Executive Summary for "International Portfolio Frictions"
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We study patterns and implications of global asset allocations of European insurers and banks using newly available supervisory data from Solvency II filings. We present a new set of stylized facts on banks' and insurers' global fixed-income portfolios and discuss their macro-financial implications.

Government bonds face favorable treatments for regulated financial institutions in Europe as they are exempted from capital charges associated with default risk. Despite the high demand for government bonds, the total supply of government bonds, especially from safe European countries, is significantly smaller than total assets of insurance companies and pension funds (ICPF) and banks securities holdings. The split between government bonds and other non-government fixed-income securities, generally referred to as corporate bonds, is a key portfolio decision for regulated financial institutions.

We first document cross-country evidence that the share of corporate bonds outstanding over all domestic fixed-income securities outstanding is strongly correlated with the size of the ICPF sector across countries, highlighting the important role of the ICPF in promoting capital market deepening.

Using these new data on European insurers' and banks' global fixed-income portfolios, we document several novel facts that cannot be explained by traditional international finance frictions, such as home bias and home-currency basis. First, there is large cross-country heterogeneity in insurers' and banks' portfolio allocations, in spite of banks and insurers across countries all having access to global capital markets and being regulated under the common pan-European regulations. Second, the composition of domestic fixed income markets, as measured by the share of corporate bonds in outstanding domestic fixed-income instruments, is strongly positively correlated with the fraction of the overall portfolio invested in corporate bonds for both insurers and banks. Third, when investing abroad, insurers and banks do not offset attributes of the domestic markets (such as the composition of fixed-income markets, interest rates, and sovereign credit risk), which we label ``domestic projection bias.'' Fourth, subsidiaries of multinational groups act like local entities, which we label the ``going native bias.''

Taken together, our key finding is that characteristics of domestic financial markets dictate European insurers' and banks' overall portfolio allocation. This allocation pattern occurs despite a significant fraction of their assets being invested abroad and despite an active local market participation by large multinational insurance and banking groups. Despite these features, our results imply that capital market integration is more challenging due to the new international portfolio frictions that we document.

We propose a theoretical framework to explain our empirical findings on why countries with larger ICPF sector tend to a larger ICPF sector, and why banks and insurers allocate a larger fraction of their fixed-income portfolios to corporate bonds. Intuitively, if the regulated institutions would all be forced to hold government bonds, then the convenience yield of government bonds would be

very large. It is then optimal for banks and insurers to reduce their allocations to government bonds and tilt to corporate bonds. If the supply of corporate bonds is elastic, both facts follow.

Finally, using firm-level data, we illustrate how higher corporate bond allocations are absorbed in the insurance sector. The first option the insurance sector as a whole is riskier, implying additional risk for equity holders and, in case of default, policyholders or potentially taxpayers if insurance receive government support. Second, insurance companies can raise additional equity to compensate for their riskier asset allocation. Third, insurers may be able to adjust the structure of insurance products so that some of the risk can be shared with policyholders. We find empirical support for all three channels. Understanding how macroeconomic shocks are absorbed and which sector bears the shock are key to assessing financial stability.