Navigating the new volatility adjustment framework: Implications of the Solvency II Directive amendments

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The review of the Solvency II Directive (the Directive) has been underway since 2020. In January 2025, the directive amending the Solvency II Directive was published in the Official Journal of the European Union. This briefing note summarises the amendments to the Volatility Adjustment (VA) and considers the effectiveness of the VA under this new approach.

The VA is a long-term guarantee measure that was introduced as part of the Solvency II (SII) regime. The key objectives of the VA are to prevent procyclical investment behaviour, to reduce the forced buying or selling of investments under extreme market conditions, to mitigate the impact of exaggerated bond spreads on own funds and to recognise illiquidity characteristics of liabilities.

The Solvency II review aims to improve a series of deficiencies that were identified in the current design of the VA. One of the key objectives of the European Insurance and Occupational Pensions Authority (EIOPA) was to remove the overshooting effect of the VA in cases where the dampening effect of the VA exceeds the effect of a loss in the market value of fixed-income assets. This overshooting effect is typically the result of differences in asset allocations between the VA reference portfolio and the company-specific portfolio and of mismatches in volume and duration between spread-sensitive assets and liabilities.

In this briefing note, we will explore the new supervisory approval requirements, the overhaul of the VA mechanism and the introduction of new components such as the Credit Spread Sensitivity Ratio (CSSR) and the undertaking-specific adjustment to the risk-corrected spread, which we will refer to as the basis risk adjustment (BRA)[1]. Additionally, we will provide real-world examples to illustrate the impact of these changes on the solvency position of insurance companies.

Background

In December 2020, EIOPA published its opinion on the Solvency II review[2] (EIOPA's opinion). In September 2021, the European Commission published its proposals. In June 2022, the European Council shared its views on the proposals. In July 2023, the European Parliament's Committee on Economic and Monetary Affairs (ECON) approved its amendments to the Directive. Following the Trilogue negotiations, the European Parliament, European Council and European Commission finalised their agreement on the amendments to the Directive in January 2024.

The European Parliament approved the final text of the Solvency II review in October 2024. The Solvency II-amending Directive (Amending Directive) has been published in the Official Journal of the EU,[3] and its application starts on 30 January 2027. Member States have to implement the changes in national law within 24 months of that date. Based on empowerments included in the Amending Directive, delegated regulation and technical standards have to be adapted accordingly. EIOPA already released its first and second batches of consultation papers in October and December 2024, respectively, on the delegated regulation and technical standards. More consultation papers are expected to follow.

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1. The term BRA comes from earlier amendments proposed by European Parliament. The Amending Directive calls this an undertaking-specific adjustment to the risk-corrected spread.
2. EIOPA (17 December 2020). Opinion on the 2020 review of Solvency II. Retrieved 7 March 2025 from https://www.eiopa.europa.eu/document-library/opinion/opinion-2020-review-of-solvency-ii_en.
3. For full text of the Solvency II-amending Directive, see https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L_202500002.

Approved amendments in the Directive

VOLATILITY ADJUSTMENT

The VA framework has been significantly revised. Supervisory approval will now be required in all countries before applying the VA. Insurance and reinsurance undertakings that applied the VA before a prior fixed date—one year before publication date of the Amending Directive—may, without prior approval from the supervisory authority, continue applying the VA provided they comply with the conditions for prior approval under Article 77d, Paragraph 1 of the Directive. Supervisory authorities will have the power to require undertakings to stop applying the VA where the undertaking no longer meets the conditions for prior approval.

Additionally, the mechanism underlying the VA is subject to a substantial overhaul:

- The general application ratio (GAR) has increased from 65% to 85%, increasing the proportion of the risk-corrected spread from the reference portfolio that is applied in the derivation of the VA.
- Introduction of an undertaking-specific CSSR with a value between 0 and 1 to account for volume and spread duration mismatches between fixed-income investments and insurance liabilities.
- Insurance and reinsurance undertakings may, subject to a separate, prior supervisory approval, apply an additional undertaking-specific adjustment on the risk-corrected spread of the currency to account for the undertaking's fixed-income portfolio composition. This additional adjustment has a cap at 105% and may not be higher than 100% for two consecutive quarters. In this paper, we label this additional factor as the BRA.
- The risk correction deducted from spreads shall be calculated as a percentage of spreads, where the treatment of long-term average spreads is in line with the principles as advised earlier in EIOPA's opinion, with the addition that the risk correction shall never exceed an appropriate percentage of the long-term average spreads.
- In the extrapolation of risk-free interest rates, the VA also applies to the last liquid forward rate.
- The country component[4] of the VA is replaced with a macroeconomic VA for euro countries, based on the country-specific reference portfolio and with a gradual and smooth activation to avoid a 'cliff-edge' effect.

The undertaking's liquidity plan shall take into account the use of the VA and assess whether liquidity constraints may arise which are not consistent with the use of the VA.

The two new ratios, CSSR and optional BRA, in combination with the GAR set at 85%, replace the 65% application ratio in the current design. Depending on the company's asset-liability management (ALM), the new application ratios can have positive or negative one-off impact on the level of the VA—on top of impacts driven by changes in risk correction. Combining the different elements, the new VA formula is:

$$VA = GAR \cdot CSSR \cdot BRA \cdot (S - RC)$$

Here, S refers to the value weighted spread of the reference portfolio, and RC to the corresponding risk correction.

