
	Industry	Different interpretations in different markets, hampering the level playing field and creating challenges for undertakings operating in several markets.
	Supervisors	Lack of clear guidance on the interpretation of some provisions complicates reaching a common understanding with the industry.
	Other	None
Benefits	Policyholders	None
	Industry	None
	Supervisors	None
	Other	None

4.21. For these reasons, Option 1.1 is preferred.

4.4.2. POLICY ISSUE 2: UNBUNDLING

4.22. The following policy options have been identified:

1. **Policy option 2.1** Contracts should be unbundled for valuation purposes where cash flows can be allocated to each part of the contract regardless of the (inter)dependencies among them.
2. **Policy option 2.2** Contracts should be unbundled for valuation purposes if and only if two (or more) parts of the contract are equivalent in terms of risk to two (or more) contracts that could be sold separately.

Policy option 2.1 *Contracts should be unbundled for valuation purposes where cash flows can be allocated to each part of the contract regardless of the (inter)dependencies among them.*

4.23. This option is expected to lead to unbundle a larger amount of contracts, although this does not mean that unbundling would be the approach “by default”. There are several cases where it would not be possible to unbundle. For example:

- ▶ Products where a financial guarantee covers two different parts altogether⁶.
- ▶ Contracts that provide a material additional service that cannot be allocated to any of the parts of the contract.
- ▶ In general, any contract where there is a material cash flow that cannot be allocated to a part of a contract, usually due to complex interactions among the parts of the contract.

4.24. This option, in some cases, may lead to include a particular set of cash flows that may not be possible in reality. For example, in case of a contract where both parts would always lapse at the same time, having different contract boundaries for each part would lead to obligation from one part being projected longer than for the other, while this situation cannot really exist.

4.25. Besides, it could be complex to apply in some cases, for example regarding allocation of expenses to each part of the contract, which in the end could endanger convergence in best estimate valuation.

4.26. This option could have a material impact on the some undertakings since it may lead to unbundle some products that currently are not being unbundled. Since some Member

⁶ E.g. an investment product with several sub-funds, some of which have an individual financial guarantee. The product also includes a terminal financial guarantee (e.g. annualised 2%) that covers the whole product.

States are already applying an approach similar to this one, it is possible to have a rough estimate of the maximum impact in terms of own funds based on data provided via prudential reporting. The estimate is based on unit linked products, which are the products more likely to be affected by this issue, and depart from two main assumptions:

- ▶ Unbundling a unit-linked product will usually lead to short contract boundaries.
- ▶ The analysis is based on the difference in the ratio of EPIFP over technical provisions among jurisdictions for unit-linked products. Jurisdictions with short contract boundaries for unit-linked product are used as a benchmark to estimate the impact for other jurisdictions.

4.27. The graph below shows the distribution of countries based on the percentage of undertakings that have short contract boundaries for unit-linked products and the weight of EPIFP over unit-linked technical provisions:

