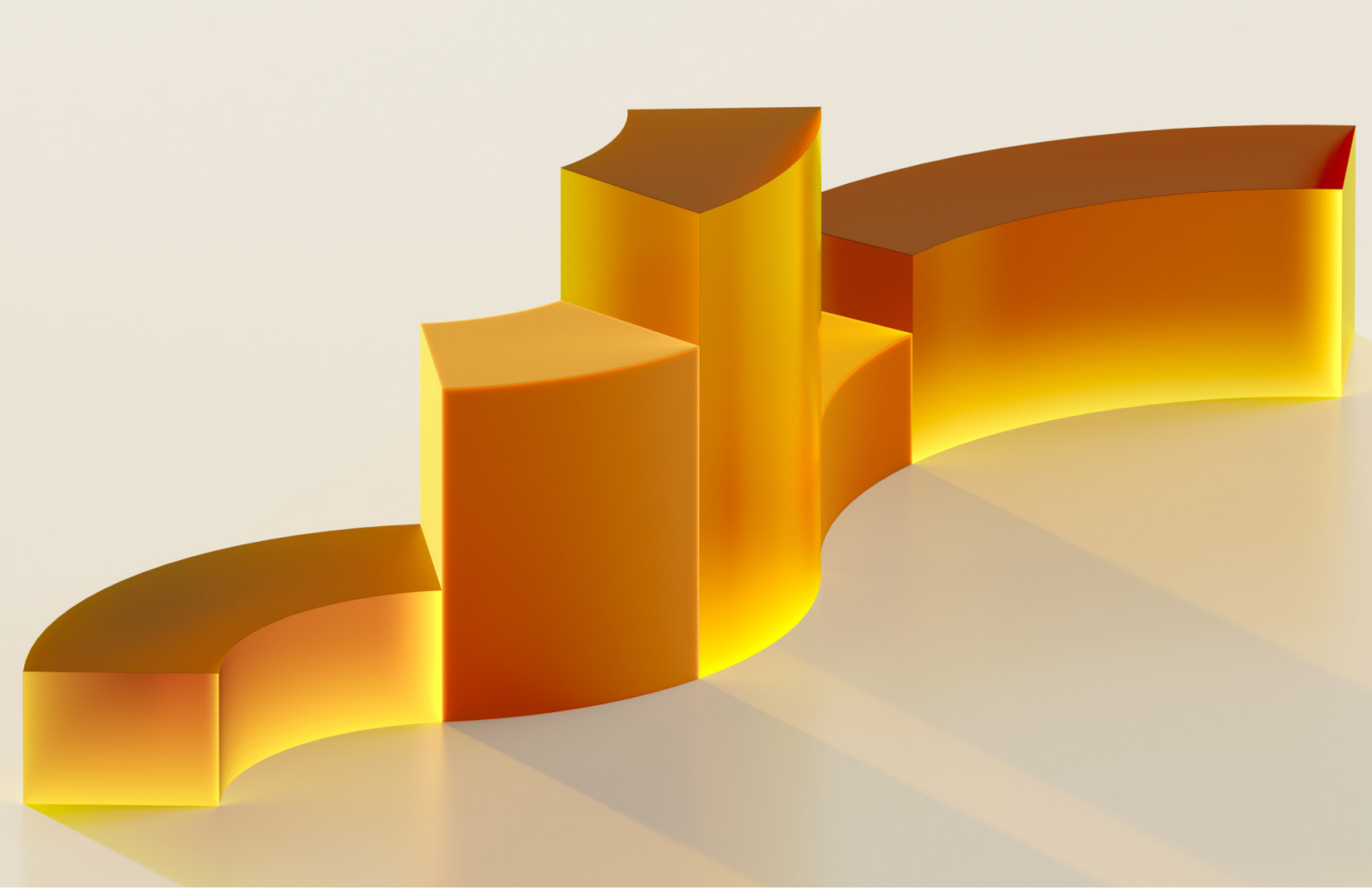


Solvency II review: Key changes and implications

September 2025

J.P.Morgan
ASSET MANAGEMENT

Executive summary

Author

Valerie Stephan
European Head of Insurance Strategy & Analytics
valerie.stephan@jpmorgan.com

Solvency II is currently undergoing a review, with implementation anticipated by 2027. The directive was issued by the European Commission in January 2025 and member states have until 30 January 2027 to incorporate it into local legislation. This directive is further supported by delegated acts.

The European Commission released draft delegated acts on 18 July 2025 and is actively seeking feedback from insurers by 5 September 2025. The goal is to finalise and publish these delegated acts in the fourth quarter of 2025.