Some of the detailed parameters, formulae and definitions regarding the VA remain to be outlined in the delegated regulation, but the Commission had previously indicated it would consider EIOPA's advice. In line with EIOPA's objectives, the overshooting effect is expected to be reduced.

DYNAMIC VOLATILITY ADJUSTMENT

For the Dynamic VA[5] (DVA), only applicable for undertakings with an internal model, a DVA prudency principle is to be introduced, in line with EIOPA's opinion.

The Solvency Capital Requirement (SCR) after DVA should be at least as high as the higher of:

(i) The SCR with EIOPA VA

(ii) The SCR with a VA based on the EIOPA methodology applied to the undertaking's investment portfolio

Moreover, changes to the macroeconomic VA under stress should be excluded from the DVA, as well as the BRA, to incentivise undertakings to build up resilience for crisis situations.

Together with the other proposed VA changes, a reduction of the dynamic VA offset is expected.

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4. A country-specific VA currently applies where the risk-corrected spread of a country specific reference portfolio is at least 100 basis points above the risk-free rate and exceeds twice the risk-corrected spread of the currency-specific reference portfolio.

5. Internal model companies may use a DVA where the VA changes when modelling credit spreads in their SCR calculations.

Deep dive into VA methodology revisions and remaining uncertainties

In the EIOPA consultation paper issued in October 2019, several options to adjust the VA methodology were proposed.[6] Amongst the options were changes which hinted at the use of a company-specific portfolio. In the holistic impact assessment, published in March 2020, the currency reference portfolio was still EIOPA's favoured approach.[7] However, two important ratios are introduced to further incorporate undertaking-specific information into the calculation of the VA. This section contains an analysis of what has been adopted and what has not.

KEY CONCLUSIONS

The amendments largely align with EIOPA's proposals, mitigating some of the overshooting effects and incorporating company-specific information into the VA calculation. However, asset and liability spread sensitivity mismatches driven by differences in the asset allocation of the undertaking's fixed income portfolio and the reference portfolio may persist under the adjusted framework.

The importance of spread sensitivity matching in terms of spread duration and volume of fixed income assets has increased, as it directly impacts the level and sensitivity of the VA. Insurers may want to adjust their asset allocations and risk management strategies to optimise the benefits of the new VA framework.

CREDIT SPREAD SENSITIVITY RATIO

The CSSR resembles EIOPA's proposal to address overshooting, known as the Application Ratio 4 (AR4). Although AR4 was more explicitly defined than the CSSR in the Amending Directive, its goal was also to measure an insurer's mismatches in its fixed-income assets and insurance liabilities in terms of spread duration and volume. In EIOPA's proposal, the change is only calculated for spread-driven assets, excluding instruments such as interest rate swaps.[8] The calculation is based on the price value of a basis point (PVBP)[9] of the undertaking's fixed-income investments and the PVBP of the best estimate liability:

$$AR_4 = \frac{PVBP(MV_{FI})}{PVBP(BEL)} \, , capped \; at \; 100\%$$

For our analysis, we have taken AR4 as the best estimate for the CSSR, but its final form will be clarified when updates are made to the delegated regulation and technical standards. The CSSR is a single number that cannot correct for differences in the composition of the insurer's asset portfolio compared to the VA reference portfolio.

EIOPA recommended an additional application ratio to account for the illiquidity characteristics of insurance liabilities, particularly in terms of surrender and mortality risk, by capturing the stability and predictability of cashflows. However, this application ratio is not explicitly mentioned in the Amending Directive.

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6. EIOPA (15 October 2019). Consultation paper on the opinion on the 2020 review of Solvency II. Retrieved 7 March 2025 from https://www.eiopa.europa.eu/consultations/consultation-paper-opinion-2020-review-solvency-ii_en.

7. See EIOPA's publications on the holistic impact assessment for more background and details around the different formulas and assumptions at https://www.eiopa.europa.eu/solvency-ii-review-information-request-national-supervisory-authorities_en.

8. See EIOPA's publications on the holistic impact assessment for more background and details around the different formulas and assumptions, op cit.