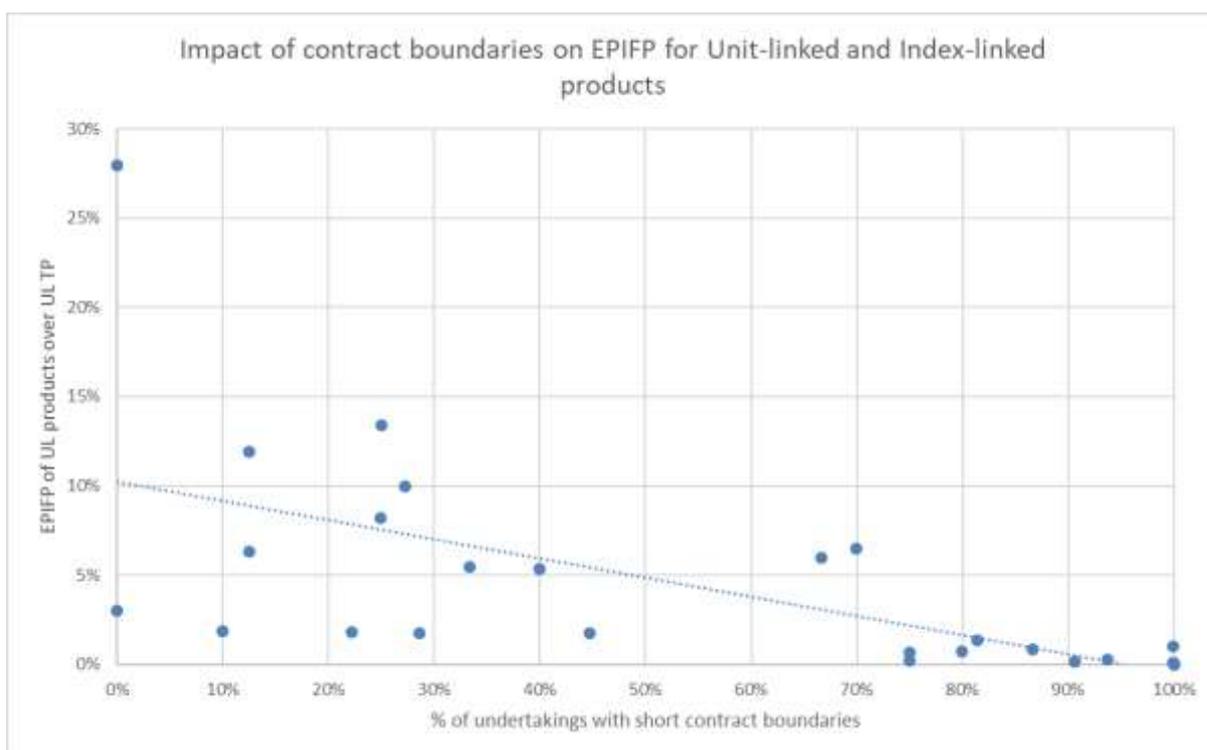


Image 1. Short and long contract boundaries in UL products

4.28. Regarding the impact on the own funds, the next graph summarizes the impact by Member State⁷. Bars highlighted in red represent Member States where the percentage of undertakings with long contract boundaries is higher than 60%.

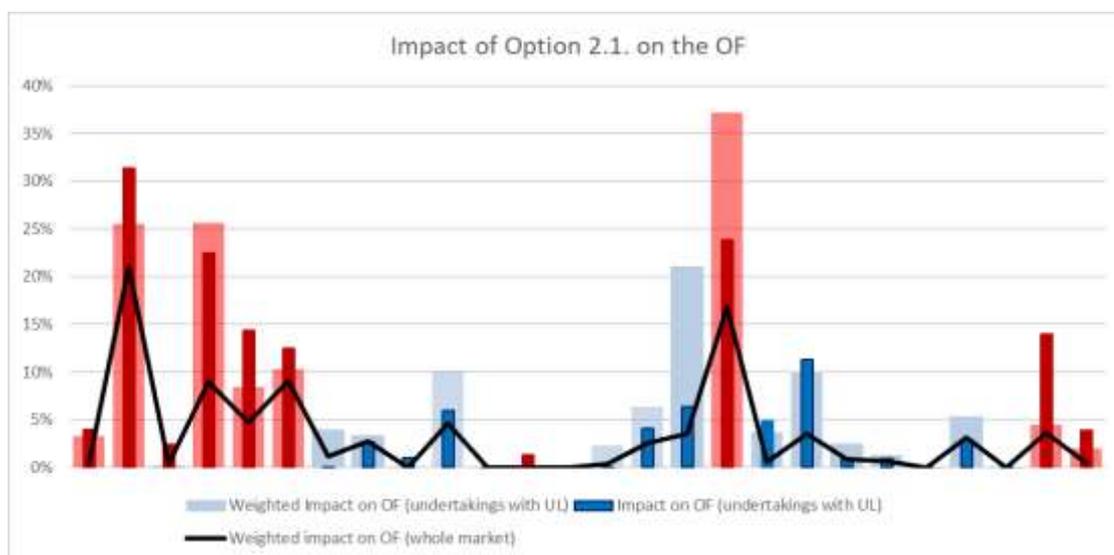


Image 2. Impact of Option 2.1 on the own funds

4.29. This assessment suggests that the impact would be in most of the jurisdictions below 5% of the own funds at market level (black line). It should be noted that this analysis is probably overestimating the impact of the change since it does not consider differences in products regarding the level of EPIFP and, more importantly, regarding whether the product could be unbundled also under this option. Data quality and the high number of assumptions to derive this analysis only from QRTs data also require precaution while interpreting these results. For this reason, the analysis is presented without identifying Member States.

