MARKET DISCIPLINE IN THE EUROPEAN INSURANCE INDUSTRY: A PROPOSAL FOR A MODEL[1]

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Abstract

This paper investigates an important issue in the insurance industry: the market discipline. The new regulatory framework called "Solvency II" includes a special pillar devoted to Supervisory Reporting and Financial Information". Thus studies on information to be provided to the financial market are greatly required. A theoretical model based on the option price theory is developed to verify if the spreads at launch of subordinated bonds could be used as a tool for the market discipline. It is worth emphasizing that insurance companies are greatly collecting capital in last years by using unsecured subordinated debt, due to their regulatory requirements and to the pressure on available capital from financial analysts. The model presented is also tested on a sample of subordinated issues in Europe by using both classical regressions and a newer method to deal simultaneously with categorical and quantitative variables, without the usual loss of information implicit in the statistical treatment of mixed predictors. The results are quite supportive of the predictions of the model. The findings could have significant implications in the assessment of the future solvency system in Europe, still in search of tools for increase the market discipline.