This paper highlights the key changes we identified that will affect insurance balance sheets, from both a solvency and investment point of view. In our analysis, we have categorised the key changes by asset class. These changes impact various modules of the Solvency Capital Requirement (SCR), including market risk, counterparty risk and technical provision calculation. While there are numerous additional changes proposed in the document concerning liabilities (non-life and catastrophe risks), and reporting standards (the Own Risk and Solvency Assessment (ORSA) and Solvency and Financial Condition Report (SFCR), we have chosen not to cover them here. Some changes were anticipated, while others are novel, and we have highlighted the unanticipated changes in green.

Key changes by asset category

Liability valuation and interest rate module

Extrapolation of risk-free interest rate curves

A new extrapolation method for interest rates is proposed that includes observations for maturities beyond the "first smoothing point", meaning interest rates of maturities above 20 years will also be accounted for in building the curve. Given that the curve is downward sloping past the 20-year point, including lower rates in the extrapolation method will increase technical provision values and consequently decrease own funds.

The "last liquid point" is replaced by the "first smoothing point" and is allowed to increase over time as liquidity in long-dated bonds develops. If at some point in the future, the share of outstanding bonds with maturities over 30 years increases above 8%, the first smoothing point could become 30 years. This 8% threshold was chosen so that the first smoothing point would still be 20 years for the EUR at the application date (in line with current regulation).

The extrapolation technique moves away from the parametric "Smith Wilson" (SW) method. Forward rates are extrapolated and converge to the ultimate forward rate (UFR) through an exponential decay from the last liquid forward rate (LLFR). The latter is a combination of interest rate swaps and government bond rates with maturities beyond the first smoothing point, weighted by their traded notionals.

$$f_h = \ln(1 + \text{UFR}) + [\text{LLFR} - \ln(1 + \text{UFR})] \cdot \frac{1 - \exp(-\alpha \cdot h)}{\alpha \cdot h}$$

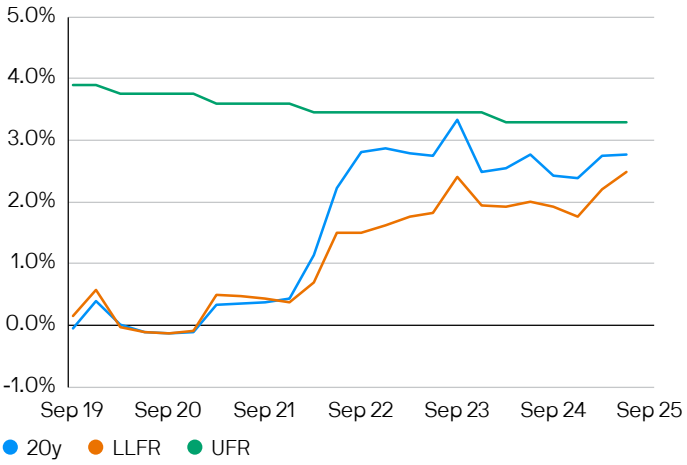
In the equation, *f* is the extrapolated forward rate,

h is the number of years past the first smoothing point and

α is the speed of convergence to the UFR.

The chart below illustrates the evolution of the 20-year rate alongside the LLFR and the UFR (**Exhibit 1**). The curve is downward sloping for maturities beyond 20 years and the last liquid forward rate is below the 20-year rate since early 2022. The inclusion of the LLFR in the extrapolation formula drags down the curve before its reversion to the UFR.

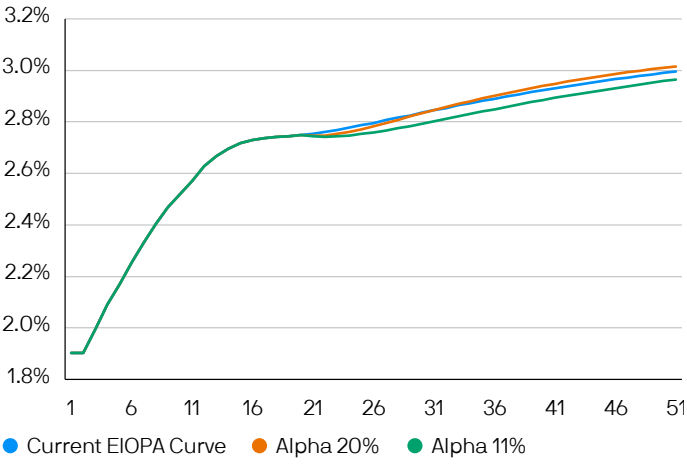
Exhibit 1: Evolution of the 20-year rate alongside the LLFR and the UFR



Source: European Commission, Draft delegated acts 2025. Bloomberg, J.P. Morgan Asset management analysis.