9. The price value of a basis point indicates how much the price of portfolio or financial instrument will change if the corresponding yield curve changes by one basis point.
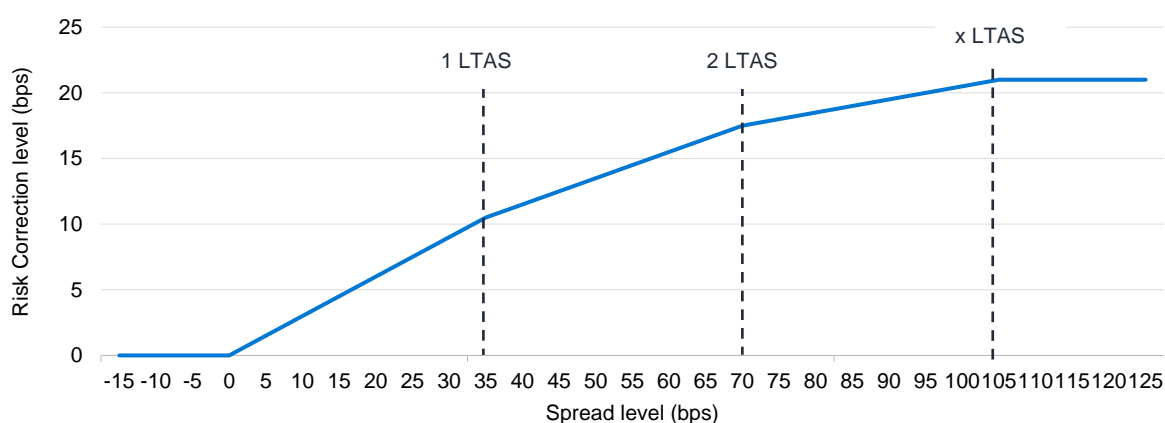
RISK CORRECTION

The calculation of the risk correction (RC), also known as fundamental spread, has been amended. Under the design of the VA in the original Solvency II Directive (the current design), the risk correction is based on long-term average spread (LTAS), the cost of downgrade (CoD) and the probability of default (PD) of assets. In practice, this leads to a risk correction that remains relatively stable over time. In the amended design, the risk correction is a percentage of the spread level, which decreases as spreads increase. Differentiation is made among at least the following three cases for each relevant asset class:

1. Spreads are below their long-term average.

2. Spreads are between their long-term average and twice that average.

3. Spreads exceed twice their long-term average.

The risk correction cannot be negative or exceed a certain percentage of the long-term average. More details remain to be published in the amended delegated regulation and technical standards. This extends EIOPA's proposal, which had only two cases: spreads below or above the long-term average. The new approach adds at least one extra case and adds that the risk correction shall remain below an appropriate percentage of the long-term average spreads.

Figure 1 illustrates how the risk correction could function under the amended design, assuming the piecewise linear relationship proposed earlier by EIOPA for the first two cases. Non-sovereign assets are expected to follow similar behaviour, albeit with different slope values.

FIGURE 1: ILLUSTRATIVE EXAMPLE SHOWING THE SOVEREIGN SPREAD RISK CORRECTION AS FUNCTION OF THE SPREAD LEVEL (X≥2)

We adopt EIOPA's proposal for the risk correction as a best estimate for the Solvency II Directive, despite its use of only two slope levels per asset class. This is sufficient for our analysis, which primarily covers spread levels up to approximately twice the long-term average spread. Our assumptions are summarised in Figure 2.

FIGURE 2: ASSUMED RISK CORRECTION SLOPE LEVEL PER SPREAD LEVEL ADOPTED FROM EIOPA'S PROPOSAL (X≥2)

RC slope per spread level S	$S < 0$	$0 \leq S < LTAS$	$LTAS \leq S < 2\,LTAS$	$2\,LTAS \leq S < x\,LTAS$	$x\,LTAS \leq S$
Sovereign	0%	30%	20%	Unknown	0%[10]
Non-sovereign	0%	50%	40%	Unknown	0%

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10. In the Amending Directive it is specified that the risk correction shall never exceed an appropriate percentage of the long-term average spreads. The slope of the function should then be zero from a certain point.

BASIS RISK ADJUSTMENT

The BRA is an optional undertaking-specific adjustment to the risk-corrected spread of the currency, designed to account for the undertaking's fixed-income portfolio composition. The BRA was not included in EIOPA's proposal.

Insurance and reinsurance undertakings may, subject to prior supervisory approval, apply a BRA on the risk-corrected spread of the currency to account for the undertaking's fixed-income portfolio composition under the conditions:

- The risk-corrected spread of the reference portfolio exceeded the risk-corrected spread calculated based on the undertaking's portfolio of investments in debt instruments during the four previous quarterly reporting periods.

- The information that is inherent to the relevant assets of the undertaking is of sufficient quality to allow a robust and reliable calculation of this adjustment.

The adjustment shall be the lesser of 105% or the ratio of the risk-corrected spread of the undertaking's portfolio to that of the reference portfolio for the relevant currency. The risk-corrected spread on the undertaking's portfolio is calculated using undertaking-specific data for weights and average duration. Where the BRA is applied, the macroeconomic VA should not be applied to the VA. The BRA may not be higher than 100% for two consecutive quarters.

Both the CSSR and BRA require additional calculation processes for the insurer in addition to existing EIOPA publications for the VA reference portfolio.

The BRA is mainly intended for insurers with lower-yielding portfolios that generally have higher creditworthiness compared to the reference portfolio. For such companies, the BRA reduces the overall size of the VA, thereby reducing its benefit to the best estimate liability (BEL). The adjustment is based on the insurer's own portfolio's risk-corrected spread, helping to better align the impact on the company's liabilities with the impact on its fixed-income assets when spreads change. This alignment promotes Solvency II balance sheet stability during periods of spread fluctuations.

Insurers whose portfolio spreads are at or above those of the reference portfolio are unlikely to pursue the BRA as its capping mechanisms would largely negate any potential benefits. Therefore, our analysis focuses on scenarios that exclude the BRA.

