Final Report on the Public Consultation on the revision of the Guidelines on the valuation of Technical Provisions

EIOPA-BoS-22/217
21 April 2022

European Insurance and Occupational Pensions Authority

CONTENTS

1. EXECUTIVE SUMMARY

1.1. INTRODUCTION

1.1 During the 2020 review of Solvency II EIOPA identified several divergent practices regarding the valuation of best estimate, as presented in the analysis background document[1] 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 best estimate valuation.

1.2 In accordance with Article 16 of Regulation (EU) No 1094/2010[2] EIOPA issues these revised Guidelines to provide guidance on how insurance and reinsurance undertakings should apply the requirements of Directive 2009/138/EC[3] ("Solvency II Directive") and in Commission Delegated Regulation (EU) No 2015/35[4] ("Delegated Regulation"), on best estimate valuation.

1.3 This revision introduces new Guidelines and amends current Guidelines on topics that are relevant for the valuation of best estimate, including the use of future management actions and expert judgment, the modelling of expenses and the valuation of options and guarantees by economic scenarios generators and modelling of policyholder behaviour. EIOPA also identified the need for clarification in the calculation of expected profits in future premiums.

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, 17.12.2019, 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 group[5].

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 the valuation of technical provisions. Unless otherwise stated in this document, the current guidelines of EIOPA's Guidelines on the valuation of technical provisions 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 shall apply from 01-01-2023.

1.3. NEXT STEPS

1.10 A translated consolidated version of the Guidelines on the valuation of technical provisions will be published on EIOPA's website. In addition, EIOPA will publish an Explanatory note including a compilation in English of the Guidelines on the valuation of technical provisions and the Explanatory text.

1.11 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.

1.12 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.

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

1.13 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.

1.14 In the absence of a response by this deadline, competent authorities will be considered as non-compliant to the reporting and reported as such.

1.15 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.

1.16 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.

1.17 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 revised 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 the valuation of technical provisions mainly focus on the entry into force, the application of the proportionality principle, the consideration of investment management expenses, the consideration of new business in setting future management actions and the role of the actuarial function in EPIFP validation.

2.5. The Consultation Paper also included an Impact Assessment. 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. 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. For this reason, EIOPA recommends undertakings to engage in a dialogue with NCAs if needed to ensure a smooth first application.

2.8. 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. APPLICATION OF THE PROPORTIONALITY PRINCIPLE

2.9. Stakeholders have highlighted the relevance to consider the proportionality principle in the application of the Guidelines on valuation of Technical Provisions. In particular, the guidelines on expert judgement are derived from the Guidelines on the use of Internal Models and some stakeholders suggested that the requirements on expert judgement for best estimate valuation might be too demanding considering that expert judgement is usually more relevant for internal models than for best estimate valuation.

2.10. EIOPA agrees with stakeholders that the Guidelines on valuation of Technical Provisions should be applied considering the proportionality principle and, for this reason, a new Guideline 0 on proportionality has been included. In particular, for the guidelines on expert judgement EIOPA agrees on the need to consider the materiality of expert judgement when applying the relevant guidelines. New Guideline should allow for this proportionate application, which has been further described in the Explanatory Text. However, EIOPA wants to highlight that the guidelines on expert judgement have always been a relevant reference for best estimate valuation as stated in the paragraph 1.3 on the Introduction to the original Guidelines on the valuation of Technical Provision. For this reason, EIOPA will keep the contents of the guidelines on expert judgement as copied from the Guidelines on the use of Internal Models.

2.4. INVESTMENT MANAGEMENT EXPENSES

2.11. Stakeholders have questioned EIOPA interpretation on the amount of expenses that Solvency II requires to consider when calculating the best estimate, in particular due to the complexity of the practical implementation of the criteria included in draft Guideline 28a of the consultation paper, and the undesired outcome in some extreme cases (e.g. large negative technical provisions).

2.12. EIOPA agrees with stakeholders that the criteria proposed could lead to undesired outcome in some extreme cases and acknowledges that the proposal leads to some circular references that, however, could be easily solved through some simplifications. Nevertheless, EIOPA agrees to revise the criteria to determine the amount of investment management expenses included in the best estimated base it on the characteristics of the product, the relevant legal requirements and expert judgement instead of basing it on any specific amount from the Solvency II framework.

2.5. CONSIDERATION OF NEW BUSINESS IN SETTING NEW FUTURE MANAGEMENT ACTIONS

2.13. Stakeholders have highlighted that due to the application of contract boundaries, the set of cash-flows is limited for valuing technical provisions even if the principle of business continuity is applied – meaning that new business will be underwritten. With the proposed Guideline 40b, insurance and reinsurance undertakings may then set assumptions that would not be any more consistent with current practices, notably in terms of asset and liabilities management.

2.14. EIOPA considers that the rationale of the proposed guidelines was to avoid assumptions settings on future management actions that only rely on the limited set of cash-flows that are projected. Indeed, interactions between existing business and new business should duly be taken into account as usually the insurance and reinsurance undertakings do not totally cease their activity. This is, indeed, taken for granted for other assumptions, as for example apportioning fixed expenses between current and new business. However, EIOPA also agrees that the proposed drafting of the Guideline 40b might be misinterpreted, leading to assumptions setting that is not realistic as it emphasis too much on the existence of new business. EIOPA thus agrees to revise the Guideline 40b in order to clarify that assumptions should be set taken into consideration existing and new business in a realistic manner.

2.6. USE OF STOCHASTIC VALUATION

2.15. Stakeholders highlighted that in case of stochastic valuation that is particularly burdensome for undertakings, materiality/proportionality is particularly relevant.

2.16. EIOPA agrees that Guideline 53a should be read considering the proportionality principle (see new Guideline 0 on proportionality). In particular, where the impact is not material, undertakings may consider other simplified approaches or even use pure deterministic valuation in case of immaterial options and guarantees. EIOPA also considers necessary to highlight that in some simple cases the time value of options and guarantees can be properly and accurately captured with closed-formula approaches. In these cases, closed-formula approaches can be used according to the proportionality principle. These clarifications have been added to the explanatory text of Guideline 53a.

2.7. ROLE OF THE ACTUARIAL FUNCTION ON EPIFP CALCULATION

2.17. Stakeholders have questioned whether the actuarial function is expected to validate EPIFP calculation according to the requirements set in the Delegated Regulation 2015/35

2.18. Recital 46 of the Delegated Regulation defines expected profits in future business (”EPIFP”) as part of the technical provisions and article 260.2 defines EPIFP as the difference between technical provisions without risk margin and technical provisions without risk margin under the assumption that future premiums are not received, i.e. the calculation of EPIFP is immediately linked to technical provisions calculation. However, article 272 does not explicitly require the actuarial function to validate the calculation of EPIFP. Therefore, EIOPA considers that EPIFP validation by the actuarial function is a best practice but acknowledges that also other approaches would be compliant with 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 as required by Article 260 of the Delegated Regulation and clarified by Guideline 77.

