Varieties of Regulation:
How States Pursue and Set International Financial Standards

Rahul Prabhakar

St John's College
University of Oxford

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ABSTRACT

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What explains the form and substance of international financial standards? Form refers to the legal or non-legal bindingness of an international standard. Substance refers to how significantly the standard changes the international status quo. The form and substance of international standards on bank capital adequacy, hedge funds, "bail-in" resolution, and insurance capital adequacy challenge the predictions of major rationalist, realist, and two-level perspectives. I propose a novel theory and present original evidence to test two central claims. First, the structure of domestic institutions and strategic interaction within a state incentivizes an actor from that state to prefer and pursue a certain form of international standard: legally or non-legally binding. The state actor, as a first mover, aims to propose a standard at an appropriate international institution which produces standards of its preferred form. Second, the state actor must bargain with representatives of other states according to certain decision-making rules at the international standard-setting institution. The type of decision-making rule used in bargaining—not the market power or other characteristics of key players—explains the substance of the final standard. More restrictive decision-making rules, which use majority or supermajority voting, lead to greater change than open rules, which are based on consensus or unanimity voting.

My empirical findings remove the veneer of technocratic legitimacy associated with international standard-setting to reveal intense distributional battles. In pursuing the Basel capital standards, the US Federal Reserve has been motivated more by turf wars with other US bank regulators than by its publicly stated desire to create a "level playing field" for internationally active banks. Supported by domestic collaboration between regulators and industry, French officials set a legally binding and deep *de facto* international standard for hedge fund managers over the vigorous objections of the City of London. By pursuing a soft standard on bail-in, the Bank of England has sought not only to protect taxpayers from costly bailouts, but also to keep Her Majesty's Treasury at arm's length. The lack of international insurance regulation is due not to the lack of effort by the UK Financial Services Authority and its European partners, but to open decision-making rules that allow US state regulators, albeit fragmented and under-resourced, to protect the international status quo. In each of these cases, I specify how domestic and international institutional settings provide enduring opportunities and constraints for key players in global finance.

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CHAPTER ONE

Battles in International Financial Regulation

In early September 2009, a group of British Members of Parliament met with American congressmen in London. The topic of conversation was the Alternative Investment Fund Managers Directive (AIFM) being debated at the European Union. Michael Fallon, a Conservative MP, told the congressmen that the directive focused on regulating hedge fund managers, private equity groups, and venture capital firms, which were only minimally regulated in Britain and the United States. He added, "The UK should strongly oppose this directive, since it would weaken London as a global financial center."

Fallon and the other MPs were confused by what motivated *French* representatives to push so hard for the directive. "The French … were taking the hardest line on the AIFM," even though "France has no real hedge fund industry." A Labour MP added that the United States and Britain needed to work together to better influence the outcome in Brussels.[1] The congressmen were keenly interested in the debate. New York is home to 118 hedge fund managers worth at least $1 billion each and who collectively control nearly half of the $1.8 trillion global industry.[2] New legally binding hedge fund regulations for accessing European markets would be deeply felt across the Atlantic—and into the Caribbean, where the funds are legally domiciled in offshore centers like the Cayman Islands.

UK representatives fought back in EU negotiations over the course of eighteen months, and welcomed supportive appeals from US Treasury Secretary Timothy Geithner to French Finance Minister Christine Lagarde. But, in the end, the French won a decisive victory in imposing direct, costly regulation of hedge fund managers and the like.

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[1] US Embassy (2009).

[2] HedgeFund Intelligence (2010).

Why would a state with "no real hedge fund industry" set legally binding international standards for the alternative investment industry? Why did the state with far more financial market power fail in negotiations to substantially weaken the proposed standard?

This is only one case of how states pursue and set international financial standards, but it highlights two motivating questions that I take up in this thesis. What explains why some states pursue legally binding standards, whereas others prefer standards in the form of "soft law"? Why do some states win and other states lose in bargaining over the substance of standards? These are theoretically puzzling and empirically fascinating questions for international political economists and engaged observers of financial markets.

The Argument

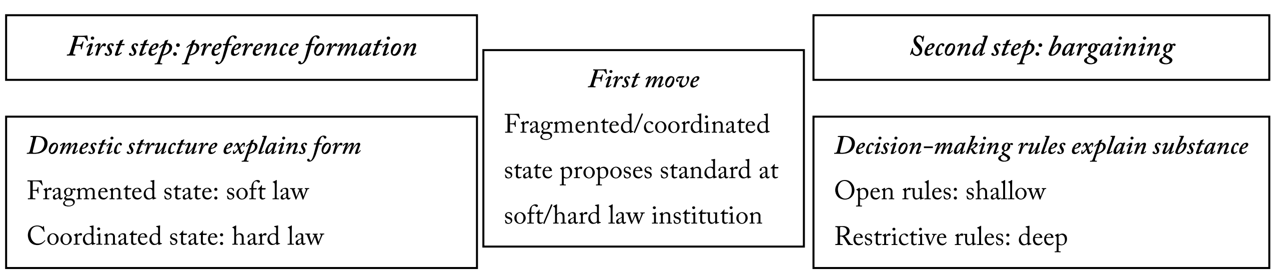
In this section, I outline my central claims and briefly discuss the two-step theoretical framework of this thesis. Following this discussion, Table 1.1 summarizes outcomes predicted by the theory.

I make two central claims in this thesis about preferences and bargaining in international standard-setting. First, the structure of domestic institutions and strategic interaction within a state incentivizes an actor from that state to prefer and pursue a certain form of international standard: legally or non-legally binding (hard or soft law). The state actor, as a first mover, aims to propose a standard at an appropriate international institution which produces standards of its preferred form. Second, the state actor must bargain with representatives of other states according to certain decision-making rules at the international standard-setting institution. The type of decision-making rule used in bargaining explains the substance of the final standard as shallow or deep (low or high change from the international status quo). More restrictive decision-making rules, which use majority or supermajority voting, lead to deeper standards than open rules, which are based on consensus or unanimity voting. This two-step process is summarized in Figure 1.1 below.

Not all states are alike in terms of their domestic institutional structures. I argue that this heterogeneity means that actors in different types of states prefer different forms of international standards. Actors in *coordinated states* are more likely to work collaboratively to set domestic standards for a given financial market. In turn, their domestic consensus incentivizes them to pursue legally binding international standards that will bring private and public distributional gains. Actors in *fragmented states* interact at arm's-length and often antagonistically. As a result, a dissatisfied actor seeks to set non-legally binding international standards to improve its domestic political position vis-à-vis other actors in its fragmented state. Regulatory actors in either type of state cannot independently pursue legally binding international standards without prior intra-state cooperation. Intra-state cooperation is more likely in coordinated states; such cooperation allows coordinated state actors to make strong credible commitments in the form of hard international standards.

Actors from both fragmented and coordinated states seek to be first-movers at international institutions (Figure 1.1). A successful first move sets the agenda at the international institution and results in higher switching costs for other actors as the drafting and negotiation phases commence.

Figure 1.1: Two-step theory of international financial standard-setting



However, first-movers are not always successful in bargaining. If discord exists among actors in bargaining, then the decision-making rules used at the international standard-setting institution matter. Open decision-making rules require consensus in order for actors to proceed with negotiating the substance of a first-mover's proposal. Open rules allow recalcitrant actors to demand concessions, exceptions, and side payments from the first-mover, even if the first-mover has assembled a supportive coalition. When discord exists among actors, open rules lead to shallower standards than do restrictive rules.

Restrictive decision-making rules improve the first-mover's success in standard-setting and can lead to deeper standards. Restrictive rules involve the use of procedures such as simple majority or weighted voting. The first-mover assembles a favorable coalition of actors by extending any necessary concessions or side payments to a "pivotal" actor, who joins the coalition. Restrictive rules allow the first-mover and its coalition to ignore recalcitrant actors. The effects of the first-mover's domestic institutional structure and the international institution's decision-making rules on the form and substance of international financial standards is summarized below (Table 1.1). Within each of the outcome boxes, the top row displays the substance of the standard (S) as a function of the decision-making rule used in bargaining. The bottom row shows the form of the standard (F) as a function of the first-mover's domestic institutional structure.

Table 1.1: Outcomes in international financial standard-setting

	Open decision-making rule	**Restrictive decision-making rule**
S **Fragmented first-mover** F	Low change from status quo (shallow) Non-legally binding standard (soft)	High change from status quo (deep) Non-legally binding standard (soft)
Coordinated first-mover	Low change from status quo (shallow) Legally binding standard (hard)	High change from status quo (deep) Legally binding standard (hard)

In sum, the process of international financial standard-setting begins with domestic regulatory politics and ends with inter-state bargaining to set a standard. Form is important because—rightly or wrongly—observers and market participants believe that the "hard" or "soft" legal form of a standard indicates how credibly committed states are to complying with that standard. Legally binding form presses upon actors the principle of *pacta sunt servanda*: agreements must be kept. Judicial review of compliance with many international standards may vary or even be non-existent, but hard law evinces a strong, unambiguous normative obligation upon actors. A soft standard, whose substance is nevertheless legitimized by international agreement, does not demand the same legal obligation of actors.

Form and substance have critical distributional dimensions. If states legally commit to and faithfully implement a standard that turns out to be faulty, then a common "shock" can have devastatingly similar consequences for financial markets and institutions across jurisdictions.[3] Market power and technical resources help advanced states lead debates on standard-setting, but do not ensure success when states disagree in negotiations: decision-making rules confer bargaining power and help define substantive outcomes.

My proposed theory fills a current gap in the scholarship of international standard-setting. Most scholars have focused on one of the two steps outlined above, but not both in the same framework. Some scholars have argued why states would choose certain forms of legalization for international standards or agreements, but significant outcomes exist contrary to their predictions.[4] Scholars interested in institutional design have asserted that powerful states "shop" for favorable negotiating forums, but do not suggest how these states bargain when discord exists within exclusive "club" institutions.[5] International political economists have thus far specified conditions under which international regulatory

[3] Hildebrand and Prabhakar (2012).

[4] Abbott and Snidal (2000); Raustiala (2005).

[5] Drezner (2007); Stone (2011).

coordination generally occurs, and in doing so, have largely "black boxed" the state.[6] As a result, the current scholarship is ill-suited to explain many features of distributionally important outcomes in international financial standard-setting.

Puzzles abound in international financial regulation, and I test the two-step theory in four cases of standard-setting: bank capital adequacy rules, alternative investment standards, financial institution resolution tools, and insurance capital adequacy rules. Following a brief overview here of each of the cases, I develop key concepts and analyze arguments in existing scholarship that are pertinent to, and will be challenged by, the remaining chapters. I conclude this chapter with a roadmap for the thesis.

Four cases

In this section, I summarize how the empirical cases in this thesis pose puzzles in light of the current scholarship on standard-setting. I briefly discuss how these cases test, and how well they are explained by, my proposed two-step theory.

The powerful central bank of the United States, the Federal Reserve Bank ("the Fed"), has been the indisputable first-mover in setting standards for how much capital banks should hold as buffer against potential losses on their assets (Chapter 3). In 1988 and 2004, the Fed led international negotiations at the Basel Committee on Banking Supervision to set a risk-based capital standard; it also led negotiations on a global liquidity standard in 2010. Yet, puzzles remain. US regulators and bankers publicly called (and still call) for a global "level playing field" to prevent weaker banks from exploiting loopholes across jurisdictions. If a level playing field is the objective, then why does the US explicitly avoid attaching *any* legal obligations to implementation of the Basel capital rules? Given the market power of the US and the resources of the Fed, why has the Fed repeatedly conceded to foreign regulators on important policy substance in the standards?

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[6] Simmons (2001); Drezner (2007); Singer (2007). For general application on actors and preferences in IR, see Frieden (1999).

The two-step theory has a compelling explanation. In 1988, after aligning with the Bank of England, the Fed chose to propose a non-legally binding accord at the Basel Committee. An international standard on risk-based capital rules, even if "soft," would allow the Fed to present the stark options of adoption or rejection to rival US regulators and help it improve its domestic political position in the fragmented US regulatory structure. Even though the world's two major financial centers aligned on a standard, the open decision-making rules at the Basel Committee made negotiations difficult. The Fed conceded major points to German regulators, who had vigorously opposed the Fed's initial proposal for the definition of capital, in exchange for agreeing to what became the 1988 Basel Accord. Negotiations over Basel II (2004) and Basel III (2010) provide further confirmation that, first, domestic structure explains the Fed's preference for non-legally binding standards and, second, the Basel Committee's open decision-making rules explain the production of shallow standards.

As discussed in the opening lines of this thesis, in 2010, France drove negotiations to set very detailed and legally binding standards for alternative investment fund managers in the European Union (Chapter 4). Given that London is home to the largest alternative investment industry in the EU, British officials and financiers strongly opposed the proposed standard and preferred the international status quo. Yet, the French mostly prevailed. What explains this outcome? Although France is a state frequently involved in international financial discussions, it is not a "great power." International political economists have not looked beyond the great powers to examine whether other states can successfully set international standards.[7] I argue that a state's market power does not determine its success in standard-setting. If a first-mover can assemble a coalition and utilize restrictive rules to resist concessions to recalcitrant actors, then the first-mover can successfully shape the form and substance of standards, regardless of its market size.

As a coordinated state, France preferred a legally binding standard for alternative investment fund managers because such a standard would bring the rest of the EU up to the stringency of its own domestic standard, thereby also benefitting French banks; through

[7] Abdelal (2007) is an exception.

the third-country equivalence process, the standard would also affect US regulation.[8] Britain opposed the French-led charge for the Alternative Investment Fund Managers (AIFM) Directive, but fought back with only meager success. Restrictive decision-making rules in the EU process for financial standard-setting do not favor actors, such as the British, satisfied with the status quo when they face a formidable coalition. French representatives and their partners did not concede much substantively to the British, and very successfully set a legally binding and deep standard that will have a major impact on a worldwide financial market.

There exist counter-arguments to both steps of this two-step theory, and the following cases intend to provide tougher tests of the theory (Chapters 5-6). Some readers may argue that it is not the first-mover's preference for form that determines whether a standard will be non-legally or legally binding, but the international institution in which the standard is negotiated. After all, the European Union is a creature of law through the Treaty of Rome and its successors. The Basel Committee has always been a relatively small "club" of jurisdictions that produces non-legally binding standards.

I counter that international standard-setting institutions do not act autonomously to propose standards; members determine their standard-setting agendas.[9] A state actor searches for an international institution which produces standards of its preferred form and initiates the standard-setting process within the institution. Cases involving first-movers, such as Britain, that have access to both hard law and soft law institutions (e.g. the EU and Basel Committee) directly test this proposition.

As actors from a fragmented state, British regulators have repeatedly chosen to pursue non-legally binding standards in soft law institutions, in order to improve their political position relative to their counterparts at the EU and in the UK without spending the time, resources, and domestic political costs of seeking legally binding standards.

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[8] Vogel (1997); Meunier and Nicolaïdis (2006); Bach and Newman (2007).

[9] Helleiner (2010); Stone (2011); Moravcsik (1998).

In 2010, the Bank of England wanted a non-legally binding standard on a bank resolution tool called "bail-in," which seeks to address the potentially systemic consequences of rescuing "too big to fail" banks (Chapter 5). By seeking to set a bail-in standard at the Financial Stability Board (and not through UK representatives at the EU), the Bank aimed to ensure its institutional autonomy in the aftermath of the 2007 bank run on Northern Rock and 2008 financial panic. A soft FSB standard could set the terms of the subsequent EU and UK debate on bail-in and, more broadly, on bank resolution.

Yet, despite making the first move, the Bank of England made concessions that resulted in a final FSB standard close to the international status quo because bargaining occurred under open rules. The US Federal Deposit Insurance Corporation (FDIC) strongly opposed the Bank's proposal and effectively diluted its substance—even though the FDIC did not officially hold a seat at the relevant FSB committee!

The final case study of this thesis further buttresses my argument that decision-making rules—not the preferences of the most powerful actor or coalition—decisively explain the substance of international standards. In the early 2000s, at the International Association of Insurance Supervisors (IAIS), the UK Financial Services Authority sought a non-legally binding risk-based capital standard for insurance firms because it lacked a domestic consensus on how to regulate the London Market (Chapter 6). Although the UK FSA had considerable support from other major European states, it faced opposition from the US National Association of Insurance Commissioners (NAIC) and state insurance regulators, whose fragmented regulatory structure should have prevented US officials from effectively bargaining at the IAIS.

A perpetual late-comer to international negotiations, the NAIC oversees a fragmented US insurance market, attempts to coordinate the views of 50 state insurance regulators, and has few technical resources because it is not a regulator itself. How could the NAIC possibly battle back in negotiations? Open decision-making rules at the level of working groups and subcommittees in the IAIS allowed the US NAIC and state representatives to dilute proposals for a risk-based capital standard. Thus the shallow IAIS Principles of Capital

Adequacy and Solvency (2002) simply reflect the international status quo, to the chagrin of the UK-led coalition, which has now sought to make an emerging EU standard, known as Solvency II, the *de facto* global standard.

The Need for a Two-step Theory of International Standard-Setting

The previous section discussed the empirical cases I marshal to test my two-step theory of international standard-setting. In this section, I discuss variation in the form of international financial standards and why the prevailing explanation for such variation falls short. Further, I outline salient differences between international financial standard-setting institutions and argue that explanations for inter-state bargaining outcomes within such institutions should be based neither on "forum-shopping" motivations nor on complex models of decision-making, such as those applied to European Union institutions. Finally, I demonstrate how a two-step theory of preference formation and bargaining advances our understanding of international standard-setting.

Form: non-legally binding versus legally binding standards

International financial standards regulate the behavior of financial firms and markets, "distinguished from domestic regulation in terms of where the regulatory activity takes place,"[10] i.e. above the level of the state and including inter-state and supranational activity.[11] The principal motivation for prudential financial standards is to mitigate systemic risk and negative externalities arising from the actions of individual banks because "left to themselves, financial systems are prone to bouts of instability and contagion."[12] Scholars and observers frequently assert that actors set international standards because of extensive cross-border financial integration: a "level playing field" of standards across

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[10] Mattli and Woods (2009): 2.

[11] Regulation refers to rules, whereas supervision is the "more general observation of the behavior of financial firms." Llewellyn (1999): 6.