SCALING FACTOR

In EIOPA's opinion, a scaling factor was recommended which corrects for the non-debt assets in the reference portfolio:

$$Scale_c = \frac{1}{weight_{Gov} + weight_{Corp}} \, , the \ result \ will \ be \ a \ number \geq 100\%$$

For the EUR currency, this currently results in a scaling factor equal to 162% at year-end 2024.

The Amending Directive does not explicitly mention the scaling factor. However, wording related to the reference portfolio now refers to debt instruments, implying that the scaling factor could be absorbed into the value weights. Indeed, the current Directive refers to a VA that is based on the spread '… that could be earned from assets included in a reference portfolio for that currency.' The Amending Directive refers to a spread '… that could be earned from a refence portfolio *of investments in debt instruments* for that currency.'[11]

For our analysis, we have included scaling factor effects into our best estimate for the new design by adjusting the weights underlying the reference portfolio spread, S, and the risk correction, RC, in the new VA formula:

$$VA = GAR \cdot CSSR \cdot BRA \cdot (S - RC)$$

This adjustment increases the VA proportionally with $Scale_c$ compared to the situation where scaling is excluded. Clarification is expected once updates are made to the delegated regulation and technical standards. As a result, the VA increases.

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11. In both the current and Amending Directive, the text is quoted from Article 77d, Paragraph 2. The current delegated regulation also explicitly mentions that the current reference portfolio should also include other assets than debt instruments like equity and property.

MACRO-VA

The country component of the VA in the current design faced criticism due to its reliance on thresholds that often fail to trigger adjustments. Moreover, when triggered, the risk-corrected country spread could exceed the risk-corrected currency spread by a substantial amount, resulting in a 'cliff-edge' effect.

The introduction of the macro-VA for euro countries based on the country-specific reference portfolio enables a gradual and smooth activation to avoid this 'cliff-edge' effect.

The macro-VA adjustment for country co, where ω_{co} is the country adjustment factor for country co; RCS_{co} and RCS_{Euro} are the risk-corrected spread for country co and the $Euro$, respectively, is calculated as follows:

$$VA_{Euro,macro} = 85\% \cdot CSSR_{Euro} \cdot max(RCS_{co} - 1.3 \cdot RCS_{Euro}; 0) \cdot \omega_{co}$$

In our analysis, we have excluded the impact of the macro-VA in order to consider the impact at a euro level.

UNCERTAINTIES

Important details remain to be outlined in the delegated regulation and technical standards, introducing several uncertainties at the point of writing:

- Calculation of undertaking-specific adjustments: The methodology for calculating undertaking-specific adjustments, including the parameters and data requirements, has not been fully detailed. This creates uncertainty around the treatment in the CSSR of spread derivatives, such as bond futures, cross-currency hedged fixed-income exposure and guaranteed unit-linked assets. Additionally, it remains unclear if and how other fixed-income instruments, such as mortgages, are allowed in the BRA.

- Calculation of risk-corrected spreads: The exact percentages to be used, the calculation methodology and the potential variability across different market conditions are uncertain.

- Treatment of VA in extrapolation: The application of the VA to all rates up to the last liquid forward rate instead of only the 20-year forward rate, as per EIOPA's opinion, has not been addressed in the Amending Directive.

- Supervisory approval process: The requirement for supervisory approval before applying the VA introduces a new layer of regulatory oversight. Currently, countries like Germany and Ireland impose an approval process, while others like the Netherlands, France and Italy do not. The specifics of how this approval process will be conducted for each country, the criteria for approval, and the consistency of application across different Member States remain unclear.

- The supervisory approval process for the use of the BRA is currently unclear.

Impact analysis for VA design change

ASSUMPTIONS

The new design for the VA requires a few undertaking specific assumptions. We start our VA impact analysis with providing background on these assumptions.

We focus on two representative life insurance companies: a sample Dutch life company (DLC) and a sample Irish life company (ILC). Figure 3 presents their respective portfolio weights, which are based on the typical allocations for life companies in each market, derived from the relevant Solvency and Financial Condition Report (SFCR) databases. Notably, the assumed duration of each asset class is consistent for both companies.

We developed a calculation tool for the VA under the new design for the purpose of this analysis. The calculated CSSRs highlight the differing sensitivities to credit spread movements between the two sample companies. The CSSR is 60% for DLC and 68% for ILC, reflecting variations in their asset allocations, use of derivatives and liability profiles. We have allowed for mortgages & loans (M&L) in the calculation of the asset spread sensitivity for the CSSR.

Figure 3 lists some other key VA inputs, like the reference portfolio weights and long-term average spread levels. The reference portfolio weights are based on 2024 data. The long-term average spreads have been rounded.