The inclusion of these lower long-term rates in the extrapolated curve will increase technical provision values for longer-dated liabilities. The speed of convergence towards the UFR will decrease progressively over time. Starting at 20%, as illustrated in **Exhibit 2**, the new curve (orange) will be close to the current SW curve (blue) and move down to 11% over five years (green).

Exhibit 2: Current EIOPA risk-free curve and proposed extrapolated curve



Source: J.P. Morgan Asset Management analysis as of 30th June 2025. EIOPA = European Insurance and Occupational Pensions Authority. Alpha is the speed of convergence to the UFR and will linearly decrease from 20% to 11% over five years.

Key changes by asset category continued

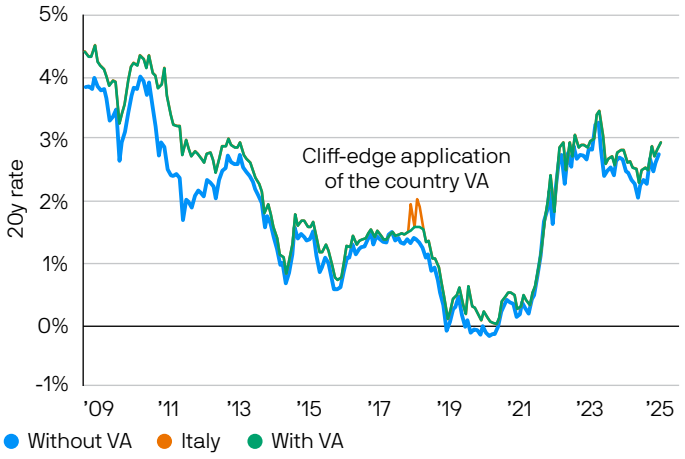
Liability valuation and interest rate module

Volatility adjustment (VA)

Exhibit 3 shows that the current framework for volatility adjustment has multiple issues, such as the cliff-edged switch between country and currency VA and the low frequency of activation. For example, Italian VA was only active for very short periods in history. Furthermore, the application ratio was considered too low.

Finally, in other cases, the VA sometimes led to overshooting effects where companies benefited because of the disconnect between the reference portfolio and the investment portfolio. During the Covid pandemic, Dutch insurers benefited too much from the VA. Indeed, they tend to hedge their liability exposure with interest rate swaps rather than long-duration assets and their investment portfolio is heavily tilted towards Dutch mortgages, which are not represented in the VA portfolio. The VA spread widened significantly more than the actual portfolio, resulting in increasing own funds and a rise in the solvency ratio.

Exhibit 3: Evolution of the 20-year risk-free rate with and without volatility adjustment



Source; EIOPA, European commission draft delegated acts July 2025, J.P. Morgan Asset Management analysis.

To address these shortcomings, the new VA framework features a currency VA to which a macro VA (country dependent) is added as country risk-corrected spreads (RCS) exceed 130% of the EUR RCS. This framework ensures a progressive introduction of the country VA (**Exhibit 4**). Furthermore, the application ratio has increased from 65% to 85%, while a company-dependent application ratio is introduced by multiplying the credit spread sensitivity ratio (CSSR) with the application ratio. The CSSR is company specific and captures the mismatch in terms of spread duration between assets and liabilities in each currency.

The CSSR calculation excludes interest rate derivatives that are used in hedging liabilities; this will limit VA usage for companies that rely on interest rate derivatives for their asset-liability management (ALM).