3. ANNEX I: GUIDELINES WITH EXPLANATORY TEXT

Proportionality

NEW: GUIDELINE 0 – PROPORTIONALITY

3.1. Insurance and reinsurance undertakings should apply the Guidelines on valuation of technical provisions in a manner that is proportionate to the nature, scale and complexity of the risks inherent in their business. This should not result in a material deviation of the value of the technical from the current amount that insurance and reinsurance undertakings would have to pay if they were to transfer their insurance and reinsurance obligations immediately to another insurance or reinsurance undertaking.

Expert judgement

3.2. All new guidelines on expert judgement are identical to the guidelines on expert judgement included in the Guidelines on the use of internal models[6] except for Guideline 24a – Materiality in assumptions setting, which has been slightly adapted to best estimate valuation.

3.3. Moreover, insurance and reinsurance undertakings usually have more data for best estimate valuation than for solvency capital requirement valuation. Thus, even if the principles that are applicable for expert judgment in best estimate valuation and within internal models are similar, their implementation might slightly differ. For instance, it is expected that insurance and reinsurance undertakings mainly focus on the identification of material assumptions where expert judgment is needed and implement a proportionate framework in terms of documentation, governance or validation process for those assumptions only. In particular, the governance and validation process might involve internal committees, senior executive committees or the administrative management and supervisory body depending on the predefined framework and the sensitivity of the best estimate calculation to some material assumptions relying on expert judgment.

3.4. It is not possible to define specific criteria for assessing materiality of any expert judgment use case. However, this could usually be based on sensitivity tests with a percentage of

[6] https://www.eiopa.europa.eu/document-library/guidelines/guidelines-use-of-internal-models_en

variation of technical provisions or future profits. It could either be considered at portfolio level or for the whole calculation, depending on the nature of the assumption. One criteria might also be defined based on the users (e.g. would a significant change in an assumption set by expert judgment influence decisions taken by the management body - change in the program of reinsurance, change in the activities/products sold, etc.).

3.5. Finally, the validation process regarding expert judgment might usually not be independent from the general validation process that insurance and reinsurance undertakings implement to validate the calculation of the technical provisions in order to maintain and promote homogeneity and convergence. Thus, use of expert judgments should be fully integrated in the different steps of validation (e.g. internal committees, “clearance” committees or management committees) depending on the nature, complexity and materiality of the cases where expert judgment has been applied.

NEW: GUIDELINE 24A – MATERIALITY IN ASSUMPTIONS SETTING

3.6. Insurance and reinsurance undertakings should set assumptions and use expert judgment, in particular taking into account the materiality of the impact of the use of assumptions with respect to the following Guidelines on assumption setting and expert judgement.

3.7. Insurance and reinsurance undertakings should assess materiality taking into account both quantitative and qualitative indicators and taking into consideration binary events, extreme events, and events that are not present in historical data. Insurance and reinsurance undertakings should overall evaluate the indicators considered.

Explanatory text:

3.8. It is necessary to consider all potential events, including 'events not in data' and extreme events, also known as binary events within a financial context, to ensure that the best estimate reflects an expected value of the outcomes of all possible scenarios, as opposed to something less, such as an expected value of the outcomes of all reasonably foreseeable scenarios.

3.9. Examples of such events would include environmental issues such as global warming and legislative or political changes that might impact the sustainability of the business model – either by increasing claim amounts or by reducing the volumes of new business.

3.10. Where there is a short history of representative data, the expert judgment on the amount of weight to be placed on events that are not in that data is more likely to be material.

NEW: GUIDELINE 24B – GOVERNANCE OF ASSUMPTIONS SETTING

3.11. Insurance and reinsurance undertakings should ensure that all assumption setting and the use of expert judgement in particular, follows a validated and documented process.

3.12. Insurance and reinsurance undertakings should ensure that the assumptions are derived and used consistently over time and across the insurance or reinsurance undertaking and that they are fit for their intended use.

3.13. Insurance and reinsurance undertakings should approve the assumptions at levels of sufficient seniority according to their materiality, for most material assumptions up to and including the administrative, management or supervisory body.

NEW: GUIDELINE 24C - COMMUNICATION AND UNCERTAINTY IN ASSUMPTIONS SETTING

3.14. Insurance and reinsurance undertakings should ensure that the processes around assumptions, and in particular around the use of expert judgement in choosing those assumptions, specifically attempt to mitigate the risk of misunderstanding or miscommunication between all different roles related to such assumptions.

3.15. Insurance and reinsurance undertakings should establish a formal and documented feedback process between the providers and the users of material expert judgement and of the resulting assumptions.

3.16. Insurance and reinsurance undertakings should make transparent the uncertainty of the assumptions as well as the associated variation in final results.

NEW: GUIDELINE 24D - DOCUMENTATION OF ASSUMPTIONS SETTING

3.17. Insurance and reinsurance undertakings should document the assumption setting process and, in particular, the use of expert judgement, in such a manner that the process is transparent.

3.18. Insurance and reinsurance undertakings should include in the documentation the resulting assumptions and their materiality, the experts involved, the intended use and the period of validity.

3.19. Insurance and reinsurance undertakings should include the rationale for the opinion, including the information basis used, with the level of detail necessary to make transparent both the assumptions and the process and decision-making criteria used for the selection of the assumptions and disregarding other alternatives.

3.20. Insurance and reinsurance undertakings should make sure that users of material assumptions receive clear and comprehensive written information about those assumptions.

NEW: GUIDELINE 24E - VALIDATION OF ASSUMPTIONS SETTING

3.21. Insurance and reinsurance undertakings should ensure that the process for choosing assumptions and using expert judgement is validated.

3.22. Insurance and reinsurance undertakings should ensure that the process and the tools for validating the assumptions and in particular the use of expert judgement are documented.

3.23. Insurance and reinsurance undertakings should track the changes of material assumptions in response to new information, and analyse and explain those changes as well as deviations of realisations from material assumptions.

3.24. Insurance and reinsurance undertakings, where feasible and appropriate, should use validation tools such as stress testing or sensitivity testing.

3.25. Insurance and reinsurance undertakings should review the assumptions chosen, relying on independent internal or external expertise.

3.26. Insurance and reinsurance undertakings should detect the occurrence of circumstances under which the assumptions would be considered false.

Biometric risk factors

AMENDED: GUIDELINE 25 – MODELLING BIOMETRIC RISK FACTORS

3.27. Insurance and reinsurance undertakings should consider whether a deterministic or a stochastic approach is proportionate to model the uncertainty of biometric risk factors.