FIGURE 3: PORTFOLIO AND SPREAD ASSUMPTIONS

Asset Class / CSSR	Reference portfolio	Dutch Life Insurer	Irish Life Insurer	Durations (Years)	LTAS (basis points)
Government	29%	19%	33%	12	35
Corporate	37%	14%	31%	5	125
Mortgage & loans		29%	5%	7	125
Non-fixed income	34%	38%	31%	N/A	N/A
CSSR		60%	68%		

DYNAMICS OF THE NEW VA

Figures 4 and 5 provide an illustrative comparison of VA levels and movements for government and corporate spread changes under both the current and the amended VA design, at CSSR levels of 60%, 70% and 100%. The BRA is only applied to one example where the CSSR is set at 60%. For the BRA calculations, mortgage & loans are assumed to be a fixed-income asset class with its own spread assumptions.

FIGURE 4: ILLUSTRATIVE EXAMPLE FOR THE IMPACT OF CORPORATE BOND SPREAD CHANGES ON THE VA CALCULATION IN THE CURRENT AND NEW DESIGN PER 2023YE REFERENCE PORTFOLIO WEIGHTS
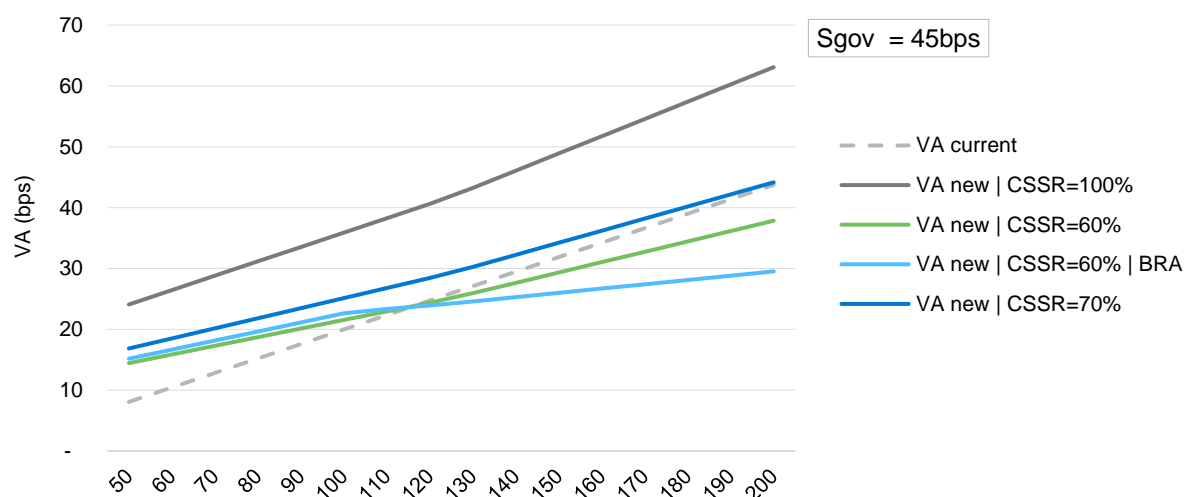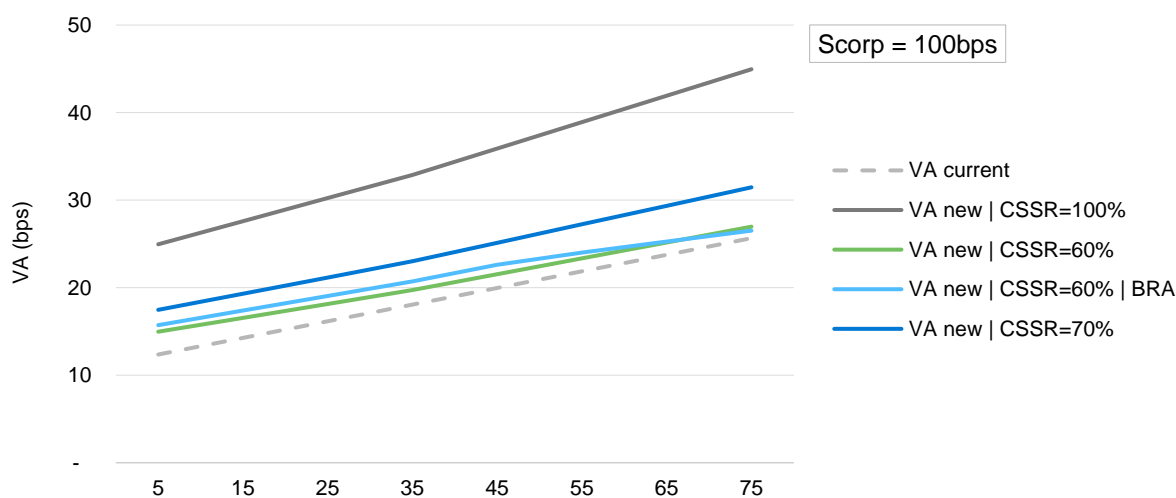

FIGURE 5: ILLUSTRATIVE EXAMPLE FOR THE IMPACT OF GOVERNMENT BOND SPREAD CHANGES ON THE VA CALCULATION IN THE CURRENT AND NEW DESIGN PER 2023YE REFERENCE PORTFOLIO WEIGHTS

The CSSR of 70% relates to a relatively strong spread sensitivity matching. As a result, the corresponding VA level is higher than under the current design. Also, the reactiveness of the VA is increased under changing corporate and government spreads compared to the current design. The lower CSSR of 60% yields lower VA levels that are less responsive to corporate and government spread changes.