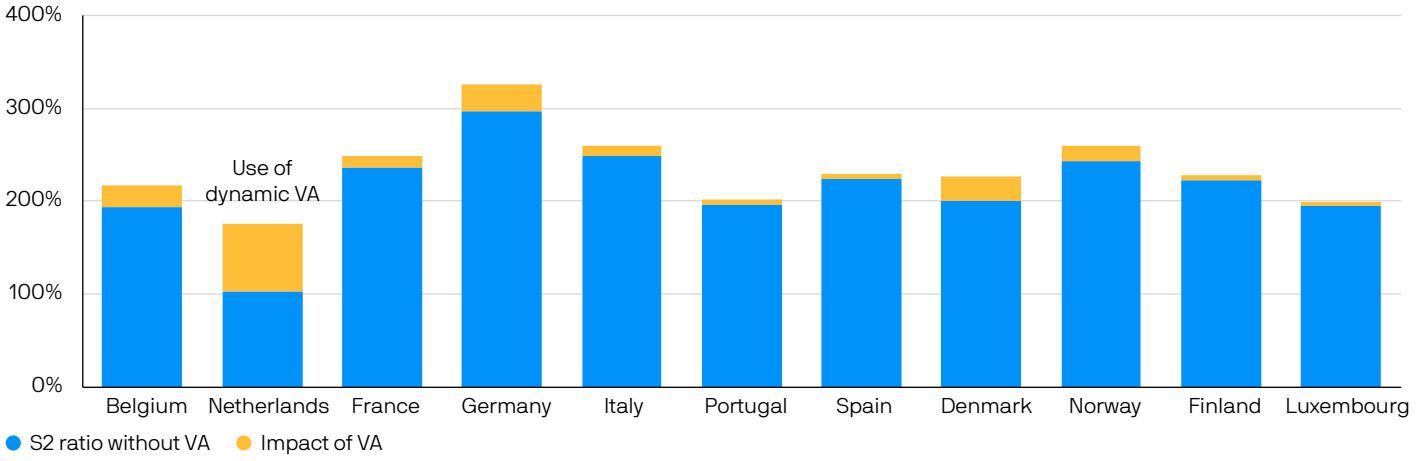
$$CSSR_{curr} = \max\left(\min\left(\frac{PVBP(MV^{FI})}{PVBP(BEL)}; 1\right); 0\right)$$

PVBP(MV^{FI}) is the absolute change in market value of the fixed income portfolio (in that currency), assuming that for each asset, its spread widens by the VA amount (assuming CSSR = 1), divided by the VA. Similarly, *PVBP(BEL)* is the price value of a basis point of the best estimate liabilities *(BEL)* in that currency, for a parallel shift in the curve of the VA amount.

The higher application ratio could lead to an increase in solvency ratios of about 15%. However, this increase would only be achieved assuming a perfect match between the spread duration of assets and the duration of the liabilities.

Key changes by asset category continued

Exhibit 4: Impact of the new VA framework on solvency ratios

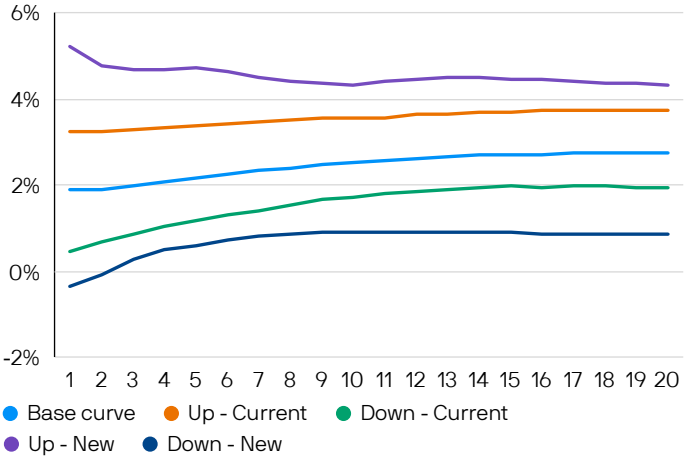


Source: Solvency II wire as of December 2024.

Interest rate shock

As expected, a new interest rate shock is proposed in the delegated acts, which is a combination of a proportional shock and a parallel shock (**Exhibit 5**). In the past, negative interest rates were not shocked to the downside; this is no longer the case. Interest rates can become more negative but only down to a term-dependent floor (-1.25% for short maturities, increasing to -0.893% in year 20). We expect the new interest rate shock to double the capital charge from the interest rate module. The UFR is also shocked up and down by 15 basis points (bps); the shocked curve is extrapolated past the LLP to this shocked UFR following the same method as the risk-free curve extrapolation (including a shock to the last liquid forward rate).

Exhibit 5: Comparison of old and new interest rate shocks



Source: EIOPA, European commission, draft delegated acts July 2025.
UFR = ultimate forward rate, LLFR = Last liquid forward rate