4.30. The previous results have been confirmed by the information gathered through the specific information request, which showed that less than approximately 3% of the undertakings will be impacted by Guideline 5. In one half of the cases the impact leads to an extension of contract boundaries and an increase in the Own Funds (approximately 12%), while in the other half contract boundaries are reduced with almost no impact on the Own Funds in average. The reduced number of undertakings reporting an impact after the change in Guideline 5 does not allow to perform individual analysis by Member State.

⁷ Some jurisdictions are not represented due to data quality issues, which left a sample too small to reflect any characteristics of the market.

4.31. In terms of SCR, the data received show a significantly less material impact, which however cannot be accurately quantified with a reasonable accuracy due to reduced size of the sample of undertakings that reported quantitative estimates of the impact on the SCR.

Policy option 2.2 *Contracts should be unbundled for valuation purposes if and only if two (or more) parts of the contract are equivalent in terms of risk to two (or more) contracts that could be sold separately*

4.32. This option is very close to unbundle a contract for valuation purposes where the contract can be unbundled for cash flow projection purposes, which bears significant merits:

- ▶ It is simpler to implement, since it requires unbundling in less cases than the previous option.
- ▶ It is closer to IFRS 17, which uses contract as unit, i.e. usually does not require unbundling of insurance obligations.
- ▶ It avoids the two main cons of the previous option.

4.33. However, non-material dependencies could prevent a contract from being unbundled, which could open the door for very similar having very different treatments in the Solvency II framework just depending whether the products have been commercialized separately or altogether. For this reason, the criterion has been rephrased to ensure that combinations of products that are equivalent in terms of risk are treated consistently.

4.34. The impact of this option is not expected to be material in most of the cases since it is consistent with the approach followed in most of the jurisdictions, although in some particular cases a change may be needed.

4.35. Contracts not unbundled under this approach that were unbundled in the past should usually lead to an increase in the own funds of the undertakings. However, it is not possible to estimate the impact of this change with the data currently available for two main reasons:

- ▶ The level of EPFIP significantly varies from case to case when contract boundaries are long as we can see in the previous Image 1.
- ▶ Not unbundling a product does not necessarily mean that contract boundaries would be longer.

4.36. Contracts unbundled under this approach that were not unbundled in the past should usually lead to a decrease in the own funds. However, the impact in this second case is justified since not unbundling these products would hamper the level playing field, since

one product with the same risks than two separate products would have different contract boundaries.

- 4.37. This option would have affected a similar market share (4%), but usually leading to a reduction of contract boundaries and Own Funds (-7%). Similarly to Option 1, the impact on SCR is less material.

Conclusion on Policy issue 2

- 4.38. EIOPA believes that Option 2.2 better reflects the approach currently being followed in most of the cases and is closer to IFRS 17, therefore, minimizing the impact for undertakings. EIOPA also considers that this option clearly reflects the main objective of unbundling: ensuring a consistent approach for products equivalents in terms of risk regardless of their commercial structure.

- 4.39. The following table shows the main costs and benefits for EIOPA stakeholders:

Policy issue 2: Unbundling		
Option 2.1: Unbundling when the cash flows of the contract can be allocated to each part of the contract.		
Costs	Policyholders	None
	Industry	<ul style="list-style-type: none"> - Some undertakings would need to adjust their unbundling assessment process to this approach. However, this is unavoidable when addressing divergent practices. - Allocation of some cash flows (e.g. some expenses) could be complex and/or require material expert judgement, complicating the assessment.
	Supervisors	<ul style="list-style-type: none"> - Some supervisory authorities would need to adjust their supervisory practices to this approach. However, this is unavoidable when addressing divergent practices. - Allocation of some cash flows (e.g. some expenses) could be complex and/or require material expert judgement, complicating its supervision.
	Other	None
Benefits	Policyholders	<ul style="list-style-type: none"> - This approach would usually lead to higher technical provisions compared to Option 2.2 and therefore to a higher level protection of policyholders. - Same level of protection across Europe.
	Industry	<ul style="list-style-type: none"> - Clearer guidance reducing uncertainty. - Consistent treatment of the same products across Europe enhancing the level playing field.