When examining the application of the optional BRA for the example with a CSSR of 60%, several conclusions can be drawn. One of the aims of the BRA is to reduce the potential for significant fluctuations in the VA compared to undertaking-specific portfolio spreads, resulting in a more stable and predictable solvency coverage. Due to allocation weight differences between the undertaking's portfolio and reference portfolio, the BRA is high for lower corporate and sovereign spreads and vice versa. The BRA cap of 105% dampens the ability of the VA to move together with the undertaking's portfolio spread if corporate or sovereign spreads tighten. Companies should therefore carefully consider whether the application of the BRA is suitable for their specific circumstances.

HISTORICAL VA LEVELS

Using the earlier mentioned assumptions, we can compare the VA under the new approach to the current VA framework.

Figure 6 illustrates the VA for both DLC and ILC from December 2019 to September 2024. For clarity, the BRA is not shown, as it does not materially affect the VA for either DLC or ILC during this period. The VA under the new approach with the CSSR equal to 100% is shown for illustration purposes to indicate maximum VA levels. The CSSR is 60% for DLC and 68% for ILC.

FIGURE 6: HISTORICAL VA LEVELS UNDER VARIOUS VA DESIGNS AND FOR VARIOUS CSSR LEVELS
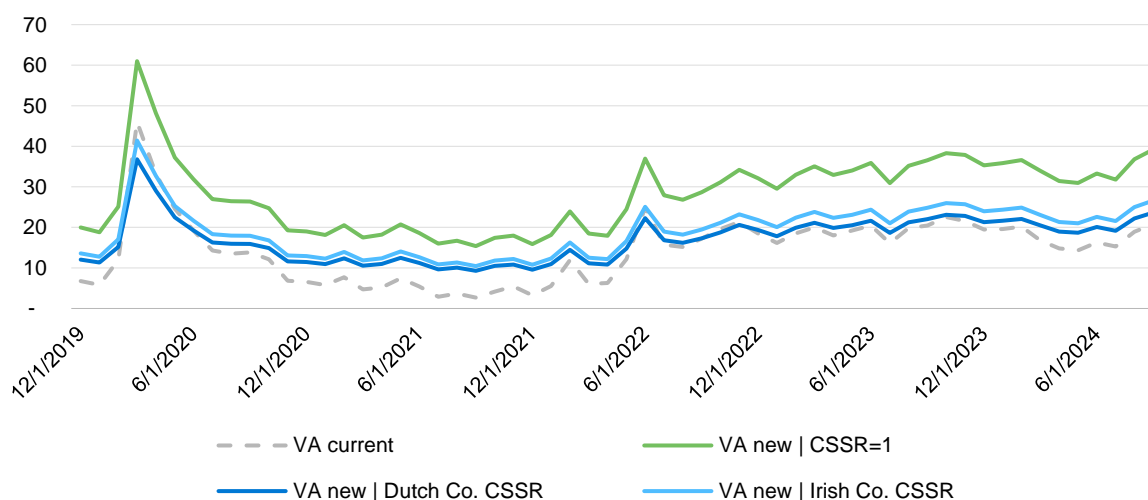
The size of the VA under the new approach is heavily influenced by the CSSR. One of the primary objectives of the CSSR is to mitigate the overshooting effect, where the VA adjustment would otherwise exceed the actual economic impact of spread movements.
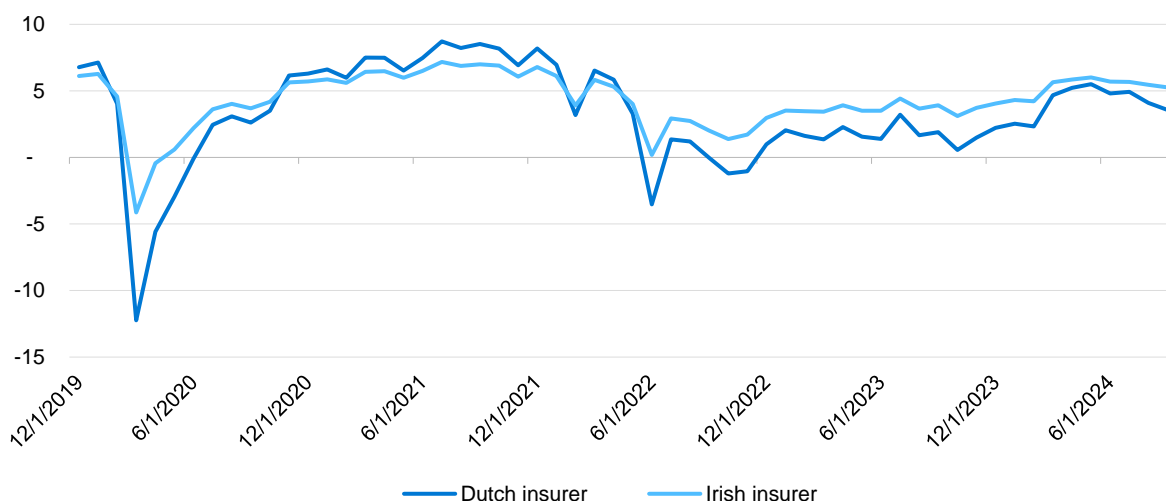
Under the new approach, the VA tends to be higher than the current VA when credit spreads are low. However, in times of market stress, the VA under the new framework is generally lower. For DLC, the VA under the new approach is lower during the stress periods of March through May 2020, June 2022, and October through November 2022. For ILC, the VA is lower under the new approach primarily during March through April 2020.