Key changes by asset category continued

Fixed income

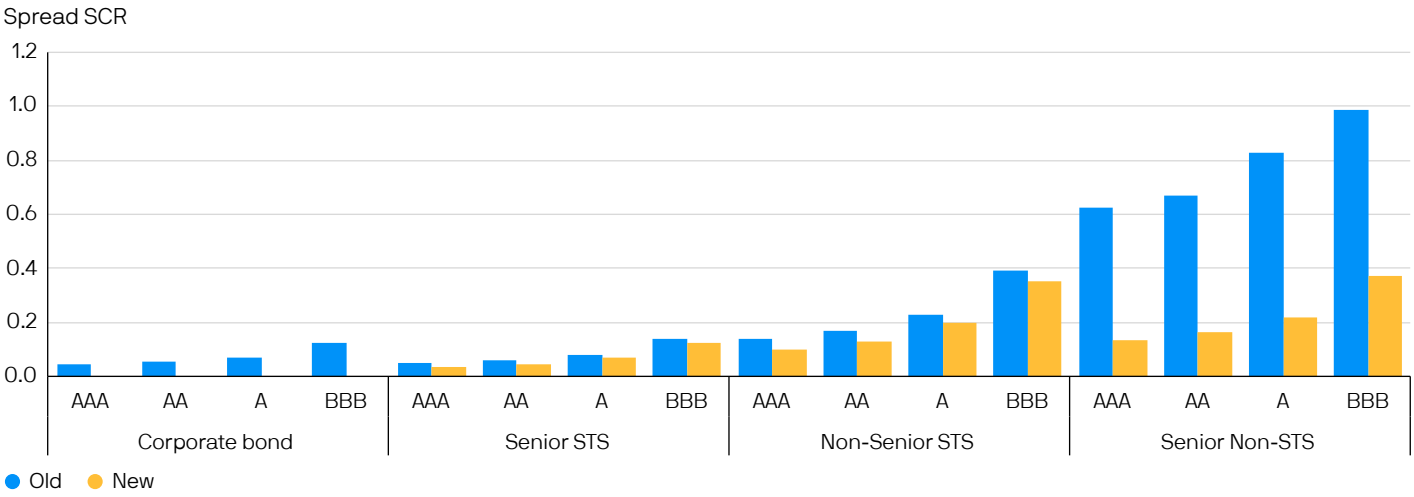
Securitised assets

Securitisation represents less than 1% of insurance balance sheets. The Commission aims to revive the securitisation market in the EU and facilitate the transfer of risks to insurance balance sheets. Capital charges for simple, transparent and standardised securities (STS), both senior and non-senior, as well as senior non-STS have been significantly lowered. Senior STS capital charges are now in line with covered bonds. Meanwhile, senior non-STS, such as European collateralised loan obligations (CLOs), would attract a charge of approximately 2.7% per year of spread duration for an AAA-rated security. **Exhibit 6** shows the spread risk capital charge for a five-year spread duration security.

Mortgages

Mortgages held on insurance balance sheets fall under the counterparty risk module as type 2 exposures. Previously, mortgages with a loan-to-value (LTV) ratio below 80% had a 0% capital charge. Now, a floor of 5% of loan value is introduced in the calculation of the loss-given-default (LGD), resulting in a minimum counterparty charge of 0.8% for mortgages. This charge remains relatively small, especially considering the counterparty risk module's diversification with the market risk module.

Exhibit 6: Spread risk capital charge for a five-year spread duration security



Source: Bloomberg as of 30 June 2025, J.P. Morgan Asset Management analysis. STS – Simple Transparent and Standardised.

The table below highlights the option-adjusted spread (OAS) / spread SCR for various segments of the securitisation market and compares these with European corporates. There is a clear pick-up in return on capital for the securitisation market.

Asset class	Category	Average rating	Yield To Worst (YTW)	OAS (bps)	Spread Duration (yr)
EUR ABS	Senior STS	AAA	2.55%	43	1.8
EUR RMBS	Senior STS	AAA	2.60%	43	2.9
EUR CLO	Senior Non-STS	AAA	3.16%	113	2.3
EUR Corp 1-3y A+		A	2.43%	44	2.0
EUR Corp 1-3y BBB		BBB	2.69%	70	2.0

Key changes by asset category continued

Equity and alternative investments

Long-term equity investments (LTEI)

The long-term equity module, introduced in the January 2025 directive, defines a category of equity exposure that attracts a lower capital charge (22% compared to 39% for public equity and 49% for private equity). Further details of this module, particularly regarding the list of eligible funds and the necessary balance sheet tests for eligibility, are now available.

Portfolio requirements

Insurers must clearly identify a portfolio of equity intended for long-term holding (at least five years on average). This portfolio should be managed separately and be well diversified. It can include Organisation for Economic Co-operation and Development (OECD) equity that is public or private and held directly or in funds.

