

WINDS OF CHANGE REGULATORY REFORMS FOR INSURERS OFFER OPPORTUNITIES



- Overhaul enables greater investment diversification and reshapes asset mixes.
- Right-sizes capital requirements that insurers must hold against certain assets.
- Insurers having flexibility across public and private fixed income have competitive advantage.

The European Union's Solvency II requires insurers to hold regulatory capital, sufficient to cover unexpected losses that occur less than once in two hundred years.¹ However, reasonable approaches to estimating the range of future outcomes can produce quite different estimates for what this level is. Solvency II, and Solvency UK, its post-Brexit successor in the UK, established a standard formula framework that insurers can either adopt or use as a benchmark for validating their own internal models.

This article discusses recent and upcoming changes in these standard formulae, which is of material interest to insurance portfolio managers. In the EU, these include making securitisations, particularly senior tranches, more attractive and investable. In the UK, insurers will now be less constrained in the range of assets they can hold to back their annuity businesses.

CONTEXT

The standard formula has repeatedly evolved since it was originally established, often with special treatment for specific asset types. This increase in complexity is inevitable: ancient astronomers, working in a geocentric model of the universe, repeatedly added epicycles - smaller circles revolving around larger ones - to bring their forecasts into closer agreement with observations.

In an insurance regulatory context, it is appropriate that these adjustments reflect broader public policy. Alternative calibrations can be equally defensible and yet result in the insurance sector being required to hold more or less capital and make some assets more or less attractive to hold. In the context of spread risk on bonds, the main changes in the EU's regime to date have been:

- **STS regime:** The original (2015) treatment of securitised bonds distinguished between 'Type 1' securitisations - senior, highly rated tranches of pools meeting specific requirements - which were treated only slightly more favourably than the other (Type 2) securitisations that suffered penal capital charges. This was modified with effect from 2019, with 'simple, transparent and standardised' (STS) securitisations, especially their senior tranches, being treated favourably, while the penal treatment of other securitised assets continued.
- **Infrastructure debt:** Loans supporting infrastructure - initially direct project loans and later through infrastructure companies - became eligible for more favourable capital treatment. While justified by the quality of underlying cash flows, this change also addressed the EU's broader goal of channelling capital into the sector.²

¹ A confidence level of 99.5 % over a one-year period: Article 101 of the Solvency 2 directive, 2009/138/EC

² Eg the EU in their press release https://ec.europa.eu/commission/presscorner/detail/en/memo_15_3120 highlighted the calibration's ability 'to stimulate long-term investment by insurers'.

SOLVENCY II: SECURITISATION IN THE SPOTLIGHT

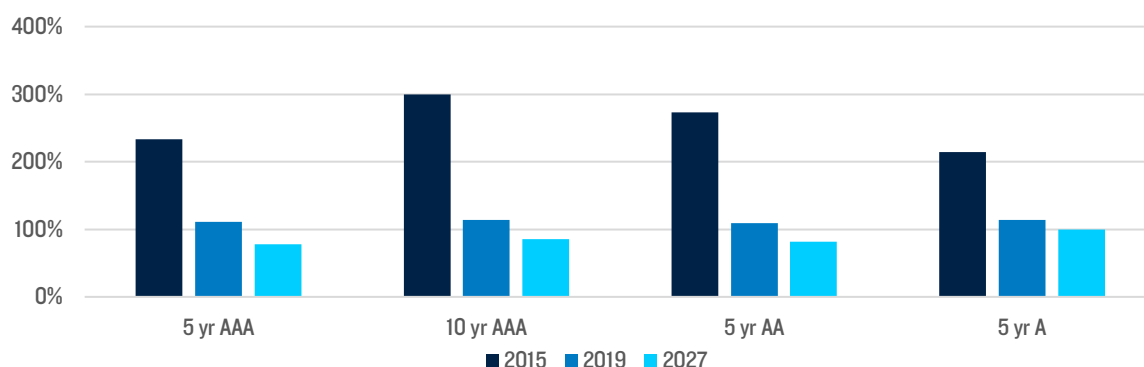
Long-term capital should, in principle, have more appetite than banks for funding innovation and infrastructure. However, as the 2024 Mario Draghi report highlighted, the securitisation market has remained hamstrung by rules such as those embedded within Solvency II.³ The rules strongly discouraged insurers from securitised investments, closing off a major avenue for diversification and yield. Regulators have proposed another round of amendments to capital requirements, with examples shown in Figures 1 and 2.

The senior tranches of securitisations that did not meet the STS conditions were unaffected by the tweaks in 2019 (Figure 2). The change likely to come into force in 2027 therefore represents a significant capital reduction - albeit to a level where capital requirements are still around three times higher than for bonds of the same duration and rating that are not securitised.