The level of spread duration matching becomes crucial under the new framework, as it directly impacts both the level of the VA and its movements during times of financial stress. Insurers with better-matched spread durations between their assets and liabilities will see higher VA levels, enhancing their solvency positions. Our analysis indicates that Irish and Dutch life insurers are, on average, well matched and would generally receive a greater benefit under the new VA. However, individual companies that are less well matched could experience a materially lower benefit compared to the current structure. This aligns the VA benefit more closely with ALM.

SOLVENCY TRANSITION IMPACTS

Using the insights from the previous section, we can assess how the changes in the VA impact the Solvency II ratios of insurance companies. Figure 7 estimates the historical impact on the ratio when transitioning from the current VA to the new VA. For simplicity, we assume that the ratio impact is approximately 1.3 percentage points for a typical Dutch life insurer and approximately 0.9 percentage points for a typical Irish life insurer per basis point change in the VA. These sensitivities are derived from publicly available SFCR data at year-end 2023, during which average Solvency II ratios were significantly higher in the Netherlands, resulting in a greater sensitivity of the ratio.

**FIGURE 7: SOLVENCY II RATIO IMPACTS AT HISTORICAL SPREAD LEVELS FOR TWO SAMPLE INSURERS.**

Under the new approach, the impact on ratios is positive when credit spreads are low. In periods of widening credit spreads, the VA under the new framework tends to have a negative impact on solvency ratios compared to the current framework. The Solvency II ratio would, for example, be 12 percentage points and 4 percentage points lower for DLC and ILC, respectively, during the peak spread levels in March 2020. These impacts would vary from company to company in practice based on their individual characteristics.

PORTFOLIO SPREAD SENSITIVITIES

Here, we provide insight into the consequences of the amended VA (without BRA) for spread sensitivities. Figures 8 and 9 illustrate the two example insurers' sensitivity to various 1 basis point spread changes on both assets and liabilities,[12] showing the ratio of change in total asset value over the change in liability value. The closer this ratio is to 100%, the more effectively own funds spread sensitivities are dampened. Sensitivities are analysed under both the current and the new VA design for both DLC and ILC.

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12. We assume that government and corporate bond spread movements for both the undertakings and reference asset portfolio are exactly the same, ignoring any basis risk.

FIGURE 8: SOLVENCY II SPREAD SENSITIVITY RATIOS FOR THE EXAMPLE DUTCH LIFE COMPANY PER 2023YE REFERENCE PORTFOLIO WEIGHTS
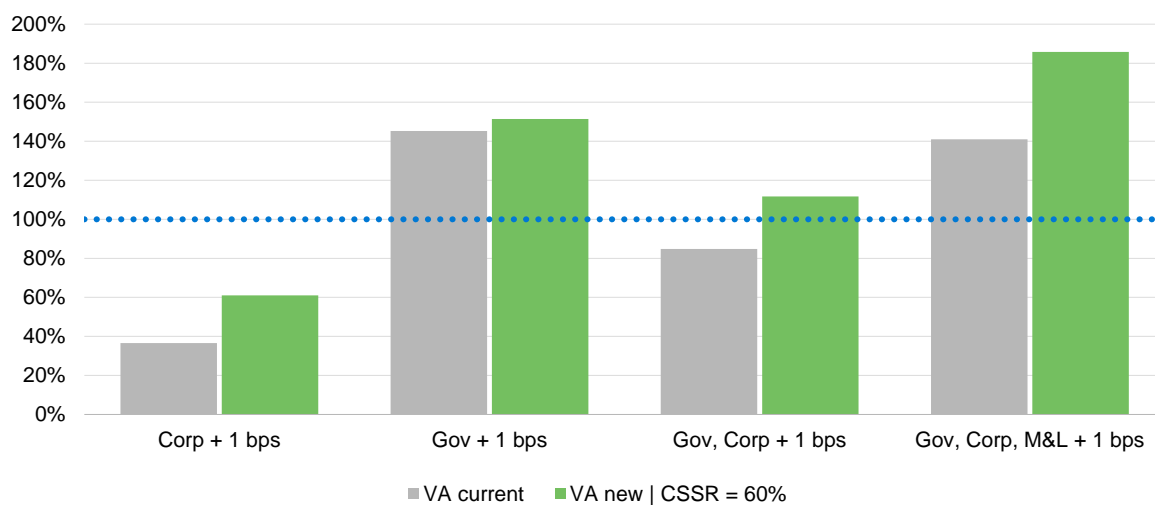
FIGURE 9: SOLVENCY II SPREAD SENSITIVITY RATIOS FOR THE EXAMPLE IRISH LIFE COMPANY PER 2023YE REFERENCE PORTFOLIO WEIGHTS
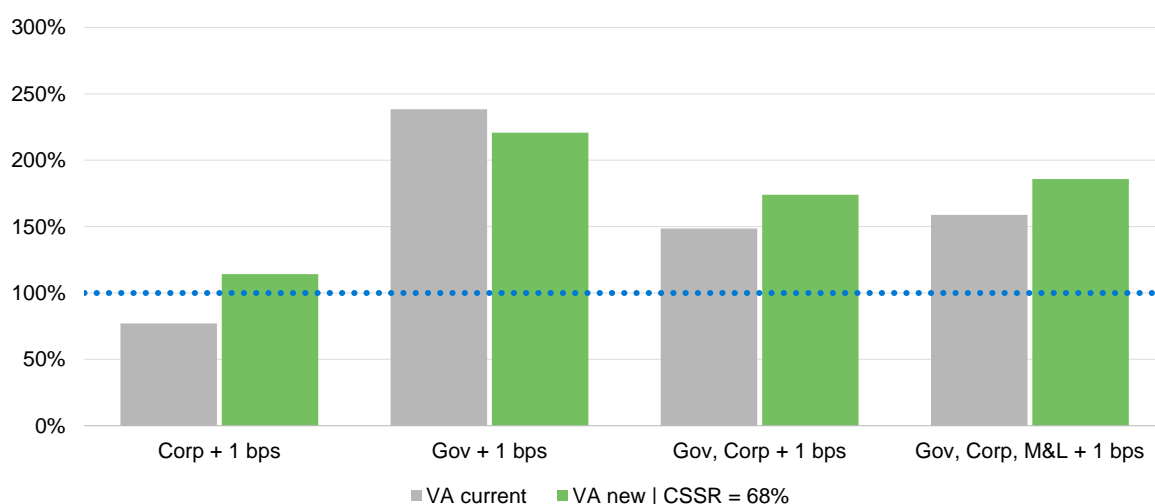
Differences in the various DLC and ILC spread sensitivities are primarily due to relatively larger government and corporate bond exposures on the ILC balance sheet as shown in Figure 3.

