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Market-based finance and private market expansion: implications for supervision

Market-based finance channels savings to borrowers through markets and securities rather than banks. Historically it was dominated by public equity and bond markets, offering access, transparency, liquidity and price discovery, while private markets were smaller. Since the early 2000s, in the U.S, listings have fallen and more funding is raised via private equity, venture capital and private credit instead of public issuance.

The European market is seeing a similar, but smaller, shift. Also, EEA insurers' private credit exposure remains limited, ranging from around 2% to 5% of total assets, depending on the definition applied (i.e. whether mortgages are excluded or included) – a level that does not yet raise supervisory concern but requires monitoring.

As finance becomes increasingly market-based and private markets expand, prudential supervision grows more important. Risks are disciplined less by market transparency; instead, they accumulate on the balance sheets of

institutional investors, making their resilience central to financial stability.

From a micro-prudential perspective, Solvency II provides tools to address the risks associated with asset classes characterised by illiquidity and valuation uncertainty. Capital requirements capture major risks, notably credit and issuer-level concentration risk, but do not cover all potential vulnerabilities. Supervisors can fill this gap through the Prudent Person Principle (PPP), challenging excessive exposures to illiquid assets and requiring robust valuation practices.

Solvency II, with its market-consistent valuation of assets and liabilities, has promoted transparency and risk sensitivity. However, growing allocation to private assets creates new challenges. Unlike publicly traded instruments, these lack observable market prices and are often complex, opaque, and difficult to value reliably, increasing uncertainty in balance-sheet assessments. The PPP approach is principle based and allows flexibility but requires greater supervisory judgement, particularly as insurers and pension funds expand into less traditional and more illiquid investments.

When it comes to pension markets, the IORP II Directive provides for the implementation of the PPR to investments of IORPs, and a risk-based supervisory approach. And the Commission's proposal from November 2025 for the review of the Directive takes it one step forward to more principle based, aiming to facilitate IORP's investment diversification by ensuring better access to alternative investments and encouraging economies of scale and cross-border consolidation. However, the proposal also promotes more rigorous governance and supervision as an essential pre-requisite for greater investment autonomy.

Rising private-market opacity shifts risk monitoring from market discipline to supervisors.

As finance becomes more market-based and lending increasingly takes place outside the banking sector, insurance companies and pension funds (ICPFs) also play, among other institutions, a larger role in credit provision. Against this backdrop, the question emerges of whether they are becoming macro-prudentially relevant actors, whose actions can meaningfully influence

overall financial stability. However, the scale of these activities by EEA ICPFs remains limited so far.

ICPFs are traditionally regarded as stable, long-term investors. Their real-money status, business models and investment strategies distinguish them from more leveraged or run-prone financial intermediaries and make them well placed to hold illiquid assets through market cycles.

ICPFs can play a stabilising role by providing long-term, loss-absorbing capital. However, this effect is conditional and nuanced. It is most likely to hold when exposures are well diversified across sectors and geographies, when assets and liabilities are aligned, including in terms of liquidity, and when capital buffers are comfortable. Absent these conditions, the illiquidity and opacity of private markets can instead create channels through which insurers and/or pension funds may amplify and transmit financial stress, particularly in niche market segments where they may constitute the dominant investor base.

This dual role, both stabilizing and potentially procyclical, underscores the need for supervision to evolve alongside the expansion of private markets within market-based finance. In its last revision, Solvency II has been strengthened to better reflect the macro-prudential role of insurers. This includes the introduction of specific provisions for undertakings identified by risk-based criteria, particularly regarding liquidity management and investment strategies (ORSA and PPP), as well as enhanced supervisory powers to address liquidity vulnerabilities in exceptional circumstances. The IORP II's proposed amendments also highlight a more substantial role on governance, transparency and the consolidation of supervision.

Finally, market-based finance also increases cross-sectoral interconnectedness, which calls for enhanced cooperation and coordination among supervisors from different regulatory domains.