	Supervisors	- Clearer guidance
	Other	None
Option 2.2: Unbundling when the parts of the contract could be sold separately		
Costs	Policyholders	None
	Industry	- Some undertakings would need to adjust their unbundling assessment process to this approach. However, this is unavoidable when addressing divergent practices.
	Supervisors	- Some supervisory authorities would need to adjust their supervisory practices to this approach. However, this is unavoidable when addressing divergent practices.
	Other	None
Benefits	Policyholders	- Same level of protection across Europe.
	Industry	- Clearer guidance reducing uncertainty. - Consistent treatment of the same products across Europe enhancing the level playing field. - Closer to IFRS 17
	Supervisors	- Clearer guidance - Closer to IFRS 17
	Other	None

4.40. For these reasons, Option 2.2 is preferred.

4.4.3. POLICY ISSUE 3: DISCERNIBLE EFFECT

4.41. The following policy options have been identified:

1. **Policy option 3.1** Static contract boundaries. Whether a cover or financial guarantee has a discernible effect is determined at inception of the contract and does not depend on the economic environment.
2. **Policy option 3.2** Dynamic contract boundaries. Undertakings should perform a reassessment of the effect of a cover or financial guarantee after extreme changes in the economic environment.

Policy option 3.1 *Static contract boundaries. Whether a cover or financial guarantee has a discernible effect is determined at inception of the contract and does not depend on the economic environment.*

- 4.42. Under Option 3.1, discernibility of a cover or financial guarantee is a characteristic of the contract and should not depend on the economic environment. Therefore, the assessment performed at the inception of the contract should consider potential material future economic scenarios and analyse whether the cover or financial guarantee could be discernible in some of them. This means that the initial assessment should not change even in case of changes in the economic environment that would lead to a different conclusion if discernibility were be reassessed.
- 4.43. Option 3.1 would enhance stability since any reassessment can potentially lead to a change in contract boundaries, probably having a cliff-edge effect in the own funds. This option would usually result in consistent contract boundaries for all products. However, since contract boundaries cannot be reassessed, there is a risk that after an extreme change in the economic environment, contract boundaries will no longer be reflecting the risk actually borne by the undertaking under the current economic environment.
- 4.44. Performing an assessment that is really independent from the economic conditions is a major challenge, since it requires to consider potential future situations. However, if any possible future situation is considered, probably (almost) all covers and financial guarantees would be considered to be discernible since there will probably always be an extreme scenario where they have a discernible effect. Conversely, if only likely or realistic potential scenarios are considered, the notion of likely/realistic would depend on the current economic environment. For example, 20 years ago negative interest rates probably would have been considered unrealistic.
- 4.45. This option would not have any immediate impact on the market, since it does not allow any reassessment. Forward-looking, it would have an impact in the markets that currently follow a dynamic approach and reassess discernibility when the economic environment changes. However, contract boundaries are expected to remain constant in most of the cases even in market where the dynamic approach is the current standard. Therefore, the impact of this option is not expected to be very material even in the long-run in most cases. However, additional information is being requested to estimate the impact of this policy issue.
- 4.46. Current Guideline 1 on contract boundaries clarifies that the principles for determining contract boundaries are consistently applied to all insurance and reinsurance contracts, in particular over time. This is consistent with Option 3.1 where the contract boundary is static. It could also be considered to be consistent with Option 3.2, since application of the same

principle may lead to different outcomes where the context has changed. This interpretation of Guideline 1 is also consistent with current Guideline 5, which requires unbundling to be reassessed at each valuation date.