The amended VA generally increases asset sensitivities relative to liability sensitivities under combined spread shocks. This indicates that for combined shocks, the amended VA achieves its goal of reducing the potential overshooting of the VA.

However, in practice spread movements of different asset classes are not fully synchronised. Examining spread sensitivity ratios for individual asset classes, the consequences of the amended VA are more varied. For corporate bonds, the spread sensitivities show a significantly better match between assets and liabilities. During the early-2020 COVID-19 spread spike, this asset class was primarily responsible for the VA overshooting effect. For ILC, this overshooting has been largely eliminated, whereas for DLC it has only been reduced. For sovereign bonds, the impact of the amended VA is considerably less significant, with spread matching even deteriorating for DLC. The standalone sensitivity ratio for mortgages & loans is not shown, as liabilities remain insensitive to these spread movements without BRA.

In conclusion, the amended VA has a mixed and often reasonably limited impact on spread mismatches for individual asset classes compared to the current VA.

Next Steps

Our analysis indicates that the immediate transitional impact on Solvency II ratio levels is expected to be manageable without necessitating changes to insurers' asset portfolios in the current market environment. This suggests that, in the short term, insurers may not need to undertake drastic measures to maintain their solvency positions, though each company should assess this individually. By incorporating additional spread-sensitive assets into their investment portfolios, insurers using the VA have the potential to improve their Solvency II ratio levels and reduce their risk through enhanced spread duration-matching. Enhancing the proportion of such assets can increase the CSSR, thereby amplifying the beneficial impact of the VA on the solvency position. This strategy could be considered as part of medium- to long-term asset allocation plans.

The impact on spread sensitivities presents a mixed picture. While the introduction of the CSSR aligns the VA more closely with insurers' actual exposure to credit spread movements, the BRA is expected to offer limited benefit for undertakings with higher-spread portfolios. Given its optional nature and the constraints imposed on its application, most such undertakings may choose not to adopt the BRA. Conversely, for companies with lower-spread portfolios, the BRA could make the VA more accessible and its utilisation easier to justify. Under the current VA design, such insurers might have faced regulatory challenges in obtaining approval. Now, regulators might expect such companies to apply the BRA, facilitating approval and better aligning the VA with their actual earning capacity and risk profile. Companies that do not currently utilise the VA but have appropriate spread-sensitive assets may wish to consider whether applying for the VA would be advantageous in light of the new design.

For companies currently using the VA, it is advisable to assess the financial and operational impacts of the new approach. This assessment will help determine if any adjustments are required to optimise the benefits of the VA under the revised methodology. It is important to note that some aspects of the new approach are still unclear, and, therefore, any analysis and assessment conducted at this stage may be subject to change as further details emerge.

It may be premature for insurers to initiate significant ALM actions solely in response to these changes. However, proactive evaluation and strategic planning will be key to leveraging potential benefits and ensuring a robust solvency position moving forward.

If you have any questions or comments on the information above or want to discuss further balance sheet management or ALM solutions, please contact your usual Milliman consultant.

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