Eligible funds include

- European long-term investment funds (ELTIF)
- Qualifying social entrepreneurship funds
- Qualifying venture capital funds
- Unlevered, closed-end alternative investment funds managed by an authorized EU alternative investment fund manager (AIFM)

Eligibility tests

To determine if the insurer is allowed to apply the LTEI framework to a portion of its portfolio, the company needs to run one of the following two tests:

1 **Demonstration of ability to avoid forced sales:**

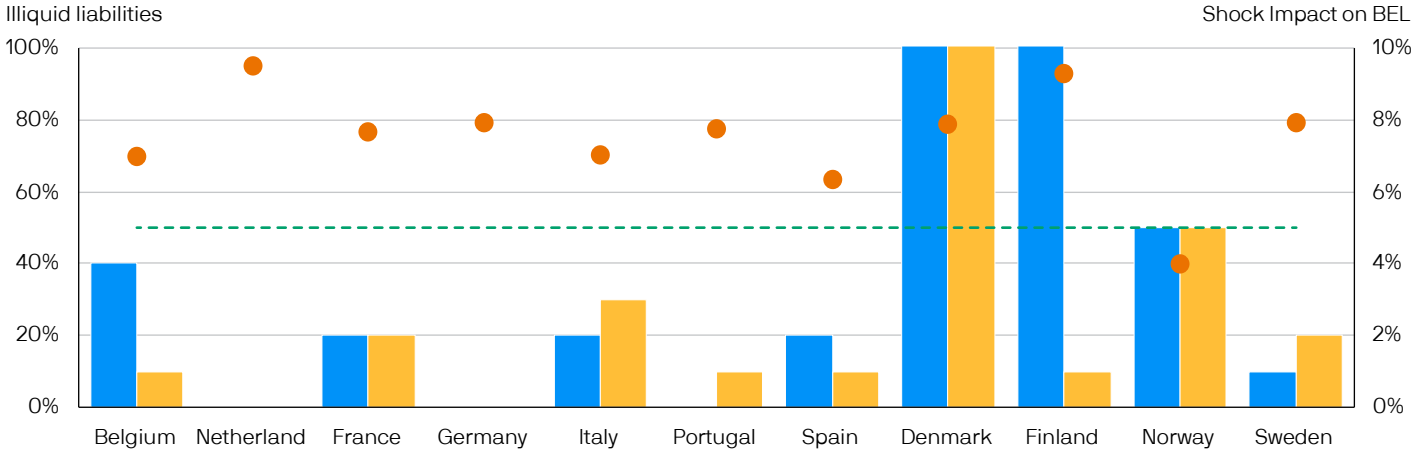
- **Life insurance**: Identify illiquid liabilities with over a 10-year duration. Illiquid liabilities are the liabilities where capital requirement for mortality shock or permanent increase in lapse is less than 5% of best estimate of liabilities (BEL). The LTEI portion should be less than this amount
- **Non-life insurance**: Demonstrate a sufficient liquidity buffer (greater than 105%) by calculating the ratio of liquid assets to the BEL. In order to estimate liquid assets, insurers need to apply haircuts to their investments based on riskiness. For example, cash and government bonds receive no haircut vs. a 50% haircut for corporate BBB or equities.

2 **Forced selling test**: Insurers must demonstrate that cash inflows exceed cash outflows, even under stressed conditions for the next five years. New premiums can be included in the calculation if done reasonably.

Life insurance

In a previous EIOPA paper, the illiquidity of liabilities was assessed by type of policies across the life industry. This paper also looked at the impact on BEL from a mortality shock and a permanent shift in lapses. These are evidenced in **Exhibit 7** where we look at the life "profit participating" policies by country. Across most of Europe, life insurers could identify a portion of liabilities that is illiquid (more than 60% of life profit participating policies are considered illiquid) and that stay under the 5% threshold under shocks. This means that most life insurers should be able to demonstrate their ability to avoid forced sales.

Exhibit 7: Illiquid liabilities and BEL impact of a mortality shock and relative lapse up, by country



Source: European commission draft delegated acts July 2025. Report on insurer's asset and liability management 2019 EIOPA. Financial stability Report June 2025 EIOPA. BEL – Best estimate liability.