Senior STS tranches are also benefiting, with the capital requirements falling close to the level of covered bonds (Figure 1). Analysis of historical experience suggests that this less penal approach is a more appropriate reflection of the risks borne by the buyers of these instruments.⁴

Figure 1: A Level Playing Field for STS Securitisations

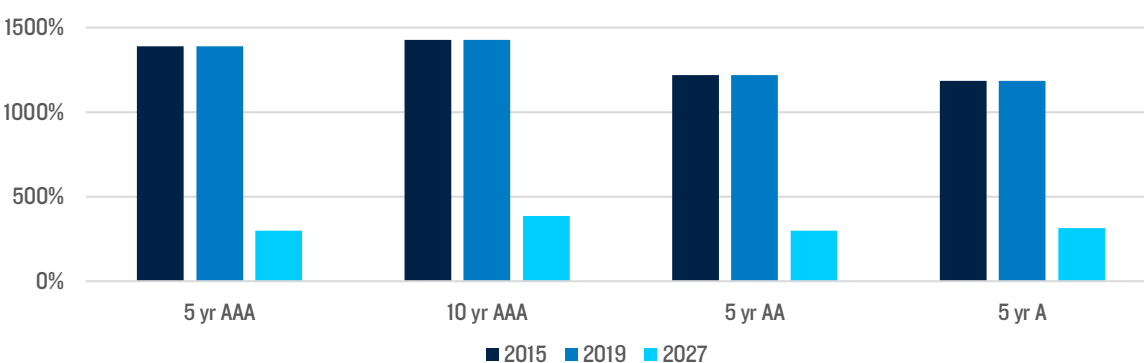
Capital requirement for senior STS securitisations, as a % of that for non-securitised bonds of the same rating and duration



Source: Solvency II delegated regulations, PGIM calculations 2025

Figure 2: Less Penal Charges for Senior Non-STS Securitisations

Capital requirement for senior non-STS securitisations, as a % of that for non-securitised bonds of the same rating and duration



Source: Solvency 2 delegated regulations, PGIM calculations 2025

³ PGIM, October 2024, Another “whatever it takes” moment for Europe?

⁴ Source: EIOPA, 2022. https://www.eiopa.europa.eu/system/files/2022-06/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf

In addition, the amount that insurers need to hold above their best estimate of liabilities – the risk margin, reflecting the additional capital that would be required to transfer these liabilities to a third party – is being reduced by about 30% to 40%. Moreover, the requirements for holdings to qualify for lower capital as long-term equity investments (LTEI) are being relaxed.

The overall changes are significant. EIOPA, the EU-wide regulatory body, has been broadly supportive but has described the European Commission's move as a “political decision” and a “concerning combination” of risk and lower capital.⁵

NEW LOOK SOLVENCY UK

In 2020, at the end of the Brexit transition period, UK's prudential regime for insurers began as a copy of the EU's Solvency II. Changes in Solvency II regulations are no longer automatically replicated in Solvency UK. Instead, following a review, the UK has introduced its own modest changes to the regime, aiming better to reflect the needs of its own domestic insurance sector.

Like the EU, the UK has decided to reduce the risk margin by about 60%, a change that will release additional capital to support new business.

However, the most significant change is for the matching adjustment (MA) regime in insurance portfolios. The MA benefits insurers holding longer-term assets that align closely with their long-term liabilities. Used in the UK to support the annuity businesses of insurers, the MA requires firms to create a separate portfolio of eligible assets and liabilities.

Under the prior MA rules, assets had to have cashflows that were fixed for all practical purposes.

Companies typically borrow in fixed income markets at shorter durations than long-term insurance liabilities and often seek flexibility to prepay before maturity. Bonds with this prepayment risk can still qualify as MA-eligible if investors receive adequate compensation (“make whole”) to replace expected cash flows when prepayment occurs.