[12] Davies and Green (2008): 15.

jurisdictions applies equally stringent (or lax) restrictions across jurisdictions and ensures that banks cannot arbitrage for competitive advantage.[13]

Soft law is generally more common than hard law in international finance.[14] Standard-setting institutions which produce non-legally binding financial standards include the Basel Committee on Banking Supervision ("Basel Committee"), the International Organization of Securities Commissions (IOSCO), and International Association of Insurance Supervisors (IAIS). The Basel capital adequacy standards, IOSCO principles of securities regulation, and IAIS principles on insurance supervision do not attach legal obligations. One of the few—and completely unheralded—legally binding standards is the 1988 United Nations Convention on International Bills of Exchange and International Promissory Notes, which facilitates trade finance.[15]

Soft law has considerable benefits because it reduces sovereignty and uncertainty costs for state actors. It facilitates compromise and adoption by actors with different interests and values—both among advanced industrial states, and between advanced and developing states. Given the difficulty of writing complete contracts, soft law allows actors to "learn" about the consequences of agreed-upon standards, which undergo frequent monitoring and policy reviews by the standard-setting institutions' secretariats.[16] By engaging legal norms and discourse, soft law forces actors to justify their behavior relative to the commitments prescribed by an albeit non-legally binding standard.[17] International agreement, even if non-legally binding, legitimizes the substantive commitments of that standard.

However, this rationalist perspective on the form of international financial standards broadly generalizes actors' interests and preferences.[18] It is not evident that soft law in finance is the optimal approach to mitigating international market failures or constructing a

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[13] Kapstein (1994); Oatley and Nabors (1998); Singer (2007).

[14] Giovanoli (2000); Simmons (2000).

[15] Hermann (1988).

[16] Abbott and Snidal (2000); Raustiala (2005); Lipson (1991); Schachter (1977); Brummer (2012).

[17] Finnemore (1999).

[18] I take Abbott and Snidal (2000) to be the most representative of this perspective.

harmonized level playing field. Some rational actors benefit from soft law accommodating the uncertainty of distributional effects, whereas others demand hard law to reduce uncertainty arising from minimally legalized frameworks.

Indeed, actors consider the effects of soft versus hard law in finance differently. Legally binding international financial standards are concentrated among EU Member States. Hard EU financial standards reduce transaction costs, reflect strong credible commitments, and punish non-compliance through extensive delegation to the European Commission and European Court of Justice. For the EU, "it was not unreasonable to argue that, as banking stands on reputation and confidence, banks were better served by operating out of 'hard' rather than 'soft' regulatory environments."[19] Construction of the EU single financial market has occurred parallel to the construction of the internal EU market in non-financial goods and services. The EU has produced legally binding directives covering capital adequacy, investment services, market abuse, insider trading, credit rating agencies, and myriad other issue-areas. Based on the principles of home-country control, mutual recognition,[20] and harmonization,[21] financial institutions can largely operate throughout the EU with a single license.

A specific example demonstrates how the rationalist approach to legalization does not explain why states have chosen to negotiate hard law in the *same issue-area* where non-legally binding international standards exist. EU Member States negotiate precisely detailed, legally binding standards for capital adequacy. According to the rationalist/legalization perspective, the justification for negotiating soft law at the Basel Committee—the uncertain effect of new rules on capital levels, credit supply, and economic growth—should apply in the EU context as well. Yet, in implementation of the Basel III standard, the European Commission will apply the principle of "maximum harmonization," that is, national regulators will be limited in their flexibility to impose higher than minimum capital requirements on their banks. British representatives vigorously objected

[19] Story and Walter (1997): 253.

[20] Nicolaïdis and Shaffer (2005).

[21] Posner (2007).

to their French and German counterparts' push for maximum harmonization, arguing that national regulators required flexibility to deter banks from excessive risk-taking.

Given the same issue-area, many of the same actors, and many of the same differences in interests and time horizons among those actors, one should expect similar outcomes between the Basel Committee and EU, according to the rationalist/legalization perspective. However, the Basel capital rules are considerably "softer" (non-legally binding and more discretionary) than the corresponding EU Capital Requirements Directives (legally binding and less discretionary). My approach argues that without reference to the domestic institutional settings in which actors operate, the rationalist/legalization perspective cannot explain the variation in states' preferences between soft and hard standards in this case. Further, without considering the decision-making rules used in bargaining, this approach cannot explain the variation in discretion for actors under the Basel standard versus the corresponding EU directive.

International financial standard-setting institutions

Actors can set international financial standards in any number of institutional settings. Standard-setting institutions employ technical experts and use certain decision-making rules that shape negotiations among actors. In international finance, there exists an impressive variety of standard-setting institutions, both sectoral (dedicated to a particular type of market) and encompassing (covering all markets). In the aftermath of the late 2000s global financial crisis, the Group of 20 (G-20) Leaders decided to establish the Financial Stability Board (FSB), a successor to the Financial Stability Forum (FSF), which was set up after the 1997 Asian financial crisis. The FSB seeks to coordinate the work of standard-setting institutions, such as the Basel Committee, IOSCO, and IAIS (and several others). These three sectoral standard-setting institutions, as well as the FSB, have produced non-legally binding standards across issue-areas, such as cross-border supervisory coordination, resolution regimes, consolidated supervision, and credit ratings.

The FSB and sectoral standard-setting institutions are as "soft" as the non-legally binding standards that they produce. As institutions, they barely have organizational identity and have minimal (if any) bylaws: the Basel Committee was founded in a press release in 1975, IOSCO was incorporated in a private bill of the Quebec National Assembly, and IAIS started as a non-profit corporation registered in Illinois.[22] Only in January 2013 did FSB members agree to establish the organization as a Swiss non-profit association. The standard-setting process within these institutions generally operates on the basis of consensus. Given that the "dominant currency is engagement and persuasion," vigorous objections are effective at dooming efforts to create standards which would substantively change the international status quo.[23]

However, other international standard-setting institutions can develop either legally binding standards or non-legally binding standards and use a variety of decision-making rules. These include the Organisation for Economic Cooperation and Development (OECD), which has promulgated widely agreed-upon principles on corporate governance and sought in the 1970s and 1980s to set international accounting standards.[24] As an intergovernmental organization, it uses "one country, one vote" decision-making rules at the highest levels, and has extensive governance and procedural rules. The World Bank has produced principles on cross-border insolvency, as has the UN Commission on International Trade Law (UNCITRAL), which uses consensus as the basis for its standard-setting. Similarly, state actors at the International Institute for the Unification of Private Law (UNIDROIT) negotiate standards on the netting of derivatives contracts. The International Monetary Fund (IMF) possesses the expertise and capacity, concentrated in its Monetary and Capital Markets Department, to facilitate financial standard-setting among members. Indeed, in the aftermath of the 1997 Asian financial crisis, the chairman of the Basel Committee feared that the IMF would assume a greater standard-setting role: "It would clearly be an enormous task [for us] to develop agreed practices/rules in each of

[22] Zaring (1998).

[23] Slaughter (2000): 205.

[24] Jupille et al. (2013).

these areas, even at a fairly superficial level. The problem is that, if the Basle Committee does not do so, the IMF says it might."[25]

Despite this array of suitable standard-setting institutions, over the past twenty years, states have often negotiated international financial standards in soft law institutions with open rules. Formal procedures within some inter-governmental institutions can restrict powerful states from quickly setting standards in areas they deem critical. As a result, some powerful states, namely the United States and Britain, prefer to forum-shop the "G-" clubs, such as the G-7 or G-20, and correspondingly soft standard-setters, such as the Basel Committee, IOSCO, and IAIS, in order to negotiate standards.[26] A number of institutions have thus been sidelined. In its soft law capacity, the IMF has produced non-legally binding standards on financial transparency and data dissemination, instead of legally binding prudential standards. The FSB set the key international standard on resolution regimes for financial institutions, instead of the World Bank or UNCITRAL.

To the extent that powerful states remain engaged in formal intergovernmental organizations, they informally dictate debates by exercising a threat of exit when stakes are high. Smaller states accede because they still generally gain from international cooperation over the long run with powerful states and the loss of access to the largest financial markets would be detrimental for them.[27] However, if states disagree amongst themselves within a "club" institution, such as the Basel Committee, how credible is the threat to exit or to exclude members who are historically relevant and resourceful states (albeit not as financially powerful), such as the Netherlands or France, without eroding the legitimacy of international standard-setting? During bargaining in club institutions, do the effects of market power "wash out"[28] or do outcomes depend on international institutional factors? Wagering on the latter proposition, this thesis argues that decision-making rules explain the substance of standards.

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[25] Tommaso Padoa-Schioppa quoted in Goodhart (2011): 463.

[26] Drezner (2007).

[27] Stone (2011); Koremenos et al. (2001).

[28] Drezner (2007).

States have not completely sidelined financial standard-setting institutions that use restrictive decision-making rules. The European Union stands apart with a standard-setting process that greatly differs from procedures at the FSB or sectoral standard-setters. In 2001, the EU introduced a multi-level financial standard-setting process (the "Lamfalussy process") that uses qualified majority voting (QMV) rules and disadvantages slow-moving Member States. The Commission proposes standards (Level 1) in the form of legally binding directives, which are then reviewed and voted upon by the Council of Economic and Financial Ministers and European Parliament. At Level 2, national representatives (one finance ministry representative and one technical expert per country) consult with Level 3 European regulatory bodies (such as the European Banking Authority), in order to supplement the Level 1 directives with technical detail and implementing measures. EU directives are subject to enforcement review by the Commission at Level 4.[29]

Instead of unanimity voting requirements, EU Member States decided to create restrictive decision-making rules for financial standard-setting.[30] Scholars continue to disagree over who holds the agenda-setting power in the EU legislative process—major Member States, Commission, Council, or Parliament—and how the sequence of proposals affects bargaining outcomes.[31] They also disagree on who holds more bargaining power: large states, domestically constrained states, unified bargaining teams, or supranational actors.[32] It can perhaps safely be stated that the EU has multiple access points for various actors to exercise influence,[33] and the agenda-setting power of the European Parliament has grown

[29] Quaglia (2007).

[30] Meunier and Nicolaïdis (1999); Meunier and Nicolaïdis (2006); Pollack (2006). This thesis does not theoretically explain the development of open versus restrictive decision-making rules. Liberal intergovernmentalist theorists argue that restrictive rules reflect prior credible commitments made by EU Member States in financial services.

[31] Steunenberg and Selck (2006).

[32] Hosli (2000); Hix (2002); Schelling (1960); König and Slapin (2006).

[33] Josselin (1996).

over time.[34] The Commission, which has played a crucial role in financial market integration,[35] initiates standard-setting proposals and privileges the views of Member States who are able to move quickly and supply timely information.[36] The Parliament can formally pressure the Commission to propose a directive, but practice suggests that prior to the use of formal procedures, negotiations among Commission officials, representatives in Parliament, and finance ministers at the Council—in the shadow of QMV rules—result in substantive bargains that facilitate standard-setting.[37]

This section has introduced some basic features of international financial standard-setting institutions, which serve as the settings for actors' bargaining. The two-step theory I propose does not explain institutional design or granularly incorporate EU institutional specificities, which are nevertheless the subject of some empirical interest in this thesis. In the second (bargaining) step of the theory, I take the present variety and design of standard-setting institutions as given and make a basic proposition about the effect of decision-making rules: restrictive rules lead to deeper standards than do open rules. This also means first-movers hold an advantage over recalcitrant actors under restrictive rules, but not under open rules. However intuitive this proposition may seem, it runs contrary to arguments premised on the exercise of market power and is much more parsimonious than existing models of the EU legislative process.

Two levels matter

My two-step theory of international financial standard-setting recognizes both the analytical priority of states' preferences and the explanatory power of international institutional constraints.

[34] Tsebelis and Garrett (2001).

[35] Jabko (2006).

[36] Héritier (1996).

[37] Stone (2011); Moravcsik and Nicolaïdis (1999); Moravcsik (1998). Farrell and Héritier (2003) analyze the relationship between formal and informal EU institutions.

Accordingly, outcomes "cannot be explained solely by the preferences and payoffs of the players; they are dependent in part on the process by which bargainers seek to resolve conflict or achieve consensus."[38] However, until recently,[39] theories of two-level games in international regulatory coordination have been tilted in their explanatory focus towards either the international or domestic setting.[40]

Most theories of international financial coordination largely "black box" the domestic level. Some assume a unipolar financial world and attribute the hegemon's "preferred regulatory innovation" to exogenously determined reasons.[41] Notwithstanding the empirical reality that a unipolar financial world no longer exists, this approach fails to explain why the hegemon would not establish hard international standards that would legally bind its successors and mitigate market failures.[42] Others posit that state actors pursue international standards that conform to the domestic status quo.[43] But, this is not a satisfactory motivation; I argue and present evidence that a state actor *dissatisfied* with the domestic status quo can be incentivized to pursue international standards that allow it to control the domestic policy agenda.[44]

On the other hand, domestically focused theories of standard-setting emphasize the role of crisis as an exogenous shock. Crisis motivates domestic regulators, who attempt to deter legislative scrutiny and maintain their autonomy. When they attempt to set standards, regulators make trade-offs between financial stability and competitiveness for the home industry.[45] Crises do produce greater information about firm and market failures,[46] spurring public demand for regulators to set new standards. Yet, the fact that standard-

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[38] Slaughter et al. (1998): 387; Legro and Moravcsik (1999).

[39] Büthe and Mattli (2011); Farrell and Newman (2010).

[40] Putnam (1988).

[41] Simmons (2001).

[42] Keohane (1984).

[43] Drezner (2007).

[44] Hemel (2011).

[45] Singer (2007).

[46] Mattli and Woods (2009).

setting takes place in the shadow of crisis tells us little about what form or substance those standards take.

I argue that the demand for regulatory change, partially as a result of crisis, affects actors differently across various types of domestic settings. Most theories have so far only considered fragmented domestic structures in which regulators operate at arm's length from each other—and interact at arm's length with fragmented industry associations, which individually lobby regulators. One scholar notes that "a regulator in one country might be especially inclined toward competitiveness as a result of domestic pressures from politicians and industry or because of some aspect of the institutional environment," but does not elaborate.[47] This proposition suggests that where competitiveness concerns dominate, they incentivize some regulators to not let a crisis "go to waste," and thereby to set standards benefitting their home firms.[48] My argument recognizes that standard-setting frequently occurs in the aftermath of crises, but goes one step further to argue how the domestic institutional environment can explain actors' preferences for the form of those standards.

Further, domestically focused theories do not account for how international institutions constrain—as well as create opportunities for—state actors. In practice, state actors routinely assess how they can succeed at the international level. According to a US policymaker I interviewed, "We have treaties. We have the WTO. Burden sharing in cross-border resolution would involve something like an international contract. But, we will not do it any time soon. We have to do what's in our interests and what's practical."[49] A two-step theory that incorporates inter-state bargaining leads to explanations not only of the fact that an international standard was set, but also of how state actors won or lost in negotiations on the substance of that standard.

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[47] Singer (2007): 23.

[48] Theories based on private-sector capture of public regulation do not explain why or how regulators set significant international standards, such as the substance of the 1988 Basel Accord or the soft form of the Financial Stability Board's bail-in standard, contrary to powerful banks' preferences. See pp. 116-118 in Chapter 3 and pp. 248-249 in Chapter 5. See also Lall (2012) and Young (2012).

[49] Interview, Washington, DC (4 January 2012).

In sum, this thesis is a novel and ambitious contribution to scholarship on international standard-setting that directly addresses downsides in existing and useful, yet incomplete, theories. This section has discussed those downsides. The rationalist perspective on the suitability of soft law in one issue-area does not delineate why some actors often choose hard law in the same issue-area. Other theories focus on how leading states "forum shop" to avoid cumbersome formal rules or recalcitrant weaker states, instead of explaining interactions when discord exists among relevant states in "club" institutions. Finally, two-level game analyses of international regulatory coordination either under-develop states' preferences or do not account for the effect of international institutional settings on outcomes.

The Plan

This thesis tackles intuitively interesting puzzles in international finance. In one interview, a senior official from the US Department of the Treasury remarked, "The French love legal text…. For us, this is about time and costs. Is it worth it to fight a big legal battle?" In Paris, a senior official of the *Autorité des Marchés Financiers* noted, "If there is a clear law, it will create confidence…. We like to have everything in well-established boxes, otherwise *ce n'est pas normal*."

My goal is to provide a theoretical framework—as general as possible—to explain not only what causes varying preferences among states for the form of international standards, but also the implications of decision-making rules for the policy substance of those standards. I present this two-step theory of form and substance in international standard-setting in the next chapter (Chapter 2).

Chapters 3 through 6 present the case studies discussed above. Chapter 3 focuses on why and how the US Federal Reserve has set soft, shallow international standards on risk-based capital for banks under open decision-making rules at the Basel Committee. Chapter 4 examines how French officials very successfully set deep and legally binding international standards on alternative investment fund managers under restrictive decision-making rules in the EU, despite the British advantage in market power. Chapter 5 discusses the Bank of England's timely pursuit of a soft standard on bail-in—a pursuit that resulted in shallow substance because of the open rules in bargaining at the Financial Stability Board. Chapter 6 demonstrates, more comprehensively than any previous IPE study, of why the IAIS failed to set a substantively deep standard on insurance capital adequacy in the early 2000s: open decision-making rules in subcommittees and working groups allowed fragmented and under-resourced US state-based regulators to block a UK-led European coalition's attempts to change the international status quo.

The conclusion in Chapter 7 accomplishes three tasks. It highlights the theoretical and empirical contributions of this thesis, discusses the validity and generalizability of the two-step theory, and offers pertinent policymaking applications.

CHAPTER TWO

A Two-Step Theory of International Standard-Setting

How do states pursue and set international financial standards? What explains the form and substance of such standards? In this chapter, I propose a two-step theory of international standard-setting. First, the fragmented or coordinated structure of a state generates certain incentives for a state actor to prefer a particular *form* of an international standard. Form can be non-legally ("soft law") or legally binding ("hard law").[50] Second, this state actor, as a first-mover, bargains with other states on the *substance* of the standard. Substance refers to how much the policy content of the standard alters the international status quo. Decision-making rules used at the international institution explain the substance of the standard as shallow (minimal change from the status quo) or deep (significant change from the status quo).

In this thesis, the relevant state actors are from "major players" in international finance, that is, advanced states with considerable resources and technical expertise. This refers not only to states with the most market power, such as the United States or United Kingdom, but also to states historically engaged and relevant in international financial policy, such as Switzerland, the Netherlands, and France. I note other assumptions and definitions as I build the theory below.