Key changes by asset category continued

Equity and alternative investments

Non-life insurance

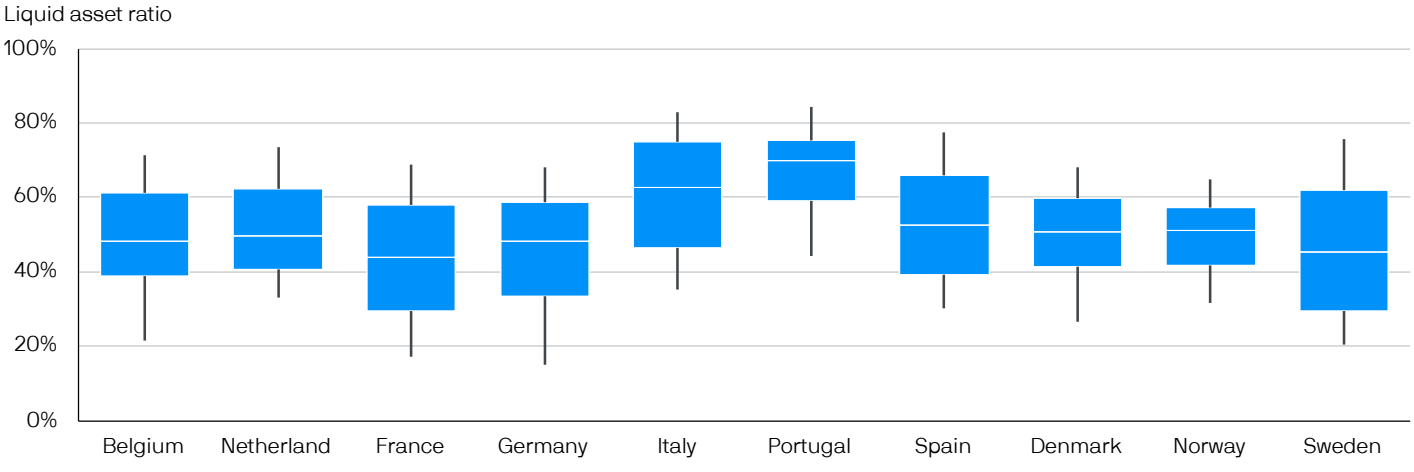
With respect to the liquidity buffer, there are two key parameters. The liquidity of assets and the ratio of assets to BEL. **Exhibit 8** illustrates the liquid asset ratio by country as evidenced in the ALM report from EIOPA dating back to 2019. For most countries, the median of this ratio is above 50%.

With a liquid asset ratio of 60%, non-life insurers would need to have BEL representing less than 58% of their assets. This sounds restrictive but is very often the case across the market and would still allow non-life players with large surpluses to also apply the long-term equity module.

Long-short equity

Previously, equity shocks were only applied to long equity exposures. Now, the absolute value of equity exposure must be used when calculating the equity risk module. Consequently, strategies such as long-short equity will become significantly more capital-intensive under the current framework.

Exhibit 8: Liquidity asset ratio by country



Source: European commission draft delegated acts July 2025. Report on insurer's asset and liability management 2019 EIOPA. Financial stability Report June 2025 EIOPA. BEL – Best estimate liability.

Supplementary observations

Cost of capital

The cost of capital in the risk margin formula has been reduced from 6% to 4.75%.

Interest rate and spread risk correlation

The correlation between interest rate risk and spread risk in the "IR Down" scenario has been lowered from 50% to 25%. This adjustment will result in a slight decrease in the market risk solvency capital requirement (SCR).

Counterparty risk module changes

Several changes have been introduced, notably the capital charge for defaulted loans (or forborne loans), which is now set at 36% of the loan value.

Repurchase agreements and securities lending

These transactions are now classified as type 1 exposure under the counterparty risk module, significantly reducing the capital consumption associated with them.

Risk mitigation techniques

Previously, there was a requirement for risk mitigation techniques to have non-material basis risk, but what constituted non-material was not specified. The new regulation clarifies that the risk mitigation technique must closely mirror the changes in value of the risk exposure under a set of risk scenarios, including 99.5 percentile scenarios. Practically, this means the hedge must be perfect.

Capital charge table

Exhibit 9 details the current capital charge, the updated capital charge and the change between the old and new capital charges.

Exhibit 9: Summary of current capital charges, updated capital charges and changes

Asset Class		Rating	Old Capital Charges by Duration				
			1	3	5	10	15
Interest Rate Charge Up			1.3%	3.8%	6.0%	10.6%	15.0%
Interest Rate Charge Down (absolute)			1.4%	3.4%	5.0%	7.8%	11.0%
Spread Charges	Corporate Bonds	AAA	0.9%	2.7%	4.5%	7.0%	9.5%
		AA	1.1%	3.3%	5.5%	8.5%	11.0%
		A	1.4%	4.2%	7.0%	10.5%	13.0%
		BBB	2.5%	7.5%	12.5%	20.0%	25.0%
	Senior STS	AAA	1.0%	3.0%	5.0%	6.2%	8.0%
		AA	1.2%	3.6%	6.0%	7.4%	9.5%
		A	1.6%	4.8%	8.0%	9.6%	12.0%
		BBB	2.8%	8.4%	14.0%	17.4%	22.5%
	Non-Senior STS	AAA	2.8%	8.4%	14.0%	17.2%	22.0%
		AA	3.4%	10.2%	17.0%	20.8%	26.5%
		A	4.6%	13.8%	23.0%	27.6%	34.5%
		BBB	7.9%	23.7%	39.5%	48.9%	63.0%
	Senior Non-STS	AAA	12.5%	37.5%	62.5%	100.0%	100.0%
		AA	13.4%	40.2%	67.0%	100.0%	100.0%
		A	16.6%	49.8%	83.0%	100.0%	100.0%
		BBB	19.7%	59.1%	98.5%	100.0%	100.0%