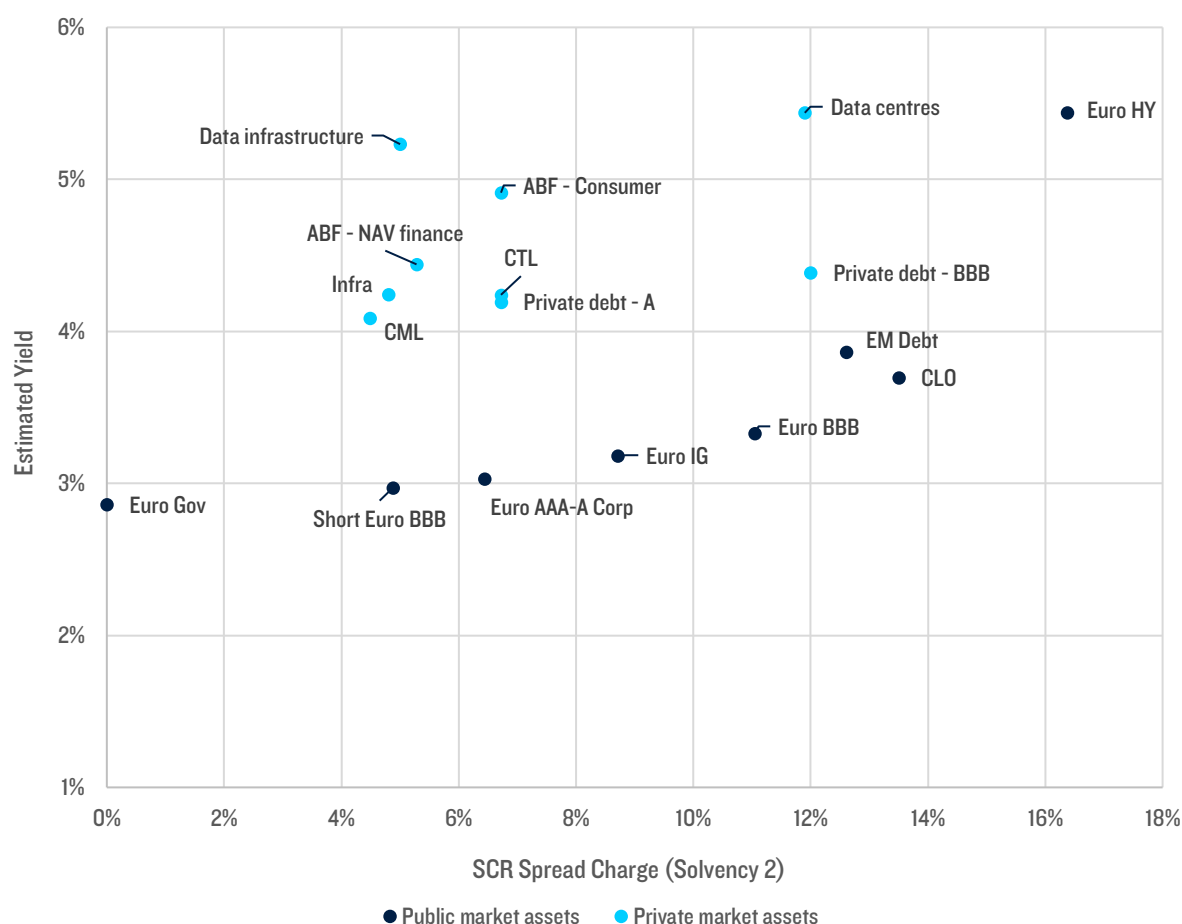
As a result of the fixed cashflow conditions, MA portfolios generally match liabilities using a limited range of short-maturity credit instruments and increasing allocations to government bonds at longer maturities. To broaden the MA investment universe, insurers increasingly look overseas to deeper markets - particularly in the U.S. - which offer higher yields and diversification. Currency risk is then managed via cross-currency swaps that convert asset cash flows into sterling, ensuring alignment with liability-matching objectives. Collateral requirements on these swaps, triggered by FX movements, are typically met using gilts, cash, or other high-quality assets from the insurer's balance sheet.

In the UK's revised MA regime, the fixed cashflow requirement is significantly relaxed. Now, assets whose cashflows are simply *bounded* in both timing and amount are potentially eligible. These are referred to as having “highly predictable” cashflows. As well as being able to invest in a broader range of callable corporate bonds, MA portfolios can now consider commercial real estate loans, renewable energy financing and tranches of public and private securitisations.

By expanding the range of eligible assets and liabilities, policymakers hope to make it easier for local insurers to support the government's initiatives to invest in domestic infrastructure projects. Increasing yields in MA portfolios also gives a pricing boost to the bulk annuity (pensions risk transfer or PRT) market.

⁵ Insurance ERM, October 2025, EIOPA: final amendments to Solvency II rules present “a concerning combination” of risk and lower capital

Figure 3: Yield Versus Capital Trade Off



Source: Bloomberg, PGIM calculations. ICE BofA indices (Euro governments, Euro corporates, Euro High Yield and Global Emerging market debt) are used as benchmarks for public market indices; proprietary data has been used to estimate appropriate spreads and durations for CLOs, data centre construction loans, private corporate debt, credit tenant leases, infrastructure debt and Commercial mortgage loans. Infrastructure debt and data infrastructure are assumed to meet the conditions as 'qualifying infrastructure' under the Solvency 2 standard formula.

INVESTMENT IMPLICATIONS

With almost ten trillion euros in assets under management, the insurance sector is key for Europe's objectives of harnessing productive investments into its domestic economy. For example, by improving the risk sensitivity of capital requirements on securitisations, the reform encourages insurers to invest in this asset class.

This should lead to the "flywheel" effect of tightening spreads between U.S. and European securitised products and incentivising issuers to sell more debt. In both the UK and the EU, we expect insurers' interest in the broad spectrum of public and private fixed income to materially increase, with a regulatory regime that is more aligned with measuring the true levels of risk in these assets. For insurers who are able to access the entire gamut of fixed income assets, ranging from investment-grade debt to asset-backed finance, that could prove to be a competitive advantage.

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