International Portfolio Frictions *

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June 19, 2023

Abstract

We study patterns and implications of global asset allocations of European insurers and banks using newly available supervisory data. We show that the total assets of insurance companies and pension funds (ICPF) far exceed the amount of government bonds outstanding in Europe, and that countries with a large ICPF sector tend to have a large corporate bond market. Despite high levels of international investments, the characteristics of domestic financial markets still loom large in insurers' and banks' portfolio allocation, with two newly documented international portfolio frictions playing a prominent role. First, 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." Second, subsidiaries of multinational groups act like local entities, which we label the "going native bias." We propose a theoretical framework to explain our empirical findings and discuss the broader policy implications for European capital market deepening and integration, monetary policy transmission and financial stability, and a multi-sectoral approach to regulatory design.

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