Asset Class		Rating	New Capital Charge by Duration				
			1	3	5	10	15
Interest Rate Charge Up			3.3%	8.1%	12.8%	18.1%	26.1%
Interest Rate Charge Down (absolute)			2.3%	5.1%	7.9%	16.2%	26.9%
Spread Charges	Corporate Bonds	AAA	0.9%	2.7%	4.5%	7.0%	9.5%
		AA	1.1%	3.3%	5.5%	8.5%	11.0%
		A	1.4%	4.2%	7.0%	10.5%	13.0%
		BBB	2.5%	7.5%	12.5%	20.0%	25.0%
	Senior STS	AAA	0.7%	2.1%	3.5%	6.0%	8.5%
		AA	0.9%	2.7%	4.5%	7.5%	10.0%
		A	1.4%	4.2%	7.0%	10.5%	13.0%
		BBB	2.5%	7.5%	12.5%	20.0%	25.0%
	Non-Senior STS	AAA	2.0%	6.0%	10.0%	15.5%	21.0%
		AA	2.6%	7.8%	13.0%	20.0%	25.5%
		A	4.0%	12.0%	20.0%	30.0%	37.0%
		BBB	7.1%	21.3%	35.5%	56.5%	71.0%
	Senior Non-STS	AAA	2.7%	8.1%	13.5%	27.0%	40.5%
		AA	3.3%	9.9%	16.5%	33.0%	49.5%
		A	4.4%	13.2%	22.0%	44.0%	66.0%
		BBB	7.5%	22.5%	37.5%	75.0%	100.0%

Asset Class		Rating	Change in Capital Charge by Duration				
			1	3	5	10	15
Interest Rate Charge Up			148.0%	111.2%	114.1%	70.7%	74.1%
Interest Rate Charge Down (absolute)			58.7%	52.9%	58.1%	107.2%	144.2%
Spread Charges	Corporate Bonds	AAA	0.0%	0.0%	0.0%	0.0%	0.0%
		AA	0.0%	0.0%	0.0%	0.0%	0.0%
		A	0.0%	0.0%	0.0%	0.0%	0.0%
		BBB	0.0%	0.0%	0.0%	0.0%	0.0%
	Senior STS	AAA	-30.0%	-30.0%	-30.0%	-3.2%	6.3%
		AA	-25.0%	-25.0%	-25.0%	1.4%	5.3%
		A	-12.5%	-12.5%	-12.5%	9.4%	8.3%
		BBB	-10.7%	-10.7%	-10.7%	14.9%	11.1%
	Non-Senior STS	AAA	-28.6%	-28.6%	-28.6%	-9.9%	-4.5%
		AA	-23.5%	-23.5%	-23.5%	-3.8%	-3.8%
		A	-13.0%	-13.0%	-13.0%	8.7%	7.2%
		BBB	-10.1%	-10.1%	-10.1%	15.5%	12.7%
	Senior Non-STS	AAA	-78.4%	-78.4%	-78.4%	-73.0%	-59.5%
		AA	-75.4%	-75.4%	-75.4%	-67.0%	-50.5%
		A	-73.5%	-73.5%	-73.5%	-56.0%	-34.0%
		BBB	-61.9%	-61.9%	-61.9%	-25.0%	0.0%

Conclusion

The Solvency II review kicked off nearly seven years ago and gained momentum during the Covid pandemic crisis. The aim was clearly stated: insurers should play a role in supporting the European economic recovery. The draft delegated acts further accelerate the agenda and expand the options available to insurers. The long-awaited long-term equity investment category will benefit investments in venture capital, social entrepreneurship, and, more generally, alternative assets. Furthermore, the introduction of lower capital charges for securitised assets will have a positive impact on reviving that market, which has seen limited issuance in Europe since the great financial crisis. Insurers will be able to support bank balance sheet transfers.

On the other hand, the capital charge is likely to become more sensitive to asset-liability mismatches due to higher interest rate capital charges and liability discounting. We expect insurers to take a closer look at their duration gaps.

Overall, our Insurance Strategy & Analytics team is happy to help you navigate the challenges and opportunities presented by these regulatory changes.

LV-JPM56948 | 09/25 | a124348f-6de8-11f0-962b-b5486e411417