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[50] Abbott and Snidal (2000) consider legalization on a spectrum according to dimensions of legal obligation, precision, and delegation. Following Raustiala (2005): 587, I refer to legal obligation as "form" in a binary way: "Governments, the architects of agreements, behave as if legal agreements are decisively different from nonlegal agreements. They do not accidentally or cavalierly choose between pledges and contracts when negotiating agreements. Nor do they calibrate the legality of pacts in a continuous fashion, designating some softer law, some harder law, some not at all legal, and so forth across a demarcated continuum of legality. Instead, states carefully choose the legal nature of their agreements dichotomously." Thus, in this thesis, the definition of form as "soft" refers to a non-legally binding standard, "hard" to a legally binding standard, and neither term refers to a spectrum of legalization.

The two-by-two Table 2.3 on p. 44 summarizes the predictions of the two-step theory. In an appendix at the end of this chapter, I discuss the theoretical foundations, methodology, and case selection used in this thesis.

Step 1: Preference for form

In this section, I first describe the structure of the state and then discuss how the nature of domestic regulatory outcomes varies depending on the state's institutional structure. Strategic interaction among domestic actors, in turn, leads to incentives for state actors to prefer either soft or hard law at the international level.[51]

Structure

As a useful simplification, consider that a state can be one of two ideal types: fragmented or coordinated. I measure how fragmented or coordinated a state is according to a few dimensions of its regulators and industry associations: level of integration, the degree of competition, and extent of public authority. Level of integration refers to how many regulators are tasked with regulating and supervising firms in a given market and how well-defined their mandates are. It also refers to whether industry associations are encompassing in their representation of firms in a given market. Degree of competition refers to the conflict observed among regulators and among industry associations. Industry associations compete with each other to increase their number of member firms, which pay fees to have their views represented in lobbying and policymaking. Public authority refers to delegation by the executive and/or legislature to regulators or industry associations to establish standards and conduct supervision.

[51] I define "preference" as Katznelson and Weingast (2005) do: preferences "signify propensities to behave in determinate circumstances by people who discriminate among alternatives they judge absolutely or relatively."

As I argue below, the structure of the state—defined by these dimensions—explains the ability of regulators and industry associations in a given market to autonomously pursue their preferences over domestic regulatory outcomes.[52]

In the ideal-type fragmented state, numerous regulators are poorly integrated. They routinely withhold information from each other as they compete over their mandates and autonomy to implement their preferred policies. Industry associations are likewise poorly integrated and compete with each other over members and resources. A high degree of competition between industry associations means that each association will have a more distinct preference than if a single, peak-level industry association existed; this raises the collective action costs for industry associations when lobbying regulators. Public authority is concentrated in regulators, who set standards at arm's length from industry associations.

In the ideal-type coordinated state, regulators are better integrated with well-defined mandates and do not aggressively compete for autonomy. Industry associations are highly integrated and encompass entire sectors, and thus do not have to compete with other associations for new members. Because they speak for all member firms in a given sector, encompassing industry associations can directly set or help set standards through public authority granted by regulators or the government. For example, industry associations may operate deposit insurance schemes or conduct compliance auditing. Regulators and representatives of industry associations sit alongside each other on boards and committees, share information about markets and firms, and jointly set the agenda for the domestic rule-making process. They are ensconced in collaboration.

Table 2.1: Structure of the state according to dimensions of sub-state actors

	Fragmented state		**Coordinated state**	
	Regulators	*Industry*	*Regulators*	*Industry*
Level of integration	Low	Low	High	High
Degree of competition	High	High	Low	Low
Extent of public authority	High	Low	High (shared)	High (shared)

[52] The state can be more or less fragmented or coordinated depending on the given market, e.g. the United States is more fragmented in insurance than in banking.

Domestic regulatory outcomes: status quo or consensus

How do actors' interactions in different institutional structures affect the nature of domestic regulatory outcomes? What do these strategic interactions mean for a state actor's preference for the form of an international standard?

In a fragmented state, a regulator is not able to achieve its policy preference without the cooperation of other regulators. Moreover, its arm's-length relationship with myriad industry associations means that firms are only involved indirectly in formulating policy. Actors are incentivized to achieve their policy preferences by outmaneuvering competitors in the domestic standard-setting process. Unsure of their future influence in standard-setting, actors focus on winning a distributional conflict that reduces another actor's autonomy, reputation, or wealth. High collective action costs and low credibility of commitments reduce the chances of regulators or industry finding consensus on a given issue.[53]

Domestic regulatory outcomes in a fragmented state are not likely to be viewed as legitimate by all regulators or industry associations. Regulators compete to oversee the same firms and markets, and their jurisdictional boundaries are fluid. Not all industry associations exercise influence throughout the domestic regulatory debate, and industry associations will often seek to undermine each other when separately lobbying regulators. Not even the successful regulator, which has achieved its preferred policy, can be satisfied that the resulting outcome will not be overturned, undermined, or evaded—by other regulators, let alone firms. This adversarial intermediation of interests in a fragmented state means that the nature of the domestic regulatory outcome is a tenuous *status quo*, defined here as an "existing state of affairs"[54] with no assurance or likelihood of durability.

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[53] North (1993). A credible commitment made between two actors means that each of these actors can be confident that the other will not renege. This is because each actor has invested resources and reputations, and has done so over time, in a given activity. If an actor has invested its resources by agreeing to a commitment with a second actor, then the second actor is assured that the first actor will suffer some cost if the commitment is not held—thus making the commitment credible.

[54] Oxford English Dictionary.

In coordinated states, regulators and industry associations jointly govern. Regulators and industry associations are much more interdependent in functions and resources than their counterparts in fragmented states. Given this interdependence, they do not face so much a distributional conflict with each other—as in a fragmented state—but a question of reconciling interests (bargaining) or optimal performance (problem-solving).[55]

This is not to suggest that actors' interactions in a coordinated state are harmonious. There are distributional implications for the actors involved, but the informal and formal mechanisms of the actors' interdependence are assurances that the domestic regulatory outcome is in the actors' common interest and viewed as legitimate, that is, the loser's preferences were fully heard and he can be assured of his continued inclusion on relevant committees and boards.

The resolution of disagreement between regulators and industry associations in the coordinated state means that the actors have come to a domestic regulatory *consensus*. Consensus is "general agreement or opinion."[56] It is "a set of parameters which bounded the set of policy options regarded as … administratively practicable, economically affordable and politically acceptable."[57] In contrast to status quo, consensus is a state of affairs *legitimated* by "those receiving the benefits and bearing the costs of the regulation."[58] Consensus is not ad-hoc. Domestic regulatory consensus is thus defined as regulation accepted as durable, legitimate, and beneficial by domestic regulators and industry associations.

Incentives and preferences for soft or hard international standards

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[55] Börzel (1998): 262.

[56] Oxford English Dictionary. Consensus can be an existing state of affairs. But, status quo does not imply consensus. The difference is that consensus is viewed as legitimate; status quo is not necessarily so.

[57] Kavanagh and Morris (1994): 13.

[58] Rose-Ackerman (1994): 1212.

What incentivizes a regulator from a fragmented state to seek an international standard? As a result of arm's-length, adversarial relations in its fragmented state, a regulator may become so dissatisfied that it seeks international leverage against its domestic counterparts. If it is a member of an appropriate international institution, then the dissatisfied regulator can pursue an international standard that would bolster its domestic political position. Improving a regulator's political position can mean expanding the scope of firms under its jurisdiction, preserving itself in the face of domestic political scrutiny, or controlling the domestic policy agenda to enact its preferred standards.

Actors perceive international standard-setting institutions to have technocratic legitimacy because of the expertise usually involved in writing standards for cross-border application. These institutions thus also legitimize their members' policy preferences that are substantively incorporated in standard-setting. This can provide leverage in domestic implementation for a dissatisfied regulator. An international standard raises the profile of the dissatisfied regulator's policy preference on the domestic agenda and can control the domestic agenda by posing a stark choice to other regulators and fragmented industry associations: accept or reject the international standard.[59]

In other words, the pursuit of international standards—for regulators from fragmented states—is the continuation of antagonistic domestic politics by other means.

What form of standard does the dissatisfied regulator prefer? Individual regulators do not have independent authority to negotiate hard law internationally—this is true across both fragmented and coordinated states. Given that states negotiating international hard law require prior intra-state policy coordination (which is easier when negotiating authority is consolidated in a single actor, such as the US President in international trade bargaining),

[59] Majone (1984); Quack (2010). It is difficult to predict what level of dissatisfaction is "enough" to motivate a regulator to change the status quo. There are "few means of predicting when feedback loops will occur ex ante; indeed their arguments suggest that they are likely by nature to be unpredictable." Farrell and Newman (2010): 619. This acknowledgement does not detract from explaining the dissatisfied regulator's incentive structure and ensuing actions.

structural fragmentation reduces the likelihood of such domestic coordination and thus, for the dissatisfied regulator, makes the pursuit of hard law exceedingly costly in terms of time and resources. Regulators from fragmented states cannot negotiate legally binding standards at the international level without considerable interference from rival domestic regulators, as well as other state actors with whom they would have to attempt to achieve common policy positions. For example, for US financial regulators, this negotiation would entail the involvement of the Department of State (not expert in standard-setting), as well as congressional scrutiny, consultation, and ratification.[60] Thus, dissatisfied regulators from fragmented states prefer and consequently pursue soft international standards.

What incentivizes a coordinated state actor to seek an international standard? Shared public governance, well-integrated organizations, and low competition all increase the likelihood of actors in a coordinated state coming to a consensus on how to regulate a given financial market. In turn, coordinated state actors seek to export their domestic regulatory consensus. An international standard is a way for the coordinated state to achieve both public *and* private interests. If its domestic standard becomes the international standard, then relevant coordinated state actors benefit distributionally; regulators and industry in the coordinated state face no compliance costs in implementing and operating under the international standard, whereas other states must adjust. Because of this domestic consensus, coordinated state actors speak with a single voice when they bargain internationally.

The hard law form appeals to coordinated state actors because of the distributional gains at stake. Regulators from coordinated states attempt to transform their domestic regulatory consensus into legally binding international standards because legal obligations are difficult for other states and market participants to ignore.[61] State practice suggests that states

[60] Raustiala (2005): 597.

[61] Or where the international institution's membership rules only admit government ministries, the relevant ministry (e.g. finance) negotiates on behalf of the regulators and industry associations. The domestic regulatory consensus manifests itself in the same policy preference being projected internationally by all coordinated state actors.

believe hard law promotes more compliance than soft law because a legal obligation reflects a stronger commitment on the part of states than a non-legal obligation: "This is true both because contracts evidence greater seriousness and because, by explicitly using international law, contracts tie the commitment to the body of international legal rules."[62]

To capture the essence of the argument: structural coordination in a state greatly increases the likelihood of achieving the domestic consensus necessary to pursue legally binding international standards. Ultimately, a state's preference for form reflects the level of credible commitment it is willing and able to make regarding its behavior to other states and market participants. Hard law represents a more credible commitment than soft law.

Table 2.2: Causal chain leading to state actor's preference for form

Structure	**Domestic interaction**	**Domestic regulatory outcome**	**Incentives to go global**	**Preference for form**
Fragmented	Arm's-length, adversarial	Status quo is ad-hoc	Improve regulator's political position	Soft law
Coordinated	Collaborative	Consensus is viewed as legitimate	Achieve public and private interests	Hard law

How does a state actor from a fragmented or coordinated state actually go about setting the standard? The state actor, as a *first mover*, aims for an international institution which produces standards of its preferred form and which has the capacity (such as a secretariat) to facilitate negotiations.[63]

The first-mover's choice of hard or soft international standard-setting institution is a function of its preferred form.[64] The decision to set a legally or non-legally binding

[62] Raustiala (2005). See also Abbott and Snidal (2000) and Simmons (2000).

[63] I am not proposing a theory of how actors successfully initiate bargaining. In all of the case studies, I empirically discuss how actors successfully initiate bargaining in a given international institution. See pp. 191-193 for a discussion on the conditions under which first-movers successfully initiate standard-setting.

[64] I am not proposing a theory of institutional choice which explains why certain focal point international institutions for path-dependent reasons are chosen by first-movers. Mattli and Woods (2009) use the same

standard reflects the level of credible commitment to the standard that the actor is willing and able to make: a coordinated first-mover's strong commitment leads it to initiate standard-setting negotiations in a hard law institution; a fragmented first-mover's weak commitment leads it to a soft law institution.[65] The first-mover prefers an agreement to no agreement, and so will accept a final standard of its preferred form, even if the standard merely affirms the status quo on policy substance.

Step 2: Bargaining on substance

A state actor prefers a hard or soft international standard and begins the standard-setting process in a hard or soft international institution. Then what? As a first-mover, it bargains with representatives of other states in order to set the *substance* of the standard.[66] Below, I define substance and offer a simple spatial model of bargaining between actors. I then argue and demonstrate that the type of *decision-making rule* used during bargaining explains variation in substance.

Substance can be defined in two ways, generally and specifically. Generally, substance refers to "depth" and specifically, to a policy space. Depth refers to how much the substantive commitments required by the standard deviate from the international status quo: depth can be shallow or deep.[67] Shallow substance means the new standard only requires minimal shift from the prevailing international standard or practice. Deep substance means significant change from the prevailing international standard or practice.

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assumption of fixed international institutional supply. In Chapters 3 through 6, I explain the international institutional choices of first-movers empirically on the basis of historical and institutional design factors. See Jupille et al. (2013) for a comprehensive theory of institutional choice in the international political economy applied to the World Trade Organization and other organizations.

[65] This theory assumes that the credibility of a commitment is prior to the policies (substance) effectuated by that commitment. This is not an outlandish assumption. Just as individuals in their personal lives may prefer low (casual date) or high (marriage) levels of credible commitment irrespective of common substantive interests, actors can pursue international standards in the same sequence.

[66] Form and substance vary independently of each other, as in Abbott et al. (2000).

[67] Downs et al. (1996); Raustiala (2005).

More specifically, bargaining on substance entails negotiations on a policy space. For example, bargaining on international derivatives standards includes negotiations on the definition of exchange-traded derivatives, prudential requirements for buyers and sellers of derivatives, and the netting of derivatives contracts. Each of these issues can be represented on a unidimensional policy space defined by a spectrum of actors' preferences, ranging from laxity to stringency, for instance.

On the policy space, I assume that actors' preferences are located at the status quo or to the right of the status quo. This is a simplifying assumption: regulatory reform generally occurs in the shadow of crisis, pressuring actors to move from the status quo in the direction of change.[68] The status quo point (*q*) represents an exogenous *international* policy outcome in case bargaining on a standard fails.[69] This could mean the continued absence of an international standard for a given market or continued reliance on an existing international standard, the outcome of previous inter-state bargaining.

Let's take an example where the international status quo is a lax international standard. I plot a simple spatial model in Figure 2.1 below with the international status quo at the leftmost point and actors' preferences to the right. I define this space generally as running from shallow to deep, in terms of the change from the international status quo—and specifically as running from lax to stringent, in terms of the policy content of the international standard. The concept of depth allows us to explain bargaining outcomes across a variety of negotiations on different policy issues, instead of always focusing on a single policy dimension, such as laxity versus stringency. For example, the policy space can also be defined by actors' preferences on other substantive issues, such as scope, e.g. should the standard apply to all banks or only the biggest banks?

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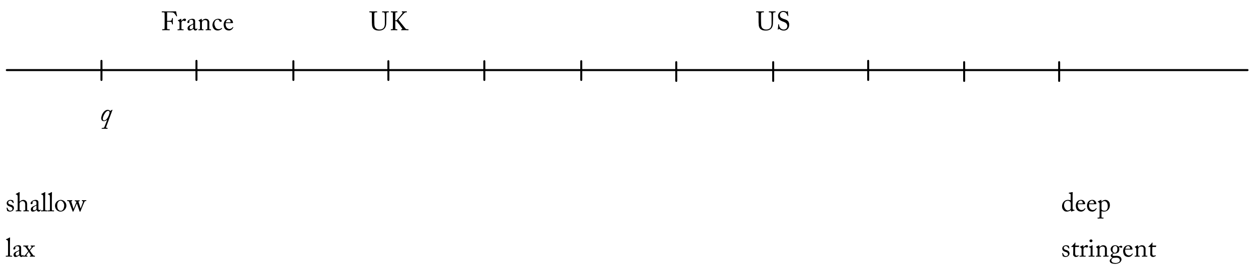
[68] Singer (2007) and Mattli and Woods (2009) also explicitly incorporate crisis in their theories of regulatory change.

[69] Krehbiel (1998) also defines status quo as the exogenous policy outcome.

The preferences of actors in Figure 2.1 are *for illustrative purposes only*. The policy preferences of actors, such as the US preference for a stringent and deep standard versus the French preference for a lax and shallow standard, are exogenous to the model; I empirically discuss the sources and development of policy preferences in the case studies.

Figure 2.1: A simple spatial model of bargaining on a single policy dimension



What explains the bargaining outcome: the final substance of a standard? Contrary to existing scholarship on international financial regulation, which favors explanations based on market power, I argue that decision-making rules used during bargaining explain the final substance of a standard. An example of an *open* decision-making rule is unanimity; every actor in bargaining holds a veto. An example of a *restrictive* decision-making rule is simple majority.

In formal terms, deviation from the status quo under open rules is always less than or equal to deviation from the status quo under restrictive rules.[70] It is “less than or equal to” because if actors bargain harmoniously, then open rules generate the same substance as restrictive rules would. If actors disagree with each other, then open rules result in substance corresponding to the preference of the actor at or closest to the status quo. This means that the more open the decision-making rule is, the shallower the substance of the standard will be. The more restrictive the decision-making rule, the deeper the substance of the standard can be.

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[70] See Crombez and Swinnen (2011); Crombez and Hix (2012), Pokrivcak et al. (2006) for studies on the frequency of legislative activity versus gridlock under different bargaining rules.

Is there a first-mover advantage? Under open rules, there is no first-mover advantage. Power during open rule bargaining on the substance of international standards is a function of an actor's distance to the status quo—not of market size. Recalcitrant actors satisfied with the status quo prevent the setting of substantively deep standards. However, there is a first-mover advantage under restrictive rules. Restrictive rules confer bargaining power on actors that can quickly project their policy preferences and build large coalitions, allowing for deeper substance than bargaining under open rules.

How do I test these propositions? In the following chapters, I present case studies wherein first-movers consistently pursue substantively deep standards.[71] These empirical chapters demonstrate that first-movers have to concede more on policy substance to recalcitrant actors under open rules than under restrictive rules.[72]

In the next two sections, I specify precisely how open rules have no built-in first-mover advantage and lead to shallow substance, and how restrictive rules allow first-movers to set substantively deep standards.