Policy option 3.2 *Dynamic contract boundaries. Undertakings should perform a reassessment of the effect of a cover or financial guarantee after extreme changes in the economic environment.*

- 4.47. Option 3.2 has been slightly redrafted after the public consultation to clarify that the reassessment after changes in the economic environment are only expected in case these changes are extreme. However, this change does not affect neither the conclusion nor the impact assessment.
- 4.48. Under Option 3.2, undertakings should perform a reassessment at valuation date where there is indication that it may lead to a different conclusion. In particular, in case of changes in the economic environment undertakings should only perform the reassessment when these changes are extreme. However, undertakings should change contract boundaries after this reassessment only where the reassessment led to a clearly different conclusion than the assessment performed at inception.
- 4.49. This option would ensure that contract boundaries are in line with the current economic environment and reflect the real risk borne by the undertaking. However, it should be noted that this approach will lead to changes in contract boundaries in exceptional cases, therefore increasing volatility of technical provisions and own funds and the burden for undertakings and supervisory authorities. In any case, under this option contract boundaries are still expected to remain constant in most of the cases, so the impact of this con is limited. Contract boundaries, for example, may change in times of financial crisis, which could lead to procyclical or countercyclical effects depending on the case.
- 4.50. Even if contract boundaries may be reassessed after changes in the economic environment, contract boundaries should not be reassessed in the calculation of the SCR scenarios, even for those that are stressing the economic environment, i.e. contract boundaries do not change in SCR calculations. The objective of the SCR is to assess the losses that the undertaking would face in extreme (1 in 200) scenarios. However, changes in contract boundaries do not reflect losses for the undertaking but only changes in the scope of the valuation of best estimate, so they should not be considered. Similarly, while performing stochastic valuation, some scenarios considered within the valuation process could trigger a reassessment of contract boundaries. This should not be considered within the stochastic valuation process since changes in contract boundaries do not reflect a change in the expected cash flows but a change in the scope of obligations to be included in best estimate.

Therefore, contract boundaries should remain constant through all the scenarios in the stochastic valuation to ensure that the valuation is consistent with the contract boundaries determined at the valuation date.

- 4.51. The immediate impact of this option is probably immaterial. The low yield environment further declined since the inception of Solvency II, therefore discernibility for most of the products with a financial guarantee is not expected to have changed. Forward-looking, it would have an impact in the markets that currently follow a static approach and do not reassess discernibility when the economic environment changes.
- 4.52. The previous assessment has been confirmed after the ad-hoc information request, which showed more than 20% of the undertakings already consider that contract boundaries should be reassessed after changes in the economic environment. Besides, less than 1% of the undertakings expects Guideline 6c to have an immediate impact on contract boundaries and only 2.5% expect an impact in the future.

Conclusion on Policy issue 3

- 4.53. EIOPA has identified that different approaches are currently being followed in different jurisdictions and therefore further guidance on the right approach is needed to guarantee the level playing field.
- 4.54. The following table shows the main costs and benefits for EIOPA stakeholders:

Policy issue 3: Reassessment of the discernible effect		
Option 3.1: Static contract boundaries		
Costs	Policyholders	None
	Industry	<ul style="list-style-type: none"> - Some undertakings would need to adjust their discernible effect assessment process to this approach. However, this is unavoidable when addressing divergent practices. - Complexity of the initial assessment to ensure it is relevant in different economic environments. - Risk of inaccurate assessment after extreme changes in the economic environment.
	Supervisors	<ul style="list-style-type: none"> - Some supervisory authorities would need to adjust their supervision of the discernible effect assessment to this approach. However, this is unavoidable when addressing divergent practices.

		<ul style="list-style-type: none"> - Complexity of the initial assessment to ensure it is relevant in different economic environments. - Risk of inaccurate assessments after extreme changes in the economic environment.
	Other	None
Benefits	Policyholders	None
	Industry	<ul style="list-style-type: none"> - Clearer guidance reducing uncertainty. - No cliff-edge effects on the own funds since contract boundaries are not reassessed.
	Supervisors	- Clearer guidance.
	Other	None
Option 3.2: Dynamic contract boundaries		
Costs	Policyholders	None
	Industry	<ul style="list-style-type: none"> - Need to reassess contract boundaries after extreme changes in the economic environment. - In some cases, cliff-edge effect on the own funds when the reassessment leads to a different outcome.
	Supervisors	None
	Other	None
Benefits	Policyholders	- Ensuring that equivalent products will have the same level of protection regardless the date when they were issued.
	Industry	<ul style="list-style-type: none"> - Clearer guidance reducing uncertainty. - More accurate assessment after extreme changes in the economic environment.
	Supervisors	<ul style="list-style-type: none"> - Clearer guidance - More accurate assessment after extreme changes in the economic environment.
	Other	None

4.55. For these reasons, Option 3.2 is preferred.

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