3.28. Insurance and reinsurance undertakings should take into account the duration of the liabilities when assessing whether a method that neglects expected future changes in biometrical risk factors is proportionate, in particular in assessing the error introduced in the result by the method.

3.29. Insurance and reinsurance undertakings should ensure, when assessing whether a method that assumes that biometric risk factors are independent from any other variable is proportionate, and that the specificities of the risk factors are taken into account. For this purpose, the assessment of the level of correlation should be based on historical data and expert judgment.

Expense allocation

NEW: GUIDELINE 28A – INVESTMENT MANAGEMENT EXPENSES

3.30. Insurance and reinsurance undertakings should include in the best estimate administrative and trading expenses associated with the investments needed to service insurance and reinsurance contracts.

3.31. In particular, for products whose terms and conditions of the contract or the regulation requires to identify the investments associated with a product (e.g. most unit linked and index linked products, products managed in ring-fenced funds and products to which matching adjustment is applied), insurance and reinsurance undertakings should consider the investments.

3.32. For other products, insurance and reinsurance undertakings should base the assessment on the characteristics of the contracts.

3.33. As a simplification, insurance and reinsurance undertakings may also consider all investment management expenses.

3.34. 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.

Explanatory text:

3.35. Investment management expenses could include administration expenses (expenses of recordkeeping of the investments' portfolio, salaries of staff responsible for investments, remunerations of external advisers, expenses connected with an investment trading activity and in some cases also remuneration for custodial services) and trading expenses (buying and selling of the portfolio securities).

3.36. In case of most unit linked and index linked products, products managed in ring-fenced funds and products to which matching adjustment is applied, the amount of investments related to a particular product are clearly identified as a consequence of the terms and conditions of the contract or requirements from Solvency II framework or other relevant regulation. In these cases, undertakings are expected to consider in the best estimate the expenses related to these investments.

3.37. For products other than those mentioned in point 3.36, neither the contract terms nor the applicable regulatory framework requires to identify the investments, hence insurance and reinsurance undertakings need to determine the amount of investments related to a product or obligation. 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 ALM 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.

3.38. When projecting the expense cash flows, insurance and reinsurance undertakings should use assumptions and calculation models that reflect the expense assumptions at the valuation date.

3.39. Sometimes the fund manager pays back commissions to the asset manager (often called kick-backs). If the kick-backs are left to the undertakings and not directed further to e.g. policyholders or sales organisations, the kick-backs should be considered as other incoming cash flows of the policy.

AMENDED: GUIDELINE 30 – APPORTIONMENT OF EXPENSES

3.41. Insurance and reinsurance undertakings should allocate and project expenses in a realistic and objective manner and should base the allocation of these expenses on their long-term business strategies, on recent analyses of the operations of the business, on the identification of appropriate expense drivers and on relevant expense apportionment ratios.

3.42. Without prejudice to the proportionality assessment and the first paragraph of this guideline, insurance and reinsurance undertakings should consider using, in order to allocate overhead expenses over time, the simplification outlined in Technical Annex I, when the following conditions are met:

a) the undertaking pursues annually renewable business;

b) the renewals must be reputed to be new business according the boundaries of the insurance contract;

c) the claims occur uniformly during the coverage period.

Explanatory text:

3.43. According to Article 31(2) of the Delegated Regulation "overhead expenses shall be allocated in a realistic and objective manner and on a consistent basis over time to the parts of the best estimate to which they relate". This provision should also be applied to all expenses where the expenses may not be directed to one single cost centre.

3.44. The process of apportionment of expenses between the existing and the future business should be done in realistic and objective manner. This can be achieved by analysing the operations of the business. Expenses are calculated on the assumption of an on-going business basis. Based on these factors, the identification of appropriate expense drivers and relevant expense apportionment ratios can be determined.

3.45. In order to consider expense data to be complete and appropriate, sufficient historical data should be available at a sufficiently granular level.

3.46. Regarding long-term business strategies, when setting the undertaking itself or a specific portfolio into run-off, the undertakings should amend the expense assumptions accordingly. It is also possible that the insurance market has changed, so some insurance lines are no longer sold, in which case the change of the product portfolio should be taken into account in setting the assumptions. However, the expense assumptions should be based on recent analysis of the operations of the business. Expense assumptions should be realistic and not materially deviate from short term business strategies. Expert judgement may be needed when determining the split between expenses before and after the valuation date.

3.47. The undertakings should assume that there are extraordinary expenses every now and then. The allocation of future recurrent one-off expenses requires use of expert judgement because the historical costs seldom reflect the future expense allocations. For example, there are almost always IT projects going on in insurance undertakings, but the annual contributions and cost centres vary.

AMENDED: GUIDELINE 33 – CHANGES IN EXPENSES

3.47. Insurance and reinsurance undertakings should ensure that assumptions with respect to the evolution of expenses over time, including future expenses arising from commitments made on or prior to the valuation date, are appropriate and consider the nature of the expenses involved. Insurance and reinsurance undertakings should make an allowance for inflation that is consistent with the economic assumptions made and with dependency of expenses on other cash flows of the contract.

Explanatory text:

3.48. Future expense cash flows are usually assumed to vary with assumed rates of general level of expense inflation in a reasonable manner.

3.49. Relevant market data should be used to determine expense assumptions that include an allowance for future cost increases. When determining correlation between inflation rates and interest rates, use of expert judgement is often needed. An undertaking should ensure that the allowance for inflation is consistent with the economic assumptions made, which could be achieved if the probabilities for each inflation scenario are consistent with probabilities implied by market interest rates.

3.50. Furthermore, expense inflation should be consistent with the inflation expectations in the country in concern and the types of expenses being considered. For example, when considering the overall expense inflation of a homogeneous risk group, different levels of inflation might be expected regarding office space rents, salaries of different types of staff, IT systems, medical expenses, etc.

3.51. In some cases, explicit inflation expenses may not be needed. For example, investment management expenses may be defined as a percentage of the value of the underlying investment funds and the product may not require explicit assumptions on inflation as inflation does not affect the expense assumptions.

3.52. When determining the inflation rate, proportionality principle can be used taking into account the materiality of the expense inflation assumption and prudency requirement in accordance with Article 56(4) of the Delegated Regulation.

Treatment of financial guarantees and contractual options

NEW: GUIDELINE 37A – DYNAMIC POLICYHOLDER BEHAVIOUR

3.53. Insurance and reinsurance undertakings should base their assumptions on the exercise rate of relevant options on:

- statistical and empirical evidence, where it is representative of future conduct, and

- expert judgment on sound rationale and with clear documentation.

3.54. The lack of data for extreme scenarios should not be considered alone to be a reason to avoid dynamic policyholder behaviour modelling and/or the interaction with future management actions.

Explanatory text:

3.55. The most commonly modelled dynamic policyholder behaviour relates to surrender options. For example, in this case, undertakings can measure the financial gain/loss that the policyholder would face by surrendering the contract early or keeping the contract on, by comparing the current credited return with the benchmark return after recognizing any surrender penalties and future discretionary profit sharing. It should be acknowledged that the average policyholder may not actively manage their insurance products as part of an investment portfolio under such a purely economic view. On the other hand, the projection horizon for savings product can be relatively long (several tens of years) and the hypothesis that the future behaviour will remain identical to the past might be subject to discussion.

3.56. Dynamic lapse is path-dependent and so varies within the stochastic scenarios, where it is particularly relevant. The benchmark return should be defined with reference to the investment conditions that prevail in the given scenario being considered.

3.57. At the same time, since there is usually little or no evidence in terms of the experienced reaction of policyholders to extreme financial conditions as the ones included in the set of stochastic scenarios, the lack of this data should not be considered alone to be a good reason to avoid dynamic policyholder behaviour modelling. In such cases, expert judgement can complement the available data to model the dynamic behaviour.

3.58. Moreover, as part of an adequate dynamic modelling, undertakings should properly consider the interaction between the relevant future management actions and the policyholder behaviour (e.g. policyholder behaviour in terms of surrender levels can be linked to the comparison between contract return and a return offered by the market, where contract return is directly influenced by management actions).

NEW: GUIDELINE 37B – BIDIRECTIONAL ASSUMPTIONS

3.59. When setting the assumptions on dynamic policyholder behaviour, insurance and reinsurance undertakings should consider that the dependency on the trigger event and the exercise rate of the option is usually bidirectional, i.e. both an increase and a decrease should be considered depending on the direction of the trigger event.

NEW: GUIDELINE 37C – OPTION TO PAY ADDITIONAL OR DIFFERENT PREMIUMS

3.60. Insurance and reinsurance undertakings should model all relevant contractual options when projecting the cash flows, including the option to pay additional premiums or to vary the amount of premiums to be paid that fall within contract boundaries.

Future management actions

NEW: GUIDELINE 40A – COMPREHENSIVE MANAGEMENT PLAN

3.61. Insurance and reinsurance undertakings should ensure that the comprehensive future management actions plan that is approved by the administrative, management or supervisory body is 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 best estimate calculation.

Explanatory text:

3.62. The comprehensive management plan mentioned in Article 23(2) of the Delegated Regulation should provide to the administrative, management or supervisory body all the needed information to evaluate the consequences of the retained assumptions for each future management actions and the interaction between those actions.

3.63. To guarantee that requirement, the administrative, management or supervisory body should have a comprehensive view of all future management actions. For that purpose, the approval of such plan should be done including a single document listing all assumptions relating to future management actions or providing a set of documents that clearly provide a complete view of all future management actions. In the latter case, a summary listing all assumptions and pointing to the detailed documents that provides all the necessary information should be established.

NEW: GUIDELINE 40B – CONSIDERATION OF NEW BUSINESS IN SETTING FUTURE MANAGEMENT ACTIONS

3.64. Insurance and reinsurance undertakings should consider the effect of new business in setting future management actions and duly consider the consequences on other related assumptions. In particular, the fact that the set of cash-flows to be projected through the application of Article 18 of the Delegated Regulation on contract boundaries is limited should not lead insurance and reinsurance undertakings to consider that assumptions only rely on this projected set of cash-flows without any influence of new business. This is particularly the case for assumptions on the allocation of risky assets, management of the duration gap or application of profit sharing mechanisms.

Explanatory text:

3.65. Future business can be split into three categories: Future business within contract boundaries (i.e. included in best estimate), future business related to current contracts but falling beyond contract boundaries (e.g. premiums to be received after the contract boundary and therefore no included in best estimate) and future business related to new contracts. Even if only the first category is included in best estimate, all of the categories may need to be considered when setting best estimate assumptions and, in particular, assumptions linked to future management actions.

3.66. This is particularly relevant for with profit contracts when profit sharing mechanisms in the future will apply to both the existing and the new business combined. In those cases, the interdependency of the new business and the existing business on the value of options and guarantees should be duly taken into account for valuing best estimates. Realistic assumptions based on the historical practices of the insurance or reinsurance undertakings should apply, independently of the fact that the application of principles on contract boundaries limit the set of cash flow to be projected.

3.67. For example, If the assumption of writing new business (linked to existing contracts or linked to new contracts) in the future leads to different investment profits than the assumption of having no business after the contract boundary, undertakings should project investment profits based on the assumption of writing new business. This does not mean that undertakings need to estimate and project future profits linked to new business.

3.68. Similarly, insurance and reinsurance undertakings should consider a balanced approach when setting up assumptions on the projection of future investments. Indeed, as those undertakings usually continue writing new business, their past experience is based on relatively stable allocation on risky assets and duration of bond portfolio – with potential adjustment on duration gap. However as the set of cash flow to be projected is limited, insurance undertakings do not have historical evidence of assumptions for such a “run-off” projection. Thus, insurance and reinsurance undertakings should adopt a balanced approach to define assumptions so that those are realistic, based on empirical evidences without exacerbating the fact that the cash flows are limited.

3.69. For instance, a large reduction of risky assets to reinvest in cash or cash equivalent will usually not be considered as realistic as it reduces the volatility of the assets – and the values of options and guarantees - across the projection without any empirical justification. A large reduction of the duration of assets in the first years of projection is also unrealistic if contracts are projected over decades.

Methodologies for the valuation of contractual options and financial guarantees

NEW: GUIDELINE 53A – USE OF STOCHASTIC VALUATION

3.70. Insurance and reinsurance undertakings should use stochastic modelling for the valuation of technical provisions of contracts whose cash flows depend on future events and developments, in particular those with material options and guarantees.

3.71. When assessing whether stochastic modelling is needed to adequately capture the value of options and guarantees, insurance and reinsurance undertakings should, in particular but not only, consider the following cases:

- any kind of profit-sharing mechanism where the future benefits depend on the return of the assets;

- financial guarantees (e.g. technical rates, even without profit sharing mechanism), in particular, but not only, where combined with options (e.g. surrender options) whose dynamic modelling would increase the present value of cash flows in some scenarios.

Explanatory text:

3.72. Stochastic modelling of options and guarantees intends to capture their time value, which is not captured following deterministic valuation. The time value of options and guarantees can be captured in any case using simulation methods, but in some simple cases it can also be measured accurately with closed-formula approaches. In addition, considering the high costs of stochastic valuation and following the proportionality principle, for non-material options and guarantees simplified approaches may be used when available.

3.73. Profit sharing usually works under asymmetric basis: profits are shared with the policyholders while losses are completely assumed by the undertaking. Under such circumstances, stochastic valuation is particularly relevant, since a set of scenarios might lead to a significantly higher best estimate than a single average scenario under a deterministic approach.

3.74. The combined effect of financial guarantees and surrender options might also be particularly relevant. A guaranteed rate might increase the value of surrender option: the policyholder would keep its policy in unprofitable low interest rates environment and surrender it in high interest rates environment. Therefore, the average present value of the liabilities may significantly increase compared to a deterministic calculation.

Economic Scenario Generator (ESG)

NEW: GUIDELINE 57A – MARKET RISK FACTORS NEEDED TO DELIVER APPROPRIATE RESULTS

3.75. When assessing whether all the relevant risk factors are modelled with respect to the provisions of Articles 22(3) and 34(5) of the Delegated Regulation, insurance and reinsurance undertakings should be able to demonstrate that their modelling adequately reflects the volatility of their assets and that the material sources of volatility are appropriately reflected (e.g. spreads and default risk).

3.76. In particular, insurance and reinsurance undertakings should use models that allow for the modelling of negative interest rates.

Explanatory text:

3.77. Insurance and reinsurance undertakings should ensure that any risk factor that could have a material impact on the outcome of the stochastic valuation is properly modelled. In particular, negative interest rates usually have a material impact and therefore the models used should allow them in any case. However, other risk factors as spreads and default risk only have a material impact in some specific cases (e.g. where the investment strategy includes a material part of high-yield bonds) and it may not be necessary to model them.

Expected profits in future premiums (EPIFP)

AMENDED: GUIDELINE 77 – ASSUMPTIONS USED TO CALCULATE EPIFP

3.78. For the purpose of calculating the technical provisions without risk margin under the assumption that the premiums relating to existing insurance and reinsurance contracts that are expected to be received in the future are not received, insurance and reinsurance undertakings should apply the same actuarial method used to calculate the technical provisions without risk margin in accordance with Article 77 of the Solvency II Directive, with the following changed assumptions:

a) policies should be treated as though they continue to be in force rather than being considered as surrendered;

b) regardless of the legal or contractual terms applicable to the contract, the calculation should not include penalties, reductions or any other type of adjustment to the theoretical actuarial valuation of technical provisions without a risk margin calculated as though the policy continued to be in force.

3.79. All the other assumptions (e.g. mortality, lapses or expenses) should remain unchanged. This means that the insurance and reinsurance undertakings should apply the same projection horizon, future management actions and policyholder option exercise rates used in best estimate calculation without adjusting them to consider that future premiums will not be received. Even if all assumptions on expenses should remain constant, the level of some expenses (e.g. acquisition expenses or investment management expenses) could be indirectly affected.

Explanatory text:

3.80. As stated in Article 260(2) of the Delegated Regulation, EPIFP is determined as the difference between the official calculation of technical provisions without risk margin and a calculation of technical provisions without risk margin under the assumption that future premiums (and related benefits) expected to emerge from existing contracts will not occur.

3.81. The methodology described is based on a difference between two different calculations of technical provisions without risk margin, so it is crucial that both terms of the subtraction are calculated following the same approach and technical hypothesis, with the only exception that in the additional technical provisions without risk margin calculation no future premiums will be included.

3.82. As written above, the technical hypothesis should remain unchanged to guarantee coherence among the official technical provisions without risk margin and technical provisions without risk margin under the assumption that future premiums (and related benefits) expected to emerge from existing contracts will not occur.

3.83. This means that the projection of future cash flows should not change when valuating EPIFP, i.e. the calculation should be only a matter of identifying the cash flows related to future premiums and taking them out from the calculation without altering the remaining cash flows.

3.84. In order to avoid divergent practices on expenses projection applied on technical provisions without risk margin without future premiums, it is important to underline the following considerations:

- 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).

3.85. EPIFP calculation is directly connected to best estimate valuation. It therefore requires sound actuarial knowledge and deep understanding of best estimate modelling. For this reason, the staff in charge of best estimate valuation is expected to have a role on EPIFP calculation (e.g. validation by the actuarial function).

3.86. For example, EPIFP calculation can be simulated using existing options for the contract, mainly the paid-up option. However, in this case insurance and reinsurance undertakings should adjust the calculation to comply with Guideline 77, in particular not considering any material penalty in the calculation. Contracts without paid-up option can also follow the approach described in Guideline 77, although this will probably require further adjustments to the calculation system.

3.87. Alternatively, insurance and reinsurance undertakings can use the approach described in Guideline 77a.

NEW: GUIDELINE 77A – ALTERNATIVE APPROACH TO CALCULATE EPIFP

3.88. Insurance and reinsurance undertakings may identify EPIFP as the part of present value of future profits related to future premiums in case the outcome does not materially deviate from the value that would have resulted from the valuation described in Guideline 77. This approach may be implemented using a formula design

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 impact of the revision of the Guidelines as a whole plus the most relevant areas individually, in particular expert judgement, investment management expenses and EPIFP calculation. 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 data gathered in the information request for the 2020 review of Solvency II.

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 calculation of technical provisions. 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 stochastic valuation, future management actions, policyholder behaviour, expenses, expert judgement and EPIFP.

4.6. In some cases, divergences arise from the penetration of more sophisticated techniques, e.g. stochastic valuation or dynamic policyholder modelling. In other cases divergences arise from a lack of clarity of some detailed assumptions, as for example the investment management expenses that should be allocated to the best estimate or the delimitation of the scope of future management actions. Overall, these divergent practices have an impact over the best estimate, which could lead to an unlevel playing field if not properly addressed.

4.7. Expert judgement guidelines do not introduce new guidance since their content is the same than the Guidelines on expert judgement already existing in the Guidelines on the use of internal models and, according to the introduction of the Guidelines on valuation of Technical Provisions, these guidelines on expert judgement are also applicable for best estimate valuation purposes. However, this reference via the introduction is not straightforward and visible enough, which led to some confusion and divergent interpretations in the past.

4.3. OBJECTIVES PURSUED

4.8. The main objective of these Guidelines is to ensure a convergent approach regarding the calculation of technical provisions 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 assumptions underlying the use of economic scenario generators, the implementation of future management actions, expenses, policyholder behaviour and the calculation of EPIFP are addressed. It also provides explicit guidance on the use of expert judgment instead of a reference to the Guidelines on the use of internal models, as it is currently the case. 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 is 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 the calculation of technical provisions is to be applied 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 how the calculation of technical provisions is to be applied 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 Sections 2, 4, 5 and 6 of the Annex 3 of the aforementioned document and mainly affect interpretation of the legal provisions regarding economic scenarios generators, future management actions, expenses and valuation of options and guarantees.

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 calculation of technical provisions:

a) supports the (re)insurance undertakings in setting up their assumptions, and therefore, ensures an enhanced level playing field among the undertakings;

b) does not modify the current expectations of supervisors but provide more clarity and more transparency on the application of regulatory requirements;

4.17. In terms of cost of compliance with the new Guidelines, it is reasonable to expect that (re)insurance undertakings shall slightly modify their assumptions, methodologies and documentation package related to the calculation of technical provisions. However, as all those assumptions and methodologies shall be regularly reviewed by (re) insurance undertakings, it is expected that the implementation of the additional Guidelines will lead to no material additional costs.

4.18. For competent authorities, those new guidelines should ease the process of reviewing the calculation of technical provisions by providing a better clarity on practices to be implemented, leading to less administrative costs

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

4.19. EIOPA believes that, without the introduction of additional guidelines, the current set of Guidelines on technical provisions fail to provide a sufficient regulatory framework for the insurance and reinsurance undertakings and the competent authorities in the field of calculation of technical provisions as shown by the current divergent practices (re)insurance undertaking.

4.20. Moreover, without the issuance of new guidelines it could lead to a situation of unlevel playing field among insurance undertakings, especially in case of activities performed through freedom of establishment of freedom of services. Indeed expectation regarding the calculation of technical provisions might differ from the Home supervisor and the host supervisor, that could lead to different own funds assessment for the same insurance obligations.

Conclusion on Policy issue 1

4.21. EIOPA believes that, without the introduction of additional Guidelines, the current set of Guidelines on the valuation of technical provisions 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.

4.22. 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	None
	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

4.23. For these reasons, Option 1.1 is preferred.

4.4.2. POLICY ISSUE 2: CONSISTENT APPROACH REGARDING USE OF EXPERT JUDGMENT FOR BOTH TECHNICAL PROVISIONS AND INTERNAL MODELS

4.24. The following policy options have been identified:

1. **Policy option 2.1** Introduction of a full set of guidelines on Expert judgment for valuation of technical provisions.
2. **Policy option 2.2** Introduction of a reference to the guidelines on Expert judgment for internal model purposes in a specific guideline.
3. **Policy option 2.3** Reference to the guidelines on Expert judgement for internal model purposes in the recitals (current situation).

Policy option 2.1 *Introduction of a full set of guidelines on Expert judgment for the valuation of technical provisions*

4.25. Expert judgment is widely used by insurance and reinsurance undertakings when setting assumptions for valuation purposes. Currently Recital 1.3 of the current guidelines refers to Chapter 4 of the Internal Models Guidelines. It is then in contradiction with internal model guidelines for which a detailed set of guidance has been provided.

4.26. Because the guidance and clarification of the application of expert judgement is equally important for the valuation of technical provisions, EIOPA believes that the introduction of the full set of guidelines regarding expert judgment in the Guidelines on the valuation of technical provisions will promote consistency and a level playing field across insurance and reinsurance undertakings.

4.27. In terms of cost of compliance with the guidelines on expert judgment, it is reasonable to expect that (re)insurance undertakings will not be significantly affected, because the recitals of the current Guidelines already refer to the same provisions in the Guidelines on the use of internal models. Indeed, insurance and reinsurance undertakings already apply specific governance and control on expert judgment, as they need to ensure the adequacy of the general governance and control systems related to the valuation of technical provisions. However, they will probably need to slightly amend existing practices to ensure alignment with the detailed guidance provided. As the general governance system is regularly reviewed by (re)insurance undertakings, it is expected that the implementation of the additional Guidelines will lead to no material additional costs.

4.28. For competent authorities, these new guidelines are expected to ease reviewing the calculation of technical provisions by providing better clarity on practices to be implemented, leading to less administrative costs.

4.29. Policy option 2.2 Introduction of a reference to the guidelines on Expert judgment for internal model purposes in a specific guideline

4.30. This option is quite similar in terms of costs and benefits to Option 2.1. It also provides the advantage to ensure a full consistency between the Guidelines on internal models and the Guidelines on the valuation of technical provisions. However, it cannot ensure the full consistency of the entire set of Guidelines on the valuation of technical provisions, which means that insurance and reinsurance undertakings that are not using internal models have to refer to guidelines that are not directly applicable to them.

4.31. Policy option 2.3 Reference to guidelines on Expert judgement for internal model purposes in the recitals (current situation)

4.32. EIOPA believes that, taking into account the current situation, the status quo is not enough to ensure sufficient harmonisation among the industry because the recitals cannot enforce an obligation.

Conclusion on Policy issue 2

4.33. EIOPA has identified that a reference in the recitals on Expert judgment for internal model purposes might not be the most suitable guidance to provide a sufficient regulatory framework for the insurance and reinsurance undertakings and the national competent authorities. Indeed it does not directly provide a full and self-functioning set of guidance to the insurance and reinsurance undertakings, leading to potentially divergent practices.

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

Policy issue 2: Consistent approach regarding use of expert judgments for both technical provisions and internal model		
Option 2.1: Introduction of a full set of guidelines on Expert judgment for valuation of technical provisions.		
Costs	Policyholders	None
	Industry	None as current guidelines on valuation of technical provisions already refer in the recitals to guidelines on Expert judgment applicable to internal models
	Supervisors	None as current guidelines on valuation of technical provisions already refer in the recitals to guidelines on Expert judgment applicable to internal models
	Other	None
Benefits	Policyholders	None

	Industry	Avoid implicit reference to other sets of guidelines and provide a full set of guidelines to the industry when assessing their compliance to valuation of technical provisions.
	Supervisors	Clearer guidance on expert judgment facilitating the review field and a common understanding with industry.
	Other	None
Option 2.2: Introduction of a reference to guidelines on Expert judgment for internal model purposes in a specific guideline		
Costs	Policyholders	None
	Industry	None as current guidelines on valuation of technical provisions already refer in the recitals to guidelines on Expert judgment applicable to internal models
	Supervisors	None as current guidelines on valuation of technical provisions already refer in the recitals to guidelines on Expert judgment applicable to internal models
	Other	None
Benefits	Policyholders	None
	Industry	Introduce an explicit guideline that reinforces the fact that guidelines applicable to internal models are also applicable for valuation of technical provisions regarding expert judgment
	Supervisors	Clearer guidance on applicability of expert judgment guidelines facilitating the review field and a common understanding with industry.
	Other	None
Option 2.3: Reference to guidelines on Expert judgement for internal model purposes in the recitals (current situation)		
Costs	Policyholders	None
	Industry	None
	Supervisors	None
	Other	None
Benefits	Policyholders	None
	Industry	None
	Supervisors	None
	Other	None

4.35. For these reasons, Option 2.1 is preferred.

4.4.3. POLICY ISSUE 3: PROPORTION OF INVESTMENT MANAGEMENT EXPENSES TO BE CONSIDERED

4.36. The following policy options have been identified:

1. **Policy option 3.1** Expenses relating to all assets
2. **Policy option 3.2** At least expenses relating to investments backing Solvency II technical provisions and the solvency capital requirement
3. **Policy option 3.3** At least expenses relating to investments backing Solvency II technical provisions or Solvency II Best Estimate
4. **Policy option 3.4** At least expenses relating to investments backing the local GAAP technical provisions
5. **Policy option 3.5** At least expenses relating to investments needed to service the insurance or reinsurance contract.

Analysis of Policy Issue 3

4.37. In June 2019, EIOPA surveyed the practices of how investment management expenses are considered in the calculation of technical provisions. Several different approaches were used, also within the same country, and EIOPA believes that there is need to harmonise the practices.

4.38. Altogether 287 undertakings took part in the survey, of which 150 were life, 48 non-life and 79 composite undertakings. 10 undertakings were reinsurance undertakings. According to the survey results, different calculation approaches could be observed:

	Life		Non-life		Composite		Reinsurance		All	
	Companies	**Models**	**Companies**	**Models**	**Companies**	**Models**	**Companies**	**Models**	**Companies**	**Models**
AT	2	1	4	2	11	3	0	0	17	3
BE	10	5	0	0	13	5	0	0	23	5
CY	3	1	0	0	2	2	1	1	6	2
CZ	0	0	0	0	4	3	0	0	4	3
DE	40	5	1	1	0	0	0	0	41	5
DK	8	5	4	3	3	3	0	0	15	6
EE	1	1	3	2	1	1	0	0	5	4
ES	2	2	0	0	8	3	1	1	11	4
FI	4	4	4	2	1	1	0	0	9	4
FR	8	3	0	0	1	1	0	0	9	3
GR	1	1	1	1	3	2	0	0	5	2
HR	0	0	2	1	4	4	0	0	6	4
HU	2	2	2	2	3	2	0	0	7	4
IE	15	4	11	3	0	0	7	3	33	5
IT	13	4	0	0	9	2	0	0	22	4
LI	7	3	3	3	2	2	0	0	12	4
LT	2	1	1	1	0	0	0	0	3	2
LU	6	2	2	1	0	0	1	1	9	3
LV	1	1	1	1	1	1	0	0	3	3
NL	4	2	0	0	0	0	0	0	4	2
NO	1	1	0	0	2	1	0	0	3	1
PL	7	3	6	4	0	0	0	0	13	6
PT	5	2	1	1	3	3	0	0	9	3
RO	4	4	0	0	4	2	0	0	8	4
SE	4	2	2	1	4	3	0	0	10	5
Total	**150**		**48**		79		10		287	

4.39. The following table shows the percentage of undertakings that considered certain investment management expenses in their calculations:

Investment management expenses considered	Life	Non-life	Composite	Reinsurance	All
All	50 %	50 %	50 %	60 %	50 %
Local GAAP	20 %	10 %	30 %	10 %	20 %
SII TP	20 %	10 %	10 %	10 %	10 %
None or n/a	0 %	20 %	10 %	10 %	10 %
SII TP and SCR	0 %	10 %	0 %	0 %	0 %
SII BE	0 %	0 %	0 %	10 %	0 %
Other	10 %	0 %	10 %	0 %	10 %
Total	100 %	100 %	100 %	100 %	100 %

4.40. Even if more than 50% of the undertakings considered expenses from all investments, there is a wide range of alternatives being used in most of the markets, probably because depending on the product the right criteria might be different.

4.41. For some with profit products where the profit sharing mechanism depends on local GAAP technical provisions (Option 3.4), these may indeed be a reasonable driver. However, for other products where the contractual terms are not linked to local GAAP technical provisions, using this driver may go against the level playing field. Similarly, other products as index-linked and unit-linked contracts, matching adjustment portfolios and ring-fenced funds there are different straightforward criteria based on the terms of the contract or

Solvency II regulation that would allow to identify the investments needed to service insurance and reinsurance contracts.

4.42. It should also be noted that any rigid approach always using as a driver a particular Solvency II amount (Options 3.2 and 3.3) could lead to questionable results in some extreme cases, as for example negative technical provisions.

4.43. Therefore, it is worth to consider a fifth alternative (Option 3.5) focused on the contractual and legal requirements, that in several cases allow a clear and reasonable identification of the investments needed to service an insurance or reinsurance contract. However, for other products the identification might not be so clear and it would require the use of expert judgement.

Conclusion on Policy issue 3

4.44. EIOPA has identified that different approaches are currently being followed in different jurisdictions and therefore further guidance on the right approach is needed to facilitate a level playing field.

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

Policy issue 3: Proportion of investment management expenses to be considered		
Option 3.1: Expenses of all assets		
Costs	Policyholders	None
	Industry	- Some undertakings may need to do some adjustments regarding the best estimate valuation to comply with the revised Guidelines. However, this is unavoidable when addressing divergent practices. - This option overestimates technical provisions compared to the requirement of the Delegated Regulation, potentially having a material impact on the Solvency of a significant number of insurance and reinsurance undertakings. - It might not respect the level-playing field for mutual undertakings because compared to insurance and financial groups they do not have the same possibilities to optimise their solvency position.
	Supervisors	None
	Other	None

Benefits	Policyholders	- This approach would usually lead to higher technical provisions compared to other options and therefore to a higher level of protection of policyholders. - Same level of protection across Europe.
	Industry	- Clearer guidance reducing uncertainty.
	Supervisors	- Clearer guidance
	Other	None
Option 3.2: At least investments backing Solvency II technical provisions and the solvency capital requirement		
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. - To avoid circular references, undertakings would need to use simplifications - This criteria could lead to unreasonable outcomes in some extreme cases, e.g. negative technical provisions.
	Supervisors	- This criteria could lead to unreasonable outcomes in some extreme cases, e.g. negative technical provisions.
	Other	None
Benefits	Policyholders	- Same level of protection across Europe.
	Industry	- Clearer guidance reducing uncertainty. - This approach is in line with article 78 (1) (1) of the Solvency II Directive that requires all expenses that will be incurred in servicing insurance and reinsurance obligations to be taken into account.
	Supervisors	- Clearer guidance
	Other	None
Option 3.3: At least investments backing Solvency II technical provisions or Solvency II best estimate		
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. - This criteria could lead to unreasonable outcomes in some extreme cases, e.g. negative technical provisions.
	Supervisors	- This criteria could lead to unreasonable outcomes in some extreme cases, e.g. negative technical provisions.
	Other	None
Benefits	Policyholders	- Same level of protection across Europe.

	Industry	- Clearer guidance reducing uncertainty. - This approach is in line with article 78 (1) (1) of the Solvency II Directive that requires all expenses that will be incurred in servicing insurance and reinsurance obligations to be taken into account. - This approach leads to lower technical provisions compared to options 3.1 and 3.2.
	Supervisors	- Clearer guidance
	Other	None
Option 3.4: At least investments backing the local GAAP technical provisions		
Costs	Policyholders	- It does not provide the same level of protection across Europe as it refers to local GAAP
	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. - It does not ensure all expenses that will be incurred in servicing insurance and reinsurance obligations to be taken into account. - It does not ensure a level playing field as it is based on local regulation.
	Supervisors	- It does not ensure all expenses that will be incurred in servicing insurance and reinsurance obligations to be taken into account. - It does not ensure a level playing field as it is based on local regulation.
	Other	None
Benefits	Policyholders	None
	Industry	- Clearer guidance
	Supervisors	- Clearer guidance
	Other	None
Option 3.5: At least expenses relating to investments needed to service the insurance or reinsurance contract.		
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. - In some cases, it requires the use of expert judgement.
	Supervisors	- In some cases, it requires the use of expert judgement.
	Other	None
Benefits	Policyholders	- Same level of protection across Europe.

	Industry	- This approach is in line with article 78 (1) (1) of the Solvency II Directive that requires all expenses that will be incurred in servicing insurance and reinsurance obligations to be taken into account. - Clearer guidance - This criteria should not lead to unreasonable outcomes in any case.
	Supervisors	- Clearer guidance - This criteria should not lead to unreasonable outcomes in any case.
	Other	None

4.46. For these reasons, Option 3.5 is preferred. This option does not restrict the undertakings to take into account expenses of all assets, which is currently the most frequent approach.

4.4.4. POLICY ISSUE 4: MANAGEMENT OF EXPENSES THAT THE FUND MANAGER REIMBURSES TO THE UNDERTAKING

4.47. The following policy options have been identified:

1. **Policy option 4.1** Reimbursement should be considered as decrease of expenses
2. **Policy option 4.2** Reimbursement should be considered as other cash inflow

Analysis of Policy Issue 4

4.48. In the same survey, EIOPA observed that 60% of the undertakings stated that either the reimbursements were not taken into account or were not relevant, or the undertakings did not provide any response.

4.49. From the remaining respondents, about 35% mentioned that they netted the reimbursements with the trading costs. Others modelled the reimbursements e.g. as separate cash flows.

4.50. According to the survey results, some undertakings directed the reimbursements to policyholders in equal terms, some directed part of them to policyholders. About 67% of the undertakings stated that they keep the reimbursements for themselves. This policy issue addressed the treatment of the reimbursements that undertakings keep for themselves.

4.51. Policy option 4.1 Reimbursement should be considered as decrease of expenses, and policy option 4.2 Reimbursement should be considered as other cash inflow, would lead to the same best estimate as both would allow a decrease of the best estimate. The difference between the two options is that in regard policy Option 4.2 the expenses are not reduced, which might have an impact in the calculation of the expense risk solvency capital requirement in comparison with policy Option 4.1 where the amount expenses is directly reduced.

Conclusion on Policy issue 4

4.52. EIOPA has identified that insurance and reinsurance undertakings do not treat consistently reimbursement of expenses from fund managers. That leads to an unequal treatment of policyholders.

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

Policy issue 4: Management of expenses that the fund manager reimburses to the undertaking		
Option 4.1: Reimbursement should be considered as a decrease of expenses.		
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	None
	Other	None
Benefits	Policyholders	- Same level of protection across Europe.
	Industry	- Clearer guidance reducing uncertainty.
	Supervisors	- Clearer guidance
	Other	None
Option 4.2: Reimbursement should be considered as other cash inflow.		
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. - Compared to Option 4.1, it might lead to higher solvency capital requirement
	Supervisors	None.
	Other	None
Benefits	Policyholders	- Same level of protection across Europe.

		- Compared to Option 4.1, it might lead to higher solvency capital requirement and thus a higher level of protection
	Industry	- Clearer guidance reducing uncertainty.
	Supervisors	- Clearer guidance
	Other	None

4.54. For these reasons, Option 4.2 is preferred.

4.4.5. POLICY ISSUE 5: DETAILED GUIDANCE ON THE CALCULATION OF EPIFP

4.55. The following policy options have been identified:

1. **Policy option 5.1** Clarification on the assumptions to be used to calculate EPIFP.
2. **Policy option 5.2** No further clarification

Analysis of Policy Issue 5

Policy option 5.1 *Clarification on the assumptions to be used to calculate EPIFP*

4.56. This option provides further clarification to (re)insurance undertakings for the calculation of EPIFP. Removing future premiums in the calculation of EPIFP may be complex and depend on several assumptions. Thus, by clarifying which assumptions are to be left unchanged, EIOPA believes that higher convergence of practices and level-playing field will be achieved.

4.57. It is reasonable to expect that (re)insurance undertakings will have to only slightly modify their assumptions, methodologies and documentation package related to the calculation of EPIFP. However, as all those assumptions and methodologies have to be regularly reviewed by (re) insurance undertakings, it is expected that the implementation of the revised guidelines will not lead to any material additional costs. Moreover, guidance on simplification might lead to less complexity and less costly calculations.

4.58. For the competent authorities, new guidelines would ease the process of reviewing the calculation of EPIFP.

Policy option 5.2 *No further clarification*

4.59. EIOPA believes that, without the introduction of clarifications regarding the EPIFP calculation, the current set of Guidelines on technical provisions fails to provide a sufficiently clear regulatory framework in the field of calculation of technical provisions for the insurance and reinsurance undertakings and for the competent authorities.

4.60. Indeed, the actual application of the current guidelines has led to divergent practices by (re)insurance undertakings, whereas EPIFP needs to be well identified in the calculation of own funds.

Conclusion on Policy issue 5

4.61. EIOPA believes that the current guideline does not provide sufficiently clear guidance on the calculation of EPIFP, in particular on the principle that some assumptions should be left unchanged. Moreover, due to the complexity of the EPIFP calculation, the role of the actuarial function is crucial to ensure an appropriate assessment of the calculation.

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

Policy issue 5: Introduction of new Guidelines vs status quo		
Option 5.1: Clarification on the assumptions to be used to calculate EPIFP		
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	None
	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 5.2: No further clarification		
Costs	Policyholders	None

	Industry	Lack of clear guidance on the interpretation of some provisions complicates reaching a common understanding on the calculation to be provided.
	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

4.63. For these reasons, Option 5.1 is preferred

EIOPA

Westhafen Tower, Westhafenplatz 1
60327 Frankfurt – Germany
Tel. + 49 69-951119-20
info@eiopa.europa.eu
https://www.eiopa.europa.eu