Bargaining under open rules

An open rule requires consensus or a unanimous vote to approve a first-mover's proposal for the substance of a standard. Consensus "requires no manifested opposition to a motion by any member present."[73] An open rule respects the equality of members, that is, any

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[71] First-movers can be actors from either coordinated or fragmented states. Coordinated first-movers seek to export their domestic regulations and impose adjustment costs on other states, in order to gain distributionally. Fragmented first-movers seek to use the significant change associated with a deep international standard to justify correspondingly deep changes to the domestic status quo.

[72] As Krasner (1991) states: "the problem is not how to get to the Pareto frontier but which point along it will be chosen." In terms of efficient or optimal outcomes, if a standard is set, then actors have reached the Pareto frontier. The first-mover prefers to agree on a standard than to not agree. However, for the first-mover, the farther that it has to move along the Pareto frontier to accommodate the preference of a recalcitrant actor, the less successful it is, while the final standard is more substantively shallow.

[73] Steinberg (2002): 343.

member can voice any objection or submit amendments at any stage of standard-setting and at any level of the institution: initial agenda-setting and proposal, early or late in negotiations, and at final consideration in working groups, upper-level committees, or the general assembly of members. As a result, actors who prefer the status quo are advantaged under open rules and are easily able to voice objections. These recalcitrant actors are *pivotal*: the final substance of the standard must reflect their preferences.

Consider bargaining between three state actors in an international standard-setting institution, as shown in Figure 2.2 below (s_f = first-mover's preferred substance, a = actor's preferred substance, p = pivotal actor's preferred substance, s^* = substance of final standard). For the sake of simplicity,[74] I assume the membership of the institution is composed of three actors, the minimum number which allows us to compare the effects of open versus restrictive rules (e.g. unanimity versus simple majority voting). Each of these three actors could also represent coalitions of multiple actors. In order to compare how the pivotal actor changes under open versus restrictive rules between Figure 2.2 and Figure 2.3 below, I identify the actors as representing the US, UK, and France.

These actors' preferences lie on a unidimensional policy space, running here from regulatory laxity to stringency (in terms of depth, shallow to deep).[75] Each actor has symmetric, single-peaked preferences. The status quo point (q) represents an exogenous international policy outcome in case bargaining on a standard fails.[76]

In this example (Figure 2.2), the first-mover US (s_f) prefers a more stringent and deeper standard than do the UK (a) and France (p). If bargaining occurred under majority voting, then the first-mover US would only have to satisfy the UK (a) in order to have sufficient votes to set the standard.

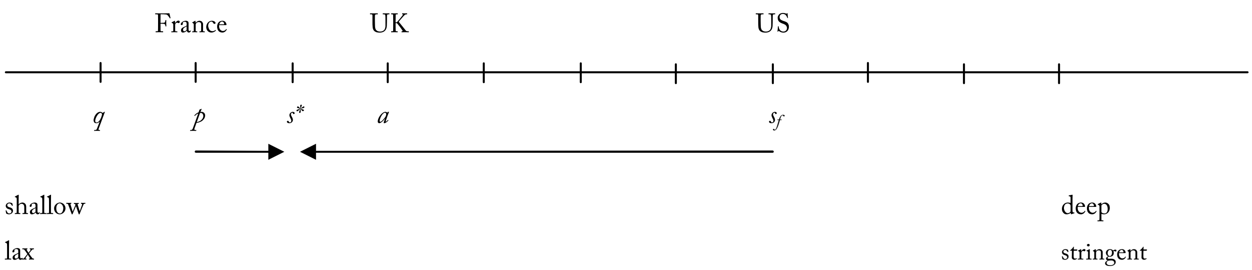
[74] In reality, the number of members is often higher, e.g. the G-7, the 27 Member States of the EU, and the 27 members of the Basel Committee.

[75] I am using the example of a space defined by laxity and stringency only for illustrative purposes.

[76] These are assumptions adopted by Krehbiel (2008) and (1998), and have been used since the advent of median voter theory in the 1950s.

However, the first-mover does not have a bargaining advantage under open rules. Consensus or unanimous voting makes p's vote pivotal to achieving agreement on a standard, and forces the first-mover US (s_f) to accede to France's (p) wishes. The first-mover's substantive concessions to the pivotal actor make the pivotal actor indifferent between the final substance and the status quo ($s^* - p = p - q$). Once it has won enough concessions to be indifferent, the pivotal actor does not vote against the first-mover. Therefore, open rules reduce first-mover's bargaining success ($s^* - s_f$) because of a pivotal actor (p) who is mostly satisfied with the status quo (q). This leads to a shallow standard.

Figure 2.2: Standard-setting under open rules



In standard-setting practice, the movement from s_f to s^* occurs through an open amendment process. An open rule permits members to submit amendments on the substance of the standard and favors pivotal actors (p) which may face high compliance or reputational costs as a result of the first-mover's original preference (s_f). Such costs may be concentrated on a narrow distribution of states, but, under an open rule, representatives of these states have low time and resource costs in issuing objections and requesting concessions or exceptions. These concessions include extending the timeline of implementation of the standard, limiting the scope of firms (perhaps excluding regional or smaller banks), and weakening criteria in order to better comply with the standard (such as permitting different types of capital for identical purposes).

In short, the pivotal actor under open rules is the actor closest to the status quo. As a pivotal actor, it demands concessions, exceptions, and side payments from the first-mover in exchange for setting a standard. When discord exists, open rules lead to shallow standards.

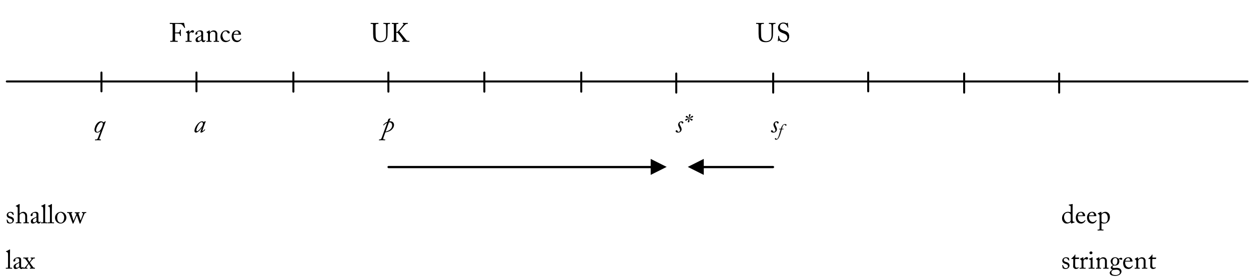
Bargaining under restrictive rules

Restrictive decision-making rules lead to deeper standards than open rules do by changing the pivotal actor. Restrictive rules include simple majority voting, weighted voting, and limited or no amendment rights; supermajority voting rules fall between open and restrictive types.

Consider the three-actor scenario under simple majority voting in Figure 2.3 below, identical to the configuration of preferences in Figure 2.2 (s_f = first-mover's preferred substance, p = pivotal actor's preferred substance, a = actor's preferred substance, s^* = final substance of standard).

In this restrictive rule scenario, only two out of three votes are required to set the substance of the standard. As a result, the pivotal actor is now the actor whose preference is closer to the first-mover's preference instead of the actor satisfied with the status quo. The hypothetical country preferences are identical to those in Figure 2.2, but the pivotal actor in Figure 2.3 has changed as a result of the simple majority voting rule: UK is now p and France is now a.

Figure 2.3: Standard-setting under restrictive rules



Restrictive rules require that the first-mover, again the US, assembles a coalition which possesses sufficient votes in order to set the standard. In Figure 2.3, the first-mover US makes concessions or side payments to the UK pivotal actor (p) whose preference lies between the first-mover's original preference (s_f) and the status quo (q). These concessions or side payments make the UK pivotal actor indifferent between the status quo and the final substance of the standard ($s^* - p = p - q$).

The first-mover US has a bargaining advantage under restrictive rules vis-à-vis recalcitrant actors. Once the first-mover US has convinced the UK to support the US's proposal for the final substance of the standard (s^*), it does not have to make concessions on the substance of the standard to recalcitrant actors (a) that favor a policy close to or at the status quo (q). Whereas the US has to concede to a recalcitrant France under an open rule (Figure 2.2), it does not do so under restrictive rules (Figure 2.3), and is thus more successful under restrictive rules.

Restrictive rules can also eliminate the possibility of proposing amendments (known as "closed rule" in the US House of Representatives), limit the number of consultative or decision-making rounds in which actors can offer amendments, require amendments to be "germane" to the substance of the standard, or stipulate that actors must justify proposed amendments in technical or legal terms (where reference to compliance or reputational costs is insufficient). After a first-mover has proposed a standard and assembled a sufficient coalition under restrictive decision-making rules, state actors (a) opposed to the proposal and facing considerable compliance or reputational costs could threaten to exit the institution.[77]

To sum up the previous two sections: I have argued that in situations where identically favorable configurations of actors exist for the first-mover under both open and restrictive rules, restrictive rules lead to deeper standards than open rules do. The effects of the first-mover's domestic structure on form and of decision-making rules on substance are summarized in Table 2.3 below (S = substance of final standard; F = form of final standard; E = examples).

[77] In reality, this is not necessarily a credible threat, given that the institution is likely a focal point in setting international standards for a given market.

Table 2.3: Outcomes in international financial standard-setting

	Open decision-making rule	**Restrictive decision-making rule**
S **Fragmented first-mover** F E	Shallow *Non-legally binding standard* Basel Committee capital rules, FSB bail-in standard, Joint Forum principles for supervision of financial conglomerates	Deep *Non-legally binding standard* OECD Principles on Consumer Financial Protection, IMF Special Data Dissemination Standard (non-mandatory)
Coordinated first-mover	Shallow *Legally binding standard* EU directives in financial services prior to 1986 Single European Act	Deep *Legally binding standard* EU directives on alternative investment fund managers, credit rating agencies

The benefits of open rules

In the previous section, I posited that restrictive rules lead to greater success for first-movers, which raises the question: why would a first-mover ever negotiate under open rules? In this sub-section, I briefly consider why: the legitimacy and reduced costs when harmony exists, as well as the benefits of open rules for certain states across different institutional designs.

State actors benefit from the "input" legitimacy and reduced time and resource costs that open rules entail. International standard-setting institutions offer credibility and technocratic legitimacy for state actors' policy preferences. International standard-setting institutions portray consensus-based rules as a de-politicized process of allowing scientifically minded actors to find "the technically optimal solution to a regulatory or technical challenge."[78] Where a technical consensus actually exists on a particular coordination problem, international standard-setting institutions can serve as useful focal points to facilitate information-sharing and bargaining among state actors. Consensus decision-making allows states to easily "learn" about the preferences of other states.[79] Institutions for which there are no member fees, such as the Financial Stability Board (which is funded by the Bank for International Settlements), further reduce costs.

Moreover, open rules offer benefits for fragmented state actors across international standard-setting institutions, even when other institutional design elements, such as membership rules, vary. These same benefits exist for coordinated state actors, but the payoff for fragmented state actors relative to bargaining under restrictive rules is considerable. Consider that two types of membership rules exist: open membership or consolidated representation (one representative per member jurisdiction). Open membership rules admit multiple representatives from a single jurisdiction, as in the case of the Basel Committee, IOSCO, and IAIS. If multiple regulators or other representatives from a fragmented state are members of the institution, then each may pursue its policy preferences independently. Each can be the first-mover or pivotal actor in any given standard-setting negotiation.

Open decision-making rules in institutions which require consolidated representation are also valuable for fragmented state actors, albeit less so than when decision-making and membership rules are both open. If the membership rule requires consolidated representation, then open rules still favor late-comers, who are likely to be fragmented state actors. Consolidated representation requires state actors to spend time and resources to achieve common policy positions, resulting in late-coming proposals and amendments. Because this membership rule favors coordinated states, fragmented state actors in the same institution greatly benefit, even as late comers, from open rules that allow them to demand concessions or side payments.

[78] Büthe and Mattli (2011): 11.

[79] Steinberg (2002).

In standard-setting institutions which use both consolidated representation and restrictive decision-making rules, fragmented state actors are doubly disadvantaged. Evidence from decision-making at the International Accounting Standards Board, which operates on the basis of consolidated representation and majority voting rules, demonstrates that coordinated states routinely succeed as first-movers, whereas fragmented states are often simply too slow to voice objections before drafting of the standard reaches an advanced stage.[80]

Appendix: Theoretical Foundations and Methodology

In this section, I briefly survey the theoretical foundations and methodology of the thesis. The two-step theory is built upon and advances the insights of rational-choice and historical institutionalism in International Relations. The ontology ("premises about the deep causal structures of the world"[81]) of these –isms requires, in turn, a suitable methodology.

The case study methodology seeks to appropriately measure key variables and test the two central claims of the thesis: 1) the type of domestic institutional structure explains state actors' preferences for form of international standards and 2) the type of decision-making rule explains the substance of international standards.

The two-step theory incorporates key insights of rational-choice and historical institutionalism to hypothesize how domestic and international institutions affect outcomes. Institutions provide crucial coordinating functions,[82] yet those equilibria—a tentative domestic status quo or a durable domestic regulatory consensus—are differently interpreted by actors in different institutional settings.[83] Equilibria emerge in institutional

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[80] Büthe and Mattli (2011).

[81] Hall (2003): 374.

[82] Bates et al. (1998): 11.

[83] Ferejohn (1991).

settings that are themselves products of prior causal paths.[84] The case studies evidence preference formation as the result of how domestic institutions affect actors' credible commitments and incentives in fragmented versus coordinated settings. The case studies fully embrace the shared ambition of rational choice (strategic interaction) and historical institutionalism (path dependence) to "see the world not as a terrain marked by the operation of timeless causal regularities, but as a branching tree whose tips represent the outcomes of events that unfold over time."[85]

Operationalization and observation

The case studies in the following chapters are concerned with specific observations of the causal process and specific elements of the outcomes. Observations of the causal process include legal battles in fragmented states, collaborative rule-making in coordinated states, and substantive amendments during bargaining.[86] The case studies are not intended to explain the frequency of soft versus hard law. This thesis is instead focused on specifying the conditions and mechanisms under which particular outcomes occur—an inquiry especially suitable for case study methodology.[87]

In the case studies, I operationalize "fragmented" versus "coordinated" states by considering key dimensions of the regulatory and market structure: level of integration, degree of competition, and public authority.[88] For example, along these dimensions, Britain, though fragmented, is less fragmented than the United States because it has fewer financial regulators. Yet, the Bank of England and UK Financial Services Authority operate at arm's length from fragmented industry associations. No major peak-level industry association exists in the UK that has public standard-setting authority, as exists in Germany. A number of causal paths that have led to more or less fragmented or coordinated states:

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[84] Pierson (2000): 255; Thelen (1999).

[85] Hall (2003): 385.

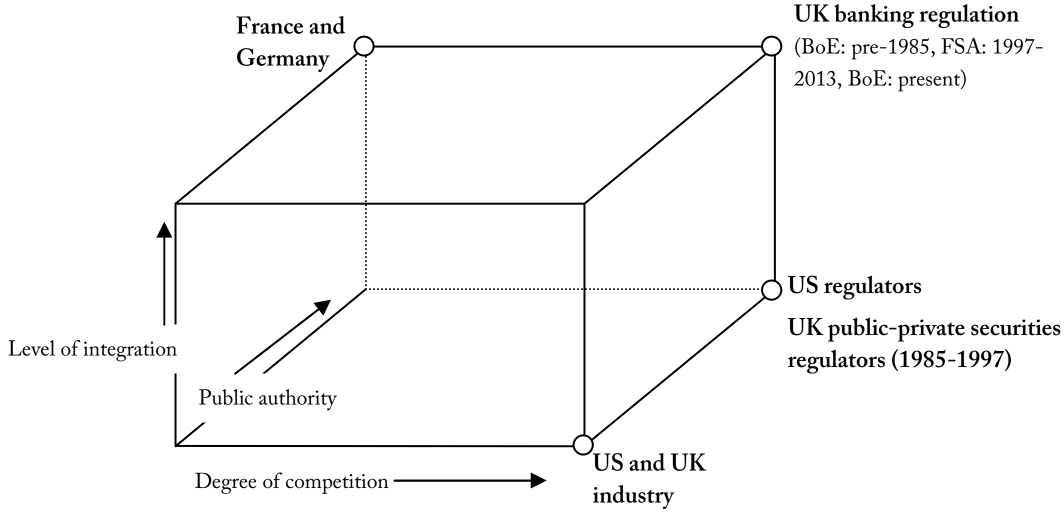
[86] King et al. (1994); Mahoney (2010): 122.

[87] George and Bennett (2005): 31.

[88] Sartori (1970). Adcock and Collier (2001) also provide useful guidance on conceptualization and operationalization.

legalistic (US), corporatist (Germany), statist (France), and market-driven (UK).[89] When states are sufficiently like each other, such as France and Germany, they are classified similarly, as demonstrated in Figure 2.4 below.

Figure 2.4: Fragmented and coordinated states



Source: Author's work.[90]

The form of an international standard is relatively easy to measure, as the standard itself pronounces the nature of the legal or non-legal obligation attached to it. State actors' preferences for form are observed by their actions and statements through first-hand interviews, testimony, public statements, legislative histories, and various documents. Evidence on bargaining within international institutions is gathered by similar means. The extent of concessions or side payments actors may transfer to each other is discussed in empirical detail.

Case selection & testing

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[89] George and Bennett (2005): 215.

[90] UK regulation has gone from "moral suasion" (pre-1985) dominated by the Bank of England to, in the securities markets, shared authority for public and private securities regulators (1985-1997), to completely consolidated supervision within the Financial Services Authority (1997-2013), which is now in the process of being enveloped into the Bank (present). A separate Financial Conduct Authority is now being created to oversee consumer and market abuse issues. See Moran (1991); Moran (1986); Thomas (1989); Hall (1987); Geddes (1987); Grady and Weale (1986).

The cases presented in Chapters 3 through 6 were selected not only because of their inherent policy importance, but also because they test the central claims of the two-step theory. In this small-*n* research design, independent variables (types of state and decision-making rule) are at their most extreme in most-likely cases, at their lowest values in least-likely cases (or in this thesis, "less-likely" cases). If the most-likely cases fail to support the theory, then the two-step theory is in serious doubt. If the less-likely cases support the theory, then this provides greater evidence of validity across issue-areas in international finance.

- The case of the US Federal Reserve at the Basel Committee is a most-likely case (Chapter 3). The US is a very fragmented state and Basel Committee decision-making rules are open. If the US Federal Reserve did *not* prefer non-legally binding standards and was extremely successful in setting deep standards, then the two-step theory would be in trouble. Although this is a most-likely case, its findings provide more support for the two-step theory than existing alternative explanations. On form, the rationalist/legalization perspective generates no specific prediction, while on substance, arguments based on market power, private-sector influence, and domestic constraints fall short.

- The case of French officials setting an EU standard on alternative investment fund managers is also a most-likely case (Chapter 4). France is a well coordinated state and EU decision-making rules for financial standards are restrictive, thus French officials should be successful if they can assemble a favorable coalition. This predicted outcome contradicts a reasonable rationalist/legalization prediction for soft law, whereas the Varieties of Capitalism approach does not specifically predict form as a regulatory preference. An alternative explanation of substance based on the influence of market size in bargaining falls short. An alternative explanation based on domestic constraints in France versus Britain would generate the same prediction as the two-step theory on substance, and the role of supranational actors is minor. This case also demonstrates that restrictive rules, compared to other possible conditions, provide the requisite bargaining advantage to first-movers seeking to set deep standards.

- The Bank of England's pursuit to set a non-legally binding standard at the Financial Stability Board is a less-likely case of the first step of the two-step theory and a most-likely case of the second step (Chapter 5). Britain is a weakly fragmented state: prudential regulatory authority has been consolidated into the Bank of England (and previously, the Financial Services Authority), while the British banking industry structure is very fragmented. The somewhat fragmented British state has access to both hard law and soft law focal point international institutions (e.g. the Basel Committee and EU), so this case is a tough test: if the Bank of England prefers a non-legally binding standard and aims to set its preferred standard in a soft law institution, then this evidence supports the two-step theory's proposition on preference formation. Decision-making rules at the Financial Stability Board are equivalent to ideal-type open rules; according to the most-likely proposition, the Bank of England should be easily thwarted in bargaining by actors satisfied with the status quo. This case's findings run counter to the predicted outcome of the rationalist/legalization perspective (hard law), and rebuff explanations of substance based on "great power" regulatory coordination and unity of bargaining team. This case also supports my contention that restrictive rules create a first-mover advantage, whereas open rules do not.

- British regulators and their European partners' efforts to set a non-legally binding standard at the International Association of Insurance Supervisors is a less-likely case of preference formation and of bargaining (Chapter 6). As in the previous case, Britain is a weakly fragmented state and has access to both hard and soft law standard-setting institutions. The soft and extremely shallow IAIS Principles of Capital Adequacy and Solvency reflect the resistance of recalcitrant US state-based regulators, which are extremely uncoordinated at the IAIS. In this case, the rationalist/legalization perspective also predicts the soft form of the IAIS standard, which may also be an instance of policy diffusion. On substance, I consider

> counter-arguments based on market power and the unity of the bargaining team (both of which fall short), although the empirics are consistent with an explanation based on domestic constraints.

Inspired by the interest of an earlier generation of scholars who studied state-society relations and state capacity,[91] this project tries to be attentive to theoretical and methodological issues. The small-*n* research design is meant to test a framework which comports with the call to theorize "highly complex causal relationships, with multitudes of interaction effects and low numbers of cases, where statistical techniques are difficult to apply."[92] It builds upon recent work on "the consequences of institutional legacies in specific, intrinsically important contexts."[93] In doing so, the tools offered by this two-step theory allow practitioners to have a "correct image of the adversary" and suggest the conditions for policymaking success.[94] With a portable theory and suitable methodology, this thesis seeks to be a contribution to interdisciplinary scholarship in international political economy, as well as institutionalist theories of standard-setting.

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[91] For example, Katzenstein (1978).

[92] Farrell and Newman (2010). See also Bach and Newman (2007); Newman (2008); and Posner (2010).

[93] Büthe and Mattli (2011): 196-7.

[94] George and Bennett (2005): 272.

CHAPTER THREE

The Fed "Can't Get No Satisfaction":[95] Setting Standards at the Basel Committee

> There is no objective basis for *ex cathedra* statements about levels of capital. There can be no certainty, no dogma about capital adequacy: it is therefore an area, par excellence, where the supervisors have to play a role in setting standards to fill what could otherwise be a vacuum.
>
> - Peter Cooke, chairman, Basel Committee on Banking Supervision (1977-1988)

As Peter Cooke observed, financial regulation, like any other economic policy, emerges from an intensely politicized process. Most of the public record is filled with statements by central bankers, financial supervisors, and commercial bankers supporting an international "level playing field" that does not create competitive advantages for some banks or states over others. While well-intentioned national regulators pursue international agreement to facilitate cross-border banking, the standard-setting for bank capital adequacy is at heart a distributional battle. The 1988 Basel Accord did lay down a common capital adequacy standard for internationally active banks. But, its form and substance were strategically shaped.

Do the findings in this case support the two-step theory presented in the previous chapter? Yes. In a fragmented state, numerous regulators compete at arm's-length over their policy preferences and autonomy. Industry associations are not encompassing, they separately and competitively lobby regulators, and they do not have public standard-setting authority. The ideal-type fragmented state maps closely on to the reality of the extreme fragmentation in relations among US banking regulators and the fragmented industry which they supervise.

[95] Rolling Stones (1965).

This domestic institutional fragmentation creates the strong "structural possibility"[96] that threats to a US regulator's policy preference and its autonomy will incentivize it to pursue an international standard to set the policy agenda and preserve or expand its domestic mandate. The lack of intra-state regulatory cooperation in a fragmented state means that the pursuit of a legally binding international standard is prohibitively costly—but soft law *is* attainable and appealing.

I argue that this incentive structure is precisely what the US Federal Reserve Bank (the "Fed") faced in the 1980s. Other major US bank regulators—the Federal Deposit Insurance Corporation (FDIC) and Office of Comptroller of the Currency (OCC)—opposed the Fed's policy preference to establish risk-based bank capital standards, as did the American Bankers Association (ABA). As a result of this domestic discord, there was no single US regulatory approach to bank capital adequacy. Not only was the Fed's policy aim under threat, but the FDIC and OCC also actively supported the Reagan Administration's efforts to remove regulatory responsibilities from the Fed.

How could the Fed enact its preferred standard?

It turned to the international level. By the mid-1980s, the Basel Committee on Banking Supervision had quickly and entrepreneurially established itself as a focal point international institution for national central banks and financial supervisors to share information on cross-border banking trends and discuss possible standard-setting. It is a *soft* institution that uses open, consensus-based decision-making rules. Importantly, the Fed would *not* need to coordinate its views at Basel with any other US bank regulator. An international non-legally binding, risk-based bank capital standard shaped by the Fed would effectively set the US regulatory agenda by presenting the FDIC and OCC with a stark choice: accept (and the Fed wins) or reject (and damage interagency harmony and US credibility).

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[96] Reinicke (1995).

What about the substance of the 1988 Basel Accord? Open decision-making rules used for bargaining in a standard-setting institution imply a bias for the international status quo—and empower the actor who most prefers a shallow standard. This means that a first-mover who prefers significant change from the status quo (preference for a deep standard), such as the US Fed, would have to substantively concede to the recalcitrant actor.

The recalcitrant actors who preferred the status quo on capital standards in the mid-1980s were the German Bundesbank and BaKred (bank regulator). The Fed and its ally the Bank of England, both preferring a quickly negotiated agreement, adopted the definition of capital developed by the European Economic Community (EEC) Banking Advisory Committee, and satisfied the German policy preference. This resulted in the soft and shallow 1988 Basel Accord.

With the Basel Accord in hand, the Fed argued before the US Congress that the failure of all US bank regulators to adopt it would have severe repercussions for the competitiveness of US banks. The Fed did not publicly add that a risk-based capital standard on the bank holding companies under its supervision would shape the regulation of subsidiaries supervised by the other US regulators. As expected in a fragmented state, the Fed had to compromise with the FDIC and add a risk-insensitive leverage ratio (preferred by the FDIC) in order to implement the overall risk-based standard.

The two-step theory also predicts the form and substance of the 2004 Basel II standard for internal ratings-based capital requirements. Dissatisfied that the 1988 Accord was not risk-sensitive enough, Fed Chairman Alan Greenspan sought an internal ratings-based approach to capital adequacy, a position opposed by the FDIC and OCC. Faced with this domestic opposition, the Fed again pursued a soft standard at the Basel Committee in the late 1990s and early 2000s.

Substantively, German officials again opposed a significant change to the international status quo, this time on the scope of the internal raings-based capital standard. Acceding to German preferences again, the Fed agreed to build a complex, detailed framework in the

2004 Basel II agreement applicable to *all* banks, despite the Fed's intention to apply only a portion of the revised capital rules to large, internationally active US banks. Fooled once, but refusing to be fooled again, the FDIC and OCC strongly resisted implementing the Basel II standard. The US had still not implemented Basel II by the time global financial turmoil began in 2007.

As my synopsis above indicates, bargaining at the Basel Committee has never been a costless process for the well-resourced, first-mover Fed. This is because of the Basel Committee's open decision-making rules. Each time, the Fed and its usual ally, the Bank of England, have had to satisfy the preference of the Committee's most recalcitrant (and coordinated) members—the German Bundesbank and BaKred banking regulator (now BaFin)—that over the decades have consistently preferred to defend the status quo and, as a coordinated state, preferred to influence international standard-setting through legally binding EU directives.

In the conclusion, I consider a number of alternative explanations for the form and substance of the Basel capital standards. The rationalist/legalization perspective does not produce a clear prediction for form, whereas arguments based on market power predict substantively deep (instead of the observed shallow) standards. Private-sector influence and domestic constraints on US and German officials do not appear to affect the substantive outcome. I also tentatively explain how the case of Basel III (negotiated in 2010) provides further, albeit preliminary, support for the two-step theory. Considering the extent of US regulatory fragmentation and the openness of Basel decision-making rules, this "most-likely" case does not sink the two-step theory.

I. Fragmentation reigns: US banking regulation and the lack of a common capital adequacy approach

In the United States, banking regulators and industry associations operate in an extremely fragmented structure. Numerous federal regulators compete with each other to set prudential standards for a variety of banks: national banks, state-chartered banks, bank holding companies (a corporate structure allowing a single financial institution to own several banks), community banks, housing finance lenders, and even “shadow banks,” such as companies running money market funds. Further, each state has its own banking supervisor. This section details the regulatory structure in which the long-running battle to set capital adequacy standards took—and continues to take—place.

The 1930s New Deal financial reforms purposefully entrenched a fragmented structure that has conditioned decades of antagonistic interaction among regulators, as well as between regulators and banks. The FDIC was formed after small depositors lost savings of over $800 million during the Great Depression.[97] In addition to operating the deposit insurance fund, the FDIC also supervises state-chartered banks. The FDIC joined the OCC as a federal regulator, which had been formed in 1863 as an independent bureau within the Treasury Department to charter and supervise national banks. The Board of Governors of the Federal Reserve (the “Fed”) was created in 1913 to serve as both an independent central bank and regulator of bank holding companies (BHCs) and state-chartered banks that are also members of the Federal Reserve System. The Fed is itself further fragmented through the existence of twelve regional Federal Reserve Banks.

The New Deal not only added the FDIC as another major banking regulator, but also stimulated fragmentation in US financial markets through the Glass-Steagall Act. The Act separated commercial from investment banking within the same firm: thus, investment banks were prohibited from accepting deposits and commercial banks were prohibited from underwriting securities on their own accounts.[98] Yet, the Act contributed to decades of regulatory arbitrage as banks and securities firms found loopholes to evade restrictions both on the services they could offer to corporations and households and on where they could offer those services.

[97] Busch (2009): 40. These losses were equivalent to $6 billion in 1990 dollars.

[98] Coleman (1996): 166. However, commercial banks were still allowed to underwrite government and Eurodollar securities.

For example, the rise in the 1970s of money market mutual funds, which paid higher rates of return than commercial bank deposit accounts and offered check-writing services, led commercial banks to intensify lobbying of federal regulators so that they could offer non-depository services (such as municipal bond brokerage, commercial paper, and securitization) and form branch networks across state lines. The concomitant growth of bank holding companies bolstered the Fed's regulatory influence; by 1977, BHCs had become dominant firms by "owning or controlling one-fourth of all commercial banks in America and controlling two-thirds of all banking assets and deposits."[99]

Banks took advantage of the competition among regulators through charter-switching. US banks can choose which regulators supervise them—a choice that, as some have long cautioned, can result in regulatory laxity. For example, on the issue of capital adequacy, US Senator William Proxmire questioned a defensive Comptroller of the Currency James Smith in the 1970s: "Don't these figures confirm that your office is more lenient as far as capital adequacy is concerned? … And they [OCC-supervised banks] have that advantage in aggressiveness because you have followed a policy of permissiveness in capital adequacy."[100]

After the 1970s, the regulatory dominoes fell quickly. In 1982, commercial banks could finally offer money-market deposit accounts,[101] and the FDIC allowed state-licensed banks to open subsidiary securities firms. Soon after, the Fed permitted subsidiaries of BHCs to underwrite corporate debt and securities.[102] By the start of the 1990s, 92 percent of banks were owned by BHCs, permitting firms to offer mortgage lending, data processing, and investment management advice.[103] In 1994, geographic restrictions on branching and

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[99] GAO (1977): 20.

[100] GAO (1977): 47.

[101] Garn-St. Germain Depository Institution Act.

[102] These so-called "Section 20 subsidiaries" were, however, not allowed to earn more than 10 percent of the BHC's gross revenues. 1987 Supreme Court ruling in *Securities Industry Association v. Board of Governors of the Federal Reserve System*.

[103] Heffernan (2005): 248.

mergers were lifted.[104] In 1999, the Gramm-Leach-Bliley Act confirmed what had already become a market reality by eliminating the Glass-Steagall restrictions on banking, securities, and insurance activities within a single corporate structure. By the end of the twentieth century, fifty years of banking deregulation led to the virtually complete lifting of geographic and market restrictions for US financial firms. Such deregulation occurred not in a single "big bang," but through the accretion of legislation, judicial decisions, and regulatory statutes.

Despite the financial conglomeration spurred by the downfall of Glass-Steagall, the US banking industry remains highly competitive and fragmented. 8,000 banks exist in the United States and even the largest—JP Morgan Chase—holds assets approximating only 15 percent of US GDP; in the UK, the Royal Bank of Scotland holds nearly 120 percent, and BNP Paribas holds 140 percent in France.[105] The intermediation of commercial and investment banking interests occurred in a legalistic, arm's-length way reflective of the fragmented institutional structure.

This market and regulatory fragmentation makes coordination among actors difficult. It especially brings to mind Robert Kagan's description of how "the American political system articulates and implements those policy ideas in a way that encourages adversarial, legalistic modes of decision making … [resulting] in enormously costly, time-consuming, and erratic policy implementation and dispute resolution" conducted in the shadow of the courts.[106]

Fragmentation has proved durable. Efforts to reform the fragmented regulatory structure have consistently failed over the past 100 years. By 1977, various legislators and regulators had already issued twenty-three proposals over the previous six decades to consolidate regulatory and supervisory functions.[107] In 1994, President Bill Clinton proposed

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[104] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

[105] From annual statements as of September 21, 2010, retrieved on Capital IQ. 2010 GDP figures from CIA World Factbook.

[106] Kagan (1991): 370.

[107] GAO (1977): 6.

consolidating the OCC, Federal Reserve Board, and the FDIC into a single regulator, the Federal Banking Commission. The proposal got nowhere.

In the aftermath of the 2008 financial crisis, Senate Banking Committee Chairman Christopher Dodd proposed stripping the Fed of its regulatory portfolio, and creating a new consolidated supervisor responsible for overseeing banking, securities, and insurance activities. The Dodd-Frank Act did establish the Financial Stability Oversight Council to identify emerging systemic risk, but failed to consolidate existing regulators.[108] As one congressional staffer recalled, "No one else supported Dodd's proposal, except for [Republican ranking member Richard] Shelby. Some members were concerned that community banks would face higher standards. We [staffers] were concerned about taking the Fed out of regulation, since their role in monetary policy does give them insight."[109]

Reflecting the variety and multitude of US banks, many industry associations interact with the fragmented regulators. Each association separately competes for membership and resources, while none have a monopoly on representation of firms' interests in lobbying regulators. Founded in 1875, the American Bankers Association (ABA) is the most prominent and is often successful in maneuvering through regulators' turf wars. "Some [regulatory] agencies are more sympathetic than others, though everywhere there is a populist sentiment that we are greedy bankers," said a senior ABA official.[110]

The ABA competes with the Independent Community Bankers of America (ICBA) to recruit smaller banks as members. Bank holding companies and affiliated regional banks are represented through their own associations, while others represent foreign firms. The Financial Services Roundtable is composed of the country's largest banks, securities, and insurance firms. Minorities and women who own small banks can join the National Bankers' Association, while Internet banking holds its own in the Online Banking Association. Although representatives of some associations, such as the ABA and ICBA,

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[108] The Act did abolish the Office of Thrift Supervision.

[109] Interview with Ellen Chube, Washington, DC (8 September 2010).

[110] Interview with Mary Frances Monroe, Washington, DC (8 July 2010).

consistently testify before Congress, there is no legal requirement for industry associations to be incorporated in the policymaking process. Unlike in France and Germany, there is no national, peak-level industry association that has a monopoly on the representation of banking interests in the United States.

In sum, the US banking structure is fragmented. Numerous federal regulators set differing prudential standards for banks under their supervision. Despite the presence of several large banks that operate in both banking and securities markets, the depth and diversity of the US banking market is reflected in the many industry associations whose fragmented representation of banking interests means that no single industry voice exists on any given issue.

A brief note on capital

What is the function of capital and why are capital requirements important? Capital is available for a bank to draw upon to meet unexpected asset losses during difficult times, such as if its borrowers begin to default on loans; the bank then draws upon the capital it has set aside for those adverse circumstances. Generally, capital helps protect a bank's depositors and creditors from losses. Shareholders are not usually repaid with this capital cushion because, ideally, they bought shares of the bank knowing the risks of ownership. The capital adequacy ratio is defined as the amount of capital divided by assets; a risk-based ratio means the assets are risk-weighted, e.g. a mortgage loan with a risk-weight of 50% requires half as much capital backing it as a corporate loan with a risk-weight of 100%. These risk-weights can be fixed (as in the 1988 Basel Accord) or internally calculated by banks (as in Basel II and III).

The purest form of capital, and one that figures prominently in the debate over the 1988 Basel Accord, is common stock ("common equity"): it does not have to be repaid to investors; there are no periodic dividend or interest payments to investors; and, it ranks last in priority to claimants during bankruptcy.[111] There are many variants of capital, however, including preferred stock ("preference shares," "preferred shares"), which resemble debt and equity to different degrees. Generally, as one deviates from common equity, the strictness of terms on repayment, dividends, and claims is weakened. Capital set aside to absorb losses is arguably unavailable to be invested, possibly reducing the amount of lending to firms and individuals. A bank can also raise more capital by issuing equity or debt, as well as by retaining earnings.

Common equity is the most readily available form of capital during a crisis. However, a bank is also incentivized to hold a low level of capital (and common equity in particular) to produce a greater return for shareholders. This private decision by a bank, motivated by profit, can have systemic consequences that it does not take into account, possibly harming customers and counterparties, leading to a cascade of runs and failures. The bank does not internalize this potential social cost (negative externality) in its decision-making; that is the role of regulation.

A tenuous domestic regulatory status quo: lack of a single US approach to bank capital adequacy

Throughout their history, the Fed, FDIC, and OCC have had differing views on how to regulate and monitor the capital adequacy of banks.[112] At the start of the 1980s, there was no single, legally defined standard on bank capital. The General Accounting Office (GAO) described it as "somewhat of a legal vacuum … While State and Federal laws generally prescribe minimum initial capital requirements, they do not dictate how a bank's capital must increase as its assets and liabilities grow."[113] Given the lack of a single approach to capital adequacy, each regulator applied its own discretion in monitoring levels of capital in the banks under its supervision.

[111] Elliott (2010).

[112] See Alfriend (1988).

[113] GAO (1981): 21.

The Fed, FDIC, and OCC disagreed on what defined capital, how much was sufficient, and how other factors related to a bank's solvency or liquidity (such as management or earnings) should be considered alongside capital. In the 1960s, the OCC decided to allow subordinated debt to count as part of capital, despite its providing less loss absorbency than equity capital; however, the OCC justified its decision as part of a move to a more holistic capital adequacy approach that also considered management, asset quality, and earnings trends.[114] The FDIC similarly allowed subordinated debt to constitute part of capital, whereas the Fed defined capital as equity plus some loan-loss reserves. Further, the Fed made a distinction between risky and non-risky assets, which it had done since the 1940s, when commercial banks made large purchases of US government debt, which the Fed classified as non-risky in order to reduce banks' capital charges. In the 1970s, the Fed used two capital adequacy ratios that considered credit and market risks, and incorporated the FDIC's risk-insensitive capital to total asset and to total deposit ratios, while the OCC preferred to focus on other factors affecting bank solvency. None of the regulators specified a minimum capital level, but instead evaluated each bank individually with more concern focused on less-diversified, smaller banks.[115]

Was there an alternative to regulation based on capital and assets? Perhaps. Until World War II, capital adequacy was measured by a ratio of capital to deposits, though this failed to recognize changing asset portfolios and the risk of asset losses.[116] In the early 1980s, the FDIC supported a risk-sensitive deposit insurance system at the same time that it downplayed the efficacy of risk-based capital rules. The premiums charged to banks that subscribed to federal deposit insurance were fixed, rather than varying according to the riskiness of the bank's activities. To some extent, capital regulation and a variable premium approach were substitutable, as a "variable premium system would substantially reduce the

[114] Frederick R. Dahl, "Subordinated Debt in Bank Capital Structures in the United States" (1976), submitted to the Basel Committee. Reproduced in Goodhart (2011): 202-203.

[115] Alfriend (1988): 29.

[116] Dahl (1976) reproduced in Goodhart (2011): 199.

moral hazard involved in insuring deposits, thus eliminating one sort of justification for these rules and regulations [on capital]."[117]

It was clear that any regulation—whether a risk-based capital standard or risk-based deposit insurance standard—would have to be publicly and *not* privately run in the context of the fragmented US institutional structure. Regulators doubted the actuarial ability of banks to determine risk, while the government would still have to implicitly re-insure the private deposit insurers. Public-private cooperation would founder because "disputes would inevitably arise as to whether a particular bank failure was due to inept decisions by management or by national economic policymakers."[118] Regulators, legislators, and households would not have confidence in a private system. The issue of capital regulation and deposit insurance would have to be resolved by the regulators, who would consult, but not rely upon, industry associations.

Crisis finally compelled US regulators to move towards setting a common domestic standard on capital adequacy. In 1983, the Latin American debt crisis reduced major US banks' capital levels, which had already been in secular decline from 8.1 percent in 1960 to 5.8 percent in 1980.[119] As a result, Congress passed the International Lending Supervision Act (ILSA), and delegated responsibility for devising capital requirements to *each* regulator, as well as directing the Fed and Secretary of the Treasury to "encourage governments, central banks, and regulatory authorities of other major banking countries" to strengthen capital adequacy for internationally active banks.[120]

The Fed, FDIC, and OCC debated on a common approach to capital adequacy and arrived at a tenuous status quo. In 1985, the Fed issued guidelines that—at first glance—seemed to agree with what the OCC and FDIC also preferred: a primary capital to total assets ratio

[117] GAO (1981): 26.

[118] GAO (1981): 28.

[119] Alfriend (1988): 7.

[120] *ILSA (*1983).

of 5.5 percent and total capital to total assets ratio of 6 percent.[121] The OCC and FDIC intended the new ratios to be legally binding, especially after the OCC was sued in the *Bellaire* case (1983) over the extent of its authority to enforce capital adequacy.

However, the Fed was not satisfied with the common approach. The Fed insisted that the new capital ratios remain non-legally binding guidelines, which, it argued, would "give the Board [of Governors of the Federal Reserve] flexibility to adjust capital requirements and definitions to changes in the economy, in financial markets, and in banking practices."[122] Further, the Fed used a diluted definition of capital, allowing capital which was not permanent to count for BHCs. The Fed was well aware that it was acting out-of-step with the other regulators. In a March 1985 meeting, the Fed Board of Governors concluded their guidelines *before* Governor Charles Partee suggested consulting with the OCC and FDIC to see if the three regulators could coordinate.[123]

II. The Fed becomes dissatisfied—and incentivized to go global

The tenuous domestic status quo on the primary and total capital adequacy ratios lasted months before the Fed sought to change it. As part of his regular report on monetary policy in summer 1985, Fed chairman Paul Volcker obliquely testified before the Senate Banking Committee:

> I think there is a tendency, a kind of inherent difficulty, in the kind of capital ratios that we have announced and enforced, that what we consider a minimal kind of ratio regardless of their condition and the activities of the bank…. It begins to suggest in my mind—and we are working in this direction—a question as to whether we should supplement the overall minimum capital ratio with what might be thought of as a more sophisticated approach of assessing different kinds of balance sheet and off-balance sheet risks with respect to capital need.[124]

[121] Reinicke (1995). Primary capital was composed of common equity, perpetual preferred equity (a type of "hybrid capital"), retained earnings, loan-loss reserves, and a few other forms.

[122] Federal Reserve Board quoted in Norton (1988): 1329.

[123] Dow Jones (March 1985).

[124] US Senate (1985).

As the summer of 1985 drew down, the Fed, OCC, and FDIC still had not agreed on the merits of risk-based capital adequacy.[125] In January 1986, the Fed proposed risk-based capital requirements that categorized assets into four different buckets (cash, money market risk, moderate risk, standard risk); they were targeted at the largest banks with considerable off-balance sheet assets. The minimum total capital to assets ratio of 6 percent would be retained.

Industry associations predictably reacted to the Fed's proposal on the basis of whether their members' capital requirements would increase or decrease. The American Bankers Association (ABA), representing the largest banks, vigorously resisted Volcker's plan, voicing a common refrain that "the proposal may reduce banks' flexibility to lend to certain types of business due to their assessed risk by regulators."[126] The Independent Bankers Association of America (IBAA; predecessor to Independent Community Banks of America) was relatively pleased. The ABA found the OCC's regulations less onerous, while the IBAA was more supportive of the Fed's proposal, asserting "higher capital ratios for community banks have never been fair or justifiable."[127]

Volcker's most prominent opponent was not the ABA, but FDIC Chairman William Seidman. Seidman and his predecessor, William Isaac, pushed for risk-based deposit insurance premiums. Seidman flatly opposed risk-based capital requirements, arguing, "When you get into the question of risk and capital, you get into difficult ground. I'm not for regulators substituting their judgment for business people on what assets are riskiest."[128]

However, the FDIC *did not* view risk-based deposit insurance premiums as perfectly substitutable for capital requirements.[129] Isaac explained, "Banks taking outsized risks

[125] Forde (1985).

[126] Easton (January 1986).

[127] Quoted in Garsson (1986).

[128] Dow Jones (November 1985).

[129] This is contrary to Hemel (2009) who presents risk-based deposit insurance premiums as a straightforward policy alternative to risk-based capital requirements.

ought to pay more for deposit insurance premiums. I did not think it would be a panacea because deposit insurance costs are not nearly high enough to cause big behavior changes even if they are risk based. But I thought it was a step in the right direction and would help some."[130]

The FDIC favored its risk-based approach to deposit insurance premiums with risk-insensitive capital ratios as supplementary tools. The Reagan Administration agreed with Seidman that risk-based rules would dictate credit allocation. The Justice Department, siding with the ABA, asserted that risk-based capital requirements would not be as effective as risk-based deposit insurance.[131] The OCC straddled its two regulatory counterparts, content with some combination of both risk-based deposit insurance premiums and capital requirements.[132]

This debate in the first half of the 1980s on capital adequacy occurred in the midst of a maelstrom about the future of the US banking regulatory structure. Vice President George H.W. Bush proposed stripping the Fed of most of its regulatory portfolio, leaving it responsible for overseeing only the largest bank holding companies (BHCs). In its place, Bush favored the creation of a Federal Banking Commission that would also overtake the OCC. Although the plan was "all but forgotten" by the end of the 1980s,[133] it was taken extremely seriously at the time by the Fed—and Paul Volcker vigorously fought back.

In a winter 1984 meeting, FDIC Chairman William Isaac was flabbergasted, not expecting Volcker to have been so persuasive in diluting Bush's proposal. The ensuing "yelling, bickering and wild accusation were so heated that … Bush finally gave them all a blistering for their backbiting and bureaucratic rivalries."[134] The ABA and Association of Bank Holding Companies lined up behind the FDIC and OCC, while the IBAA, appreciative of

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[130] Interview with William Isaac, email (23 February 2011).

[131] Langley (1986); Easton (May 1986).

[132] Naylor (1985).

[133] Garsson (1988).

[134] Anonymous quoted in Langley (1985).

the stringent supervision the Fed applied to the largest banks, supported Volcker.[135] Volcker persuaded the Reagan Administration to leave alone the Fed's powers—and the proposal later died in Congress. For Volcker, it was an institutional as well as an ideological victory at the time: punting the Fed's regulatory role would have ceded authority to the deregulatory-minded FDIC and OCC.[136]

In sum, in the early and mid-1980s, discord rang throughout the fragmented US banking regulatory structure. The domestic regulatory agenda was far from settled, as the Fed held back from converging with the capital adequacy approach of the FDIC and OCC. The Fed did not see risk-based deposit insurance premiums as an answer to the secular decline in the capital ratios of large US banks, which had also been battered by the Latin American debt crisis. But, the Fed was opposed by its fellow regulators, the ABA, and the Reagan Administration, and there was no encompassing industry association with which the Fed could cooperate to leverage influence. Not only that, but the FDIC and OCC campaigned to strip the Fed of its regulatory portfolio. Only the community bankers, glad to see the largest banks under scrutiny, cheered on Paul Volcker. For Volcker and the Fed, these were the roots of dissatisfaction.

Threats to its policy preferences and autonomy incentivized the Fed to pursue a non-legally binding international capital standard. By helping to forge a non-legally binding risk-based capital standard, the Fed would box in the FDIC and OCC to accept one of two options: either significantly damage interagency relations and American credibility abroad *or* accept an international standard on risk-based capital adequacy. A risk-based capital standard applied to the Fed-supervised bank holding companies would also dictate the capital management of these BHCs' subsidiaries supervised by the FDIC and OCC, thus expanding the Fed's regulatory mandate.

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[135] Carrington (1984).

[136] The Fed was under heavy criticism for pursuing restricting the growth of non-bank banks, which took advantage of legal loopholes to evade product and geographic restrictions. Murphy and Moore (1985); Whiting (1985).

The Fed faced excessive costs if it pursued a legally binding international standard. Operating on a short time horizon, the Fed could ill afford protracted treaty-style negotiations. Although nothing specifically precludes the Fed from seeking a legally binding international standard,[137] in the absence of a prior domestic regulatory consensus, any attempt by the Fed to negotiate a legally binding agreement would have been politically mobilizing and required pre-negotiation interagency coordination with not only other regulators but also the Department of State. Moreover, any final agreement would be subject to legislative ratification at home. The Fed preferred soft law.

III. The Basel Committee: international focal point standard-setter

What international institutional possibilities existed for the Fed? In the area of banking regulation and supervision, there was little doubt which standard-setting body would be most suitable. From its outset in the mid-1970s, the Basel Committee on Banking Supervision sought to be *the* forum for the exchange of information and site of bargaining for gradual convergence on cross-border banking issues, such as home and host supervisory cooperation on insolvency and capital requirements. In this section, I provide a brief institutional portrait of the Committee.

The Basel Committee's bargaining rules are consensus-based and, given the small number of members (until the expansion of members for Basel III negotiations), decision-making has rested on unanimous consent. With a supportive Secretariat, considerable resources and information, and the ability to facilitate the negotiation of non-legally binding standards, the Basel Committee offered an appealing soft, focal point standard-setting institution for the Fed in its international pursuit to set the US regulatory agenda on capital.

The Basel Committee was, at first, a European creature. In early 1972, Belgian and Dutch central bank officials agreed that "it was a pity that there was no place where international

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[137] Not-for-attribution interview with Federal Reserve official (20 September 2013).

supervisory issues could be discussed by those concerned."[138] They suggested the new committee, called the *Groupe de Contact*, consist of the six EU Member States at the time (Belgium, France, Germany, Italy, Luxembourg, Netherlands), as well as the four candidate EU states (UK, Denmark, Ireland, Norway); the US and Switzerland would not yet be offered membership. The second item on the first agenda was capital requirements.[139]

When Fed officials learned of the *Groupe de Contact* in 1974, they pushed for a meeting of central bankers and financial supervisors not only from the EU states, but also Canada, Japan, Switzerland, and the US. This helped prompt the G-10 central bank governors at the Bank for International Settlements (BIS) in December 1974 to create the Basel Committee on Banking Supervision. In response, the European Commission, which had been involved with the *Groupe* but would not be a member of the Basel Committee, formed the European Economic Community (EEC) Banking Advisory Committee, which would seek legally binding standards on banking regulation.[140]

The Bank of England was a key proponent of the new Basel Committee. Given that the City of London had become an important host jurisdiction—especially for the Eurodollar market that benefitted from low interest rate regulation in the United States—the Bank had strong interest in avoiding paying for the failure of foreign banks in London. The Bank of England's George Blunden was named first chair of the Basel Committee; he simultaneously served as head of the Bank's Banking and Money Market Services supervisory department, which had just been created in early 1974.[141]

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[138] Herman Baeyens, then Deputy Director of the Commission Bancaire in Belgium, telephone call, 25 February 1972, quoted in Goodhart (2011): 13.

[139] Quoted in Goodhart (2011): 14.

[140] Although the G-10 Governors invited Switzerland and Luxembourg to join the Basel Committee, they did not invite Ireland or Denmark, which had been members of the *Groupe de Contact*. Goodhart (2011): 24, 45.

[141] Goodhart (2011): 43.

There was no doubt on the part of the G-10 Governors or the members that any standards promulgated by the Basel Committee would be non-legally binding. As Charles Goodhart puts it, "The legal status of the BCBS is simple to discuss; it had none."[142] Since its founding, the Committee has not attached legal obligations to any of its standards or principles:

> The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems.[143]

Mario Giovanoli, former General Counsel of the BIS, states that the standards issued by the Committee "become legally binding only once they have been transformed into domestic law, and at the level of international law, no formal commitments are entered into within the standard-setting bodies that the standards will be turned into formal legal rules."[144] This, however, does not mean that a Basel standard is necessarily ineffective; it can have the "character of substantive rules of law," with a specificity and degree of precision that allow for transposition into domestic law.[145]

In the 1980s, the Basel Committee did not have a compliance mechanism—other than moral suasion or peer pressure—to ensure the adoption of its standards or principles. The International Monetary Fund (IMF), the organizational product of the legally binding 1945 Articles of Agreement, was disinterested in international financial regulation until the East Asian financial crisis of 1997-1998; indeed, before the late 1990s, the only formal

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[142] Ibid.: 542.

[143] Basel Committee, "History" (1 July 2011).

[144] Giovanoli (2000): 35.

[145] Ibid.: 40.

collaboration between the IMF and Basel Committee came in 1983 when an IMF official discussed new lending trends by major banks in emerging markets.[146]

However, the IMF nearly did set the Basel Core Principles, a collection of principles and standards that was requested by the G-7 heads of state in the mid-1990s. The IMF was beginning to monitor the banking supervisory standards and practices of its member states, and required a rulebook. The Basel Committee chairman at the time stated in a memo to other Committee members: "It would clearly be an enormous task to develop agreed practices/rules in each of these areas, even at a fairly superficial level. The problem is that, if the Basle Committee does not do so, the IMF says it might."[147] Instead of taking over financial standard-setting, the IMF and World Bank established the Financial Sector Assessment Programme (FSAP) to monitor implementation of 12 key financial standards and codes, including the Basel standards; yet it is still virtually impossible to sanction non-compliance (outside of traditional conditionality) because the FSAP did not come with an attendant agreement on enforcement.[148]

The Basel Committee operates according to open decision-making rules that effectively require unanimity both at the Committee and subcommittee or working group levels. Current subcommittees include the important Policy Development Group, under which fall several working groups that take up discussions that can evolve into standard-setting negotiations, e.g. on risk management and modelling, definition of capital, and liquidity. Formed at the initiative of members, these working groups are pivotal in crafting much of a proposed standard. As one former US member describes it:

> Few decisions are taken by the full committee. There is an issue from one of the

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[146] The paper discussed was "New international lending by banks: the interests of the supervisors and of the IMF," BS/83/49, 29-30 June 1983. Goodhart (2011): 438.

[147] The areas included: financial disclosure and accounting, loan valuation; supervision of cross-border banking, prudential rules (including capital standards), and authority of national supervisors. Tommaso Padoa-Schioppa, "Note by the Chairman: 12th September Conference," BS/96/80, 12 September 1996, reproduced in Goodhart (2011): 463-4.

[148] Helleiner (2011): 10.

> working groups discussed by the full committee. We go around the table and read prepared statements mostly. No votes are taken. The chairman would summarize and define the consensus. The real substantive structuring is done in the task forces and working groups. By the time it got to the full committee, the die had been cast.[149]

If a common position cannot be found, then the matter is dropped. Thus, each member holds a veto. Yet, in reality, in his reading of the Committee's records, Charles Goodhart finds:

> The smaller countries, for example, Benelux, Canada, Italy, Sweden and Switzerland, were averse to making waves, and would rarely take a minority position…. Despite its economic and financial scale, the Japanese representatives on the BCBS usually remained quiet and withdrawn, again partly due to the rapid turnover of personnel, so they had little opportunity to build up expertise.[150]

If the Committee finds agreement on standards, principles, or guidelines, it submits them to the upper level "G" group of central bank governors and heads of supervision (GHOS),[151] which have responsibility for implementation. Although the central bank governors and financial supervisors could refer a submitted standard back to the Committee for re-consideration, this does not happen in practice. Instead, the GHOS can provide impetus to and clarification of the Committee's agenda.

Most states send two representatives to the Basel Committee; depending on the domestic regulatory structure, this means one official from the central bank and the other from the bank regulator. In the early 1980s, as now, the US was an exception: the Fed sent one representative from the Board of Governors in Washington, DC and the other from the New York Fed, which carries out the Board's open market operations and is attuned to international developments. The OCC gained representation in 1978 at the invitation of

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[149] Interview with John Hawke, Washington, DC (29 March 2011).

[150] Goodhart (2011): 547.

[151] At the time of the 1988 Basel Accord, the relevant group was the G-10 Governors, who have been expanded into the G-20 Governors and Heads of Supervision (GHOS).

the Basel Committee, while the FDIC gained a seat in 1984. Germany was also an exception in sending at least three representatives to each meeting: two from the Bundesbank and one from the BaKred banking regulator.[152]

The Fed's first move at the Basel Committee

At the Basel Committee in the mid-1980s, the Fed found major European states considering the feasibility of moving to an EU common risk-based capital adequacy ratio, which the Fed sought to implement in the US over the objections of the OCC and FDIC. Before the Fed made its move in 1984, the members of the Basel Committee had made virtually no progress on negotiating the crucial substance of the standard: the definition of capital.[153]

Involved with the Basel Committee since the mid-1970s, the Fed was familiar with the progress on risk-based capital requirements achieved by the Committee's Secretariat. Indeed, one of the first papers circulated among the Committee in 1975 included "[r]ules and practices to protect the banks' solvency and liquidity" that demonstrated how countries such as Germany and the Netherlands used risk-based ratios, whereas the US, UK, and Canada did not use formal statutory ratios.[154] Between 1980 and 1982, the Committee slowly moved towards beginning negotiations on a standard by agreeing that there should be "achievement of some greater convergence in national definitions of bank capital" and, in principle, endorsed the use of risk-based ratios.[155]

As a follow-up to the Committee's high-level agreement to continue work on an international capital adequacy ratio, the Fed's Frederick Dahl led a working group of

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[152] Goodhart (2011): 69-70.

[153] In this chapter's examination of the bargaining over the 1988 Basel Accord, I focus on the negotiations over the definition of capital, which was far more contentious than risk-weighting issues.

[154] Reproduced in Goodhart (2011): 197.

[155] Secretariat paper, BS/82/39, 24-25 June 1982, reproduced in Goodhart (2011): 150.

members from Belgium, France, Germany, and the UK to work on the definition of capital and decide on the appropriateness of a risk-based or risk-insensitive ratio.

When it reported to the rest of the Committee in autumn 1983, the Dahl Group had made only minimal progress. It agreed on what constituted the highest quality capital, but could not determine whether other, lesser forms of capital should be included in the Basel Committee's definition; it did, however, propose a set of risk weights for use in a risk-based ratio, demonstrating that the capital definition issue was considerably more contentious and crucial to the eventual achievement of a standard.[156]

The Committee was at a standstill by early 1984. In a letter to Karl Otto Pöhl, chairman of the G-10 Governors and of the German Bundesbank, Basel Committee chairman Peter Cooke was pessimistic:

> I might also mention that the Committee is continuing to pursue its efforts to promote some greater degree of convergence in capital requirements for international banks than is currently evident from the enclosed paper…. I have to say, however, that it does not seem to me that this work will be either easily or quickly accomplished.[157]

Yet, just eleven days later, on 12 March 1984, Paul Volcker and the Fed injected a new sense of urgency into the Committee's work. Given ongoing disagreements with other US regulators on capital standards *and* on the heels of the Reagan Administration's proposal to diminish the Fed's regulatory portfolio, Volcker expanded the subject of his paper presentation at the Committee from judging capital adequacy during cross-border bank mergers to:

> the need generally to harmonise capital adequacy measurement techniques and improve the general level of capital adequacy in major banks around the world…. [He] suggested the work already being undertaken on these matters by the

[156] BS/83/10 and BS/83/30, partially reproduced in Goodhart (2011): 152-3, 207.

[157] Peter Cooke, letter to Karl Otto Pöhl, 1 March 1984, BS/84/27, quoted in Goodhart (2011): 154.

> supervisors in Basle should be given a new impetus by the Governors. In particular, he asked whether some measure of 'functional equivalence' could be devised on capital measurement to overcome national differences and allow a commonly agreed quantitative guideline for capital adequacy.[158]

Volcker persuaded his fellow G-10 Governors to issue a mandate to the Basel Committee to continue its work on a non-legally binding bank capital standard. Yet, the Committee's Secretariat could do no more than what members preferred over the course of 1984 and 1985. The Committee had on the table a five-tiered definition of capital, but it did not indicate the extent to which banks would be mandated to hold each type, ranging from high-quality equity capital to low-quality subordinated debt.[159]

Despite the G-10 Governors' mandate, it appeared no international standard from the Basel Committee would be forthcoming—unless the Fed continued to push the matter. The G-10 Governors preferred to let the Committee handle the detailed substance of standard-setting, as Cooke indicated: "I received no firm steer from Governors on the desirability of pressing forward to greater convergence of capital adequacy levels internationally."[160]

By mid-1986, members of the Committee had not yet engaged in serious negotiation and compromise on the definition of capital. Several of the European members preferred the *Groupe de Contact* and EEC Banking Advisory Committee, which had been working on a common EU capital adequacy ratio since the early 1980s, over the G-10 Basel Committee.[161] The time had come for the Fed to initiate and drive standard-setting at the Committee.

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[158] Peter Cooke, report of Committee meeting, BS/84/31, quoted in Goodhart (2011): 155-6.

[159] "Elements of capital in a tiered framework," BS/84/73, reproduced in Goodhart (2011): 161.

[160] Peter Cooke, record of G-10 Governors meeting, 10 March 1986, BS/86/27, quoted in Goodhart (2011): 163.

[161] Basel Committee on Banking Supervision, "Report on International Developments in Banking Supervision: 1982," March 1983, referenced in fn. 7 on Goodhart (2011): 152.

IV. Bargaining

In this section, I demonstrate how the US Federal Reserve, as first-mover, negotiated a non-legally binding risk-based capital standard at the Basel Committee. The final standard was shallow (low change from status quo) because of open decision-making rules and a recalcitrant actor mostly satisfied with the international status quo: Germany (specifically, the Bundesbank and BaKred). I focus on the bargaining over the definition of capital, which can be considered on a policy space running from stringent to lax.[162] I then discuss the international status quo on the definition of capital, which was the most stringent definition; disputes between regulators arose on what types of capital other than equity[163] should be included in the definition.

As the two-step theory in Chapter 2 proposes, in an institution which uses open rules, the actor closest to the status quo determines the substance of the standard. I describe the Fed's preference for the capital definition, and the reasons for and the substance of the German preference close to the international status quo. I then outline how the Fed and its ally, the Bank of England, pushed a proposal that did not quite move all the way to the German preference, but made it indifferent between the status quo and the proposed definition.

Despite the number of members of the Committee, the focus on the Fed and German representatives is justified given that "in practice much of the hard work of the Chairman [of the Basel Committee] would lie in reconciling the positions of the US and German representatives with that of the BCBS as a whole."[164] Upset that the rest of the G-10 settled on a capital definition less stringent than their own, German representatives could

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[162] The capital adequacy ratio is equal to capital divided by risk-weighted assets. The debate on what constitutes capital (numerator) was far more contentious than the risk weights assigned to various types of assets (denominator).

[163] "Equity" here means common equity and also types of capital with same loss-absorbent capacity as equity, such as retained earnings.

[164] Goodhart (2011): 547.

have opposed the final standard; instead, they made their objections known but did not scuttle what became the 1988 Basel Accord.

International status quo

The status quo is the international policy outcome which would occur if bargaining failed to produce agreement among actors. In this case, it meant that national central bankers and financial supervisors would continue to rely on only the most stringent definition of capital in order to compare capital levels across cross-border banks and foreign banking systems. These were essentially outlined by the Dahl Group in 1983 and the Committee's Secretariat by the end of 1984.[165] The status quo capital definition included equity shares ("issued and fully paid ordinary shares"), preferred shares that could not be redeemed, share premium (the difference between the price of shares and what a shareholder paid for them), and retained earnings.

Less stringent or more lax definitions than the status quo included varieties of capital that were not recognized across countries. For example, Germany, Italy, and Japan did not recognize subordinated debt (which the US did), while neither Germany nor the US recognized asset revaluation reserves, which Japan did (and which were especially beneficial, given banks' gains in the booming Japanese stock market at the time).[166]

If the Basel Committee did not issue an international standard, then it was likely that a European standard would eventually set the *de facto* international standard as part of the implementation of internal capital market reforms associated with the Single European Act. It was clear that some European central bankers and regulators preferred that the Basel Committee's nascent debate on a standard did not undermine discussions within the EU: "the importance of trying to carry forward work in this area in Basle while being

[165] Goodhart (2011): 152, 161.

[166] Kapstein (1994).

mindful of the EEC work was mentioned by more than one Governor" to Basel Committee chairman Peter Cooke.[167]

By mid-1984, the EEC Banking Advisory Committee had firmly committed to a risk-weighted assets ratio, instead of a risk-insensitive leverage ratio, and proposed a series of weights that determined capital charges for different types of assets. For example, government and government-guaranteed securities had a risk-weighting of 0 percent, which meant a bank did not have to hold any capital to absorb unexpected losses in holdings of sovereign debt.[168] However, the EEC Banking Advisory Committee had not yet achieved a consensus on how to define capital because of German insistence on a stringent definition, contrary to French and Italian preferences for a laxer definition.

Although German and French officials (in addition to the Netherlands) were firmly committed to the EEC Banking Advisory Committee, one major European player was not: the Bank of England. The Bank of England had been working on risk-based capital requirements since 1975, when a Joint Working Party of the Bank of England and the major clearing banks, such as Barclays, discussed the nature and assessment of capital. After the Banking Act of 1979, the Bank issued another paper which defined capital more precisely, outlined specific credit, investment, and forced sale risks, and assigned corresponding risk weights.[169]

US preference for capital definition and UK support

Aware of the Bank of England's objections to the emerging German-preferred EU capital standard, the Fed's Paul Volcker reached out directly to Bank Governor Robin Leigh-Pemberton at a dinner in Leigh-Pemberton's home on 2 September 1986.

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[167] Peter Cooke, report of Committee meeting, BS/84/31, reproduced in Goodhart (2011): 156.

[168] "Comparative weights of calculating capital ratios," Chairman's note, June 1984, reproduced in Goodhart (2011): 208.

[169] Bank of England (1980).

Volcker and the Fed found company in their foxhole. The Bank was under pressure in the aftermath of the Johnson Matthey Bankers crisis in 1984;[170] Leigh-Pemberton had noted that "time is relatively short" for financial regulatory reform in the City of London,[171] where the Bank of England encountered major UK industry opposition as it tried to account for off-balance sheet activities in capital regulation. Moreover, HM Treasury had already drafted capital adequacy rules to be incorporated as part of the 1987 Banking Act, which would supersede the 1979 law that the Bank had crafted. And most importantly, Chancellor of the Exchequer Nigel Lawson considered removing the regulatory portfolio from the Bank of England.[172]

The Fed and Bank of England largely agreed on how to define capital. Officials from both central banks were very amenable to hybrid capital, given that subordinated debt comprised substantial parts of US and UK banks' capital structures. How did the Fed and Bank project their preferred capital definition to the rest of the G-10? Battling the FDIC and OCC in January 1986, the Fed issued its "trial balloon" proposal in the US that included a number of lower-quality instruments, such as limited life preferred shares and convertible debt.[173] This proposal indicated that the Fed would push the Basel Committee to produce a risk-based ratio with a somewhat lax capital definition.

The Bank of England commented extremely favorably on the Fed's domestic proposal, which was—finally—the opening salvo that would initiate serious bargaining at the Committee. The Bank noted that the Fed's trial balloon proposal was very similar to the Bank's 1980 supervisory guidelines on capital, which it applied on an individual bank basis.[174] The Basel Committee was also receptive; as Chairman Peter Cooke noted, "members of the Basle Supervisors' Committee generally welcome the general thrust of the

[170] An important player in the London gold market, JMB overextended its lending to a concentrated number of less-than-creditworthy clients.

[171] Quoted in Lascelles and Montagnon (1985).

[172] Solomon (1995).

[173] Smith-Sands (1986): 7, 19-20.

[174] Bank of England, response to the Fed, BS/86/52, May 1986, cited in Goodhart (2011): 165.

[Federal Reserve] Board's proposals which are seen to be in harmony with evolving views and practices elsewhere."[175]

In early 1987, the Fed and Bank of England negotiated a bilateral accord on risk-based capital regulation with both a definition of capital and series of risk-weights. It was a maneuver to cajole the Committee into adopting a standard along Anglo-American lines.[176] Jacques Delors, President of the European Commission, complained to Basel Committee chairman Peter Cooke and to the press that the US-UK agreement was *non-communitaire*: "Where the Commission has competence, bilateral accords with third countries violate Community law."[177]

However, the difference between the capital definition outlined in the 1987 US-UK Accord and what the Basel Committee Secretariat had drawn up by mid-1986 was actually minimal. The US-UK Accord was laxer in terms of including general provisions and hidden reserves without limit (Tier 4 and Tier 2 in the BCBS framework, respectively), but also more stringent by deducting investments in other banks' capital instruments from the capital calculation.[178]

Therefore, the US Fed and the Bank of England, both eager to set a non-legally binding global standard on risk-based capital that could provide domestic political leverage, sought to change the international status quo. However, one key jurisdiction refused to receive the US Fed and Bank of England's proposal with open arms: Germany.

German preferences: a coordinated, single voice defending the status quo

[175] Peter Cooke, letter to William Wiles, BS/86/30, 16 May 1986, quoted in Goodhart (2011): 164-5.

[176] Duffy (1987).

[177] *Globe and Mail* (1987); *Financial Times* (1987).

[178] "The US/UK proposals for measuring capital adequacy," Secretariat note, BS/87/2, 13 January 1987, reproduced Goodhart (2011): 210-12.

This section details how Germany, as a coordinated state, formed a domestic regulatory consensus on bank capital that it sought to defend at the Basel Committee, where its preference lay close to the status quo of a stringent capital definition.

The failure of the Bankhaus Herstatt in Cologne on 26 June 1974 shocked German regulators and bankers into reconsidering the country's banking regulation. It would take a decade of deliberation to formalize a statutory response. In November 1974, an independent Commission of Enquiry on Basic Banking Questions was created and composed of a representative each from the Justice Ministry, Finance Ministry, BaKred, and Bundesbank; two academics; and, five representatives from the commercial banks, one from the savings banks, and one from the cooperative banks.[179]

But, it was the immediacy of another crisis in autumn 1983 that jolted the near-moribund process of reform and finally forced amendments to the 1961 Banking Law. The failure of Schröeder, Münchmeyer, Hengst (SMH) because of poor loans to affiliated companies in Luxembourg provided the impetus for stringent banking reform on balance sheet consolidation and tighter limits on capital exposures to single borrowers.[180]

Just because a state is coordinated does *not* mean that debate within it is harmonious. "Group competition" (*Gruppenwettbewerb*) between different industry associations prolonged the debate, as each tried to gain regulatory advantage. Cooperative banks had an advantage dating from 1934 over commercial and savings banks in their ability to draw on the uncalled liability of members—essentially "cost free" capital. Savings banks, which relied on their state governments to backstop losses, did not have access to capital markets, and fiercely contested this exemption.[181]

The Bundesbank, BaKred, and industry associations came to a consensus in the form of amendments in 1985 to the Banking Law. German banks would not be allowed to exceed

[179] Busch (2009): 109-110.

[180] Cornwell (1984).

[181] Deeg (1999): 55.

their lending by more than 18 times capital, equivalent to a capital ratio of 5.56 percent. This ratio was far more stringent than the capital standard in any other G-10 country, given that the German rules defined capital strictly as "core capital" (common equity and retained earnings), while lesser-quality, diluted forms of capital (such as subordinated debt) were outlawed. The competitive dispute between industry associations was resolved when they agreed that the finance minister would oversee a gradual reduction in the cooperative banks' exemption.[182]

Germany's relatively tough rules meant that it was also isolated at the Basel Committee. French officials were not as keen as German officials to seek a strict capital definition. Though it was a coordinated state and *dirigiste* economy, France could not be an ally. Crédit Agricole was run by the *Trésor* (an influential arm of the finance ministry), while the state also held extensive stakes in Banque Nationale de Paris, Société Générale, and Crédit Lyonnais.[183] Banking was the mechanism by which the state intervened in the economy. Guaranteed by the state, French banks had exceptionally low capital levels, and fell short of the German standard.

German officials also did not want the Basel Committee to undermine the work of the EEC Banking Advisory Committee, where they had considerably more influence. By the early 1980s, the EC had already proposed "observation ratios," which if instituted, would become legally binding on EU Member States. Peter Cooke, of the Bank of England, and the Basel Committee chairman, feared that these ratios would become "'normative' and form part of the EEC's approach to the harmonization of banking supervision, whereon the Basle group of supervisors favour a less rigid approach."[184] German officials stood a far better chance of achieving their preferred standards though a legally binding EU directive, as they had done and would do on issues such as information requirements, insider trading rules, and legal controls.[185]

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[182] Wartenbert (1985).

[183] Zysman (1983); Hall (1986).

[184] Hall (1982).

[185] Story and Walter (1997).

German central bankers and banking regulators spoke (and continue to speak) at the Basel Committee with a single voice. This is because Germany has changed little in terms of its domestic structural coordination in the past half-century. The 1961 Banking Law (*Kreditwesengesetz*) established the relationship between two main regulatory actors: the banking regulator BaKred (*Bundesaufsichtsamt für das Kreditwesen*) and the Bundesbank, the central bank.[186] (BaKred was merged with the securities and insurance regulators to form BaFin [*Bundesanstalt für Finanzdienstleistungsaufsicht*] in 2002.) They also cooperate closely with the finance ministry in sharing supervisory information and facilitating common policy positions.

Under Section 7 of the Banking Act and a Memorandum of Understanding with the Bundesbank—and continuing the legacy of cooperation that BaKred helped uphold—BaFin is responsible for regulatory design, implementation, and supervision in close consultation with the finance ministry. It uses the state-based Land Central Banks (which form the branch network of the Bundesbank) to gather supervisory data.[187] The BaFin's decision-making body, the Administrative Council, is composed of representatives from the Federal Ministry of Finance, Federal Ministry of Economics and Labour, the Bundestag, universal banks, investment banks, and insurance firms. It is joined by an Advisory Board on which representatives of industry associations sit.

Industry associations are well-integrated, do not have to compete for members, and share public authority with regulators. The BdB (commercial banks), DSGV (savings banks), VÖB (public banks), and the BVR (cooperatives) are all—despite varying public and private statuses—part of a peak-level industry association, the ZKA (*Zentraler Kreditausschuss*), which formally participates in the policymaking process.[188]

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[186] Coleman (1996): 75.

[187] Coleman (1996): 75.

[188] Story and Walter (1997): 168. ZKA (the Central Credit Committee) is now known as the German Banking Industry Committee or *Die Deutsche Kreditwirtschaft* (DK) as of 2011.

Corporatism is rooted in German law: "[T]he federal constitution gives these associations consultative or semiofficial status that draws them into policymaking. By insisting that only national trade associations be given such a role, the government forces the centralization of interest representation."[189] Sections 10 and 11 of the Banking Law mandate that the industry must be consulted before banking regulation can be changed—this legal requirement does not exist in the US or UK.

Public authority is not solely concentrated in BaFin and the Bundesbank. Deposit insurance is *privately run* for commercial banks by the Bdb, while the savings, cooperative, and public banks are state-guaranteed. The BaFin and Bundesbank rely on auditing associations (*Prüfungsverbände*) that are affiliated with the industry associations to conduct supervision and examinations.[190]

Corporatist coordination results in a single voice projected at the European and global levels. "The Germans are always the last to the table, but when they get there, they never budge," one official stated.[191] An industry executive said, "We have to go through so many political levels to achieve consensus, but once we do, it's unmovable."[192]

The coordinated institutional structure reflects collaboration between officials at the highest levels. The Bundesbank and BaFin "try to agree to positions before going to meetings [with their foreign counterparts]. They may disagree internally, but they do not disagree at the table." They meet with bankers and politicians at the informal *Patenrunde*, which is literally translated as "godfathers' roundtable."[193] As another official said:

> With a bank like Deutsche Bank, cooperation is done informally. They are big, relevant, with an enormous balance sheet. They are purposely owned and operated, and their management is inter-related with the political process, which affects the

[189] Zysman (1983): 254; Schmitter and Streeck (1985): 11.

[190] See *Banking Act*; Coleman (1996): 83.

[191] Not-for-attribution interview, London (5 December 2010).

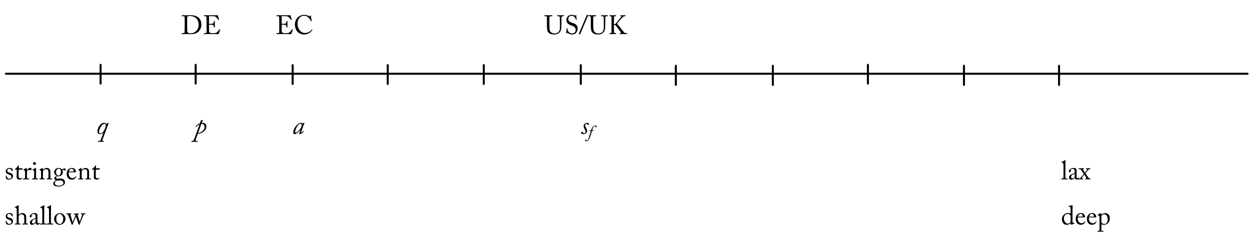
[192] Interview, London (11 March 2011).

[193] Interview with Kai Spitzer, phone (11 November 2010).

> positions taken by regional and national politicians…. The process [of how they interact] is not that much known.[194]

I have outlined the positions of the US-UK Accord (US/UK), Germany (DE), and the EEC Banking Advisory Committee/European Commission (EC) below in Figure 3.1.

Figure 3.1: Preferences on capital definition at the Basel Committee (early 1987)



The Fed makes concessions

In April 1987, members of the Basel Committee met at Gerzensee, Switzerland. Although they "lagged behind the work already done by the joint US Federal Reserve-Bank of England team,"[195] German negotiators strongly resisted including lesser-quality types of capital, such as hidden reserves, general provisions, and latent revaluation reserves, in the definition of Tier 1 capital. In response, the US and UK agreed to move towards the capital definition that had been negotiated in Brussels through the EEC Banking Advisory Committee (illustrated in Figure 3.2 below).[196] This eventually made German officials, the pivotal negotiators, indifferent between the Brussels framework to which the Fed and Bank of England now proposed (*a*, *s**) and the German preference (*p*). The Committee also agreed to split capital into two tiers, simplifying the multi-tiered framework created earlier by the Secretariat.

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[194] Interview with Peter Kerstens, phone (29 September 2010).

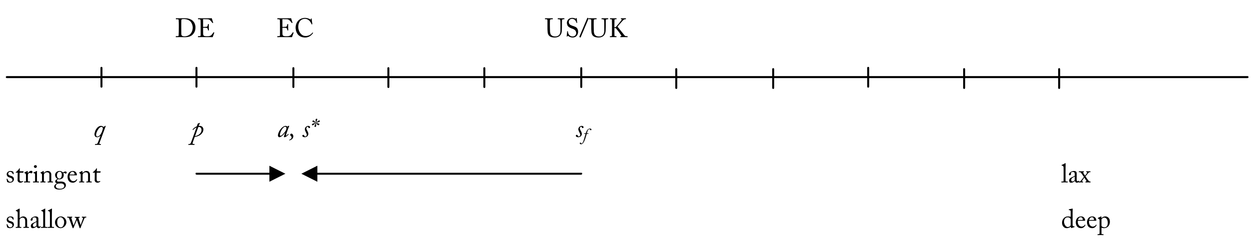
[195] Simonian (March 1988).

[196] "Comparison between the US/UK proposals, capital measurement, the Basle and Brussels frameworks and the Gerzensee outline," BS/87/41, reproduced in Goodhart (2011): 216-7.

German officials also successfully fought against Japanese officials for a stringent definition of capital. Japanese banks had sought to keep their unrealized capital gains (part of latent revaluation reserves) within the scope of allowable capital. The Fed agreed that Japan could allow 45 percent of unrealized capital gains to count towards Tier 2 capital, but it were German—not American—negotiators who were willing to suspend discussions because of Japanese authorities' insistence on counting up to 70 percent of their unrealized gains.[197] Japanese negotiators backed down.

Further, the resistance of the Bundesbank and BaFin forced the US Fed and rest of the Committee to agree to "adopt the Brussels formula with a tightly defined Tier 1, comprising only equity and disclosed reserves, which should represent at least half of the total reserves."[198] They also successfully insisted that subordinated debt could only be allowed up to 50 percent of the level of Tier 1 capital, which would be equal to 4 percent of risk-weighted assets. Finally, the US further conceded to German objections by setting a limit of 1.25 percent on the amount of loan loss reserves that could count as Tier 2 capital.

Figure 3.2: Bargaining on the definition of capital in the 1988 Basel Accord



Despite these concessions by the Fed, Germany still refused to endorse the emerging Basel Accord by the end of September 1987. Chairman Peter Cooke then proposed a tiered 8 percent capital ratio (capital divided by risk-weighted assets): 4 percent would be composed of "core capital" (Tier 1) and 4 percent of supplementary capital (Tier 2). For Germany,

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[197] Pauley and Lascelles (1987).

[198] Decided at the Basel Committee meeting, 16-18 September 1987, BS/87/87, quoted in Goodhart (2011): 179.

this would partially dilute their banking standards. Equity capital at German banks was relatively high: 5.9 percent at Deutsche Bank, 4.8 percent at Dresdner, and 4.3 percent at Commerzbank.[199]

Expressing solidarity, the French temporarily allied with German officials to put a hold on final agreement. In reality, French representatives were lobbying for a laxer definition than their German colleagues, seeking recognition by the Committee of French-specific revaluation reserves as part of the capital definition.

Contrary to the Committee's norms on secret negotiations, German authorities made publicly clear their belief in a stringent capital definition, stating that the goal of improving capital levels "can only be reached if a bank's capital stands on firm foundations and contains exclusively risk-free, first-class elements."[200] This consistent stand and the single voice of German officials at the Basel Committee garnered them what amounted to a side payment.

German officials believed the Committee's proposal was insensitive to the low-risk status of the German *Pfandbrief*, a heavily regulated type of securitized mortgage and one of the most popular bonds in the world.[201] The Fed conceded the special status of the *Pfandbrief* (according it a low risk weight and thus low capital charge), and also agreed to endorse supervisory discretion for tightening the definition of Tier 2 capital.[202]

Germany was barely satisfied at the Basel Committee. German officials made clear that they would not strongly endorse the Accord, but would not stand in its way either: "In the interests of achieving a common stand on the issue of international capital convergence, the

[199] Simonian (July 1988).

[200] Lynn (1988).

[201] Simonian (March 1988).

[202] Cooke (1990): 330.

German delegation is willing to put aside its reservations" if its preference for a stringent definition was explicitly stated in the text of the Accord.[203]

As the recalcitrant actor during open-rule bargaining, Germany has been only briefly mentioned in the scholarship on the 1988 Accord.[204] Instead, several insightful studies, such as Oatley and Nabors (1998) and Singer (2007), have focused on how the Fed and Bank of England overcame *Japanese* preferences. However, for Japanese officials, the 1988 Basel Accord was an instance of beneficial *gaiatsu*—foreign pressure to achieve domestic change—applied in the international financial realm instead of military affairs.[205] As with the Fed and Bank of England, the Ministry of Finance in Japan had difficulty introducing statutory risk-based capital adequacy rules over the opposition of its large domestic banks.[206]

Japan used the pretense of Anglo-American pressure and the 1988 Accord to prevail domestically—as one former Bank of England official put it, "They were willing participants. They had a very different motivation than what has been considered publicly."[207] Indeed, the Accord was finally concluded at a Basel Committee meeting in Tokyo in October 1988, and celebrated after the meeting at a joint banquet hosted by the Japanese Ministry of Finance and Bank of Japan—but only after Chairman Peter Cooke conducted last-minute shuttle diplomacy with Karl Otto Pöhl at the Bundesbank and Hans Tietmeyer at the finance ministry to ensure that Germany would not stand in the way of the Accord.[208]

German officials would have been better advantaged in setting the substance of the risk-based capital standard through the EEC Banking Advisory Committee. German lawyers had dominated the drafting of EU financial services directives in the 1970s, although some

[203] Peter Cooke, letter to G-10 governors, 5 July 1987, BS/88/73, quoted in Goodhart (2011): 183-184.

[204] Kapstein (1989); (1992).

[205] Kentaro (2003); Hemel (2011).

[206] Kentaro (2003).

[207] Not-for-attribution interview, London (23 February 2012).

[208] Peter Cooke, private correspondence, quoted in Goodhart (2011): fn 36, 184.

criticized the prudential substance of those directives as too legalistic and mechanistic.[209] Now, with the 1988 Basel Accord, the European Commission could point to an international standard, even if non-legally binding, as the basis for the capital definition and capital levels that it would establish in the Own Funds and Solvency Ratio Directives.[210]

These EU directives transformed the German regulatory consensus into one that resembled the Basel Accord. Given the ease of adapting to laxer standards, Germany quickly adapted to the new state of affairs, which is what it would defend in Basel II and III negotiations—going from being the Committee's "lone wolf" for stringent capital definition to an advocate for a laxer definition in Basel II and III.

Post-bargaining outcomes for the first-mover Fed

By bargaining at the Basel Committee and adopting a capital definition already accepted by the European Commission, the Fed ensured it would gain a non-legally binding international standard. The 1988 Accord is explicitly soft law, as it is an "endorsement" (not an agreement) among the G-10 Governors that the "national supervisory authorities intend to implement."[211] The 1988 Accord does not attach any compliance mechanism for monitoring and enforcement, though Basel II and Basel III would fall under the IMF Financial Sector Assessment Programme roughly fifteen years later.

As I have argued, the Fed was motivated by domestic political reasons to pursue the Basel standard. It could use the Accord to legitimize its long-standing preference for risk-based capital regulation, and use the Accord to empower it vis-à-vis the FDIC and OCC.

Before Congress, the Fed asserted that a global agreement reflecting its preference would redress a major competitive imbalance between the US and other financial centers. This

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[209] Goodhart (2011): 15.

[210] Jabko (2006): 66, 76.

[211] Basel Committee (1988): 1.

played well in the prevailing political atmosphere of the mid to late 1980s. As the *American Banker* declared, "The concept of a 'level playing field' is becoming a 1987 battle cry for domestic bankers."[212] In 1981, Japanese banks held just over 25 percent of the total assets of the world's twenty largest banks. By 1988, their share increased to 70 percent.[213] Many American bankers perceived their Japanese counterparts as subject to lower capital requirements that, by permitting more leverage, allowed them to boost returns on capital.

Without a level playing field in capital requirements, the argument went, Japanese banks' increasing market share would continue apace. Gerald Corrigan, President of the New York Fed, testified before Congress that "the single item which I would place greatest emphasis relates to bank capital adequacy standards, and specifically to the goal of moving Japanese bank capital standards into closer alignment with emerging international standards."[214]

However, evidenced by its ready concession on unrealized gains counting as part of the capital definition, the Fed was *not* primarily motivated by US banking competitiveness—nor were Japanese officials the victims of a US power play. Adjustment costs for US banks would be significant. Japanese banks could raise equity capital at lower cost than their American counterparts, meaning that even though their capital ratios would rise, the annual cost of compliance for Japanese banks would be lower than for US banks.[215]

The detailed substance of the Basel Accord legitimized the Fed's preference to enact risk-based capital rules in the US. Rival regulators had argued that capital requirements would be entirely arbitrary in determining the risk weights attached to types of assets, as the GAO had previously concluded on the lack of a uniform approach among the Fed, FDIC, and OCC: "Perhaps this is just as well since there is considerable doubt that required capital

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[212] Walters (1987).

[213] *The Banker* cited in Tarullo (2008): 46.

[214] US Senate (1987).

[215] Hemel (2009): 53-4.

ratios can be set across the board, on other than a purely arbitrary basis."[216] With a technically detailed international standard in hand, the Fed argued that the Basel standard balanced the objectives of stability and competitiveness.[217]

The Fed's preference was thus empowered vis-à-vis the FDIC and OCC. A risk-based capital standard implemented in the bank holding companies under Fed supervision would firmly establish a risk-based approach for the other commercial bank subsidiaries which were supervised by the other US regulators, but which also operated under the holding company.[218]

Furthermore, any arbitrariness in the Accord would be outweighed by not joining the rest of the world. As the Fed's Corrigan argued regarding US financial reform, "Indeed, in relation to developments in other major countries, a strong case can be made that we have actually lost ground," even as he cautioned against risk-based deposit insurance using the same arguments leveled against risk-based capital regulation: "We clearly don't want a system in which some institutions conclude that paying a higher premium is a license to undertake even more risky, if not reckless, activities."[219] Corrigan did not acknowledge that others argued the arbitrary risk-buckets approach in the Basel Accord meant banks would both take greater risks and reduce their overall capital levels.

As momentum grew towards risk-based capital regulation, the FDIC floated an idea for joining together risk-based deposit insurance *and* risk-based capital requirements—a "regulatory fairy tale," some observers concluded.[220] While the FDIC could not reverse the thrust of the Fed's preferred risk-based capital requirements embedded in the Basel

[216] GAO (1981): 21.

[217] This argument reverses the conception of regulators' motivations in Singer (2007). Singer argues that regulators face a trade-off between stability and competitiveness. I argue that regulators in fragmented states are motivated by improving their domestic political position, and these regulators will argue that the international standard balances stability and competitiveness in order to legitimize their preference.

[218] Hemel (2009).

[219] Quoted in Matthews (1988).

[220] Rehm (1987).

standard, the FDIC did manage to add a risk-insensitive leverage ratio to the bank regulatory framework by the early 1990s.

As former FDIC Chairman William Isaac recounts, "I do not believe the FDIC would have ever signed on to Basel if I had remained chairman, as I felt very strongly. In the end, the FDIC signed on for interagency harmony, but insisted on a [risk-insensitive] leverage ratio to reduce the harm Basel could do."[221]

In the 1980s, deposit insurance models varied far more than capital rules did worldwide, and the FDIC had no similar international institutional recourse. In 1979, an international deposit insurance corporation was proposed,[222] but the International Association of Deposit Insurers was only founded in 2002. Its secretariat is housed at the Bank for International Settlements. Its major product, "Core Principles for Effective Deposit Insurance Systems," was published in 2009—jointly published, that is, with the Basel Committee.[223]

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[221] Interview, email (23 February 2011).

[222] Grubel (1979).

[223] Basel Committee and International Association of Deposit Insurers (2009).

Table 3.1: The two-step theory and the Basel capital standards

Propositions	**1988 Accord**	**Basel II**	**Basel III**
Fragmented state: low level of integration, high degree of competition, no public authority for industry	Fed, FDIC, and OCC compete in US banking regulation; industry associations compete for members and for influence, and play no formal role in policymaking	Same	Same
Tenuous domestic regulatory status quo in fragmented state	Fed is dissatisfied that US capital ratios are not risk-based and disagrees with FDIC and OCC; Reagan Administration threatens to strip Fed of regulatory powers	Fed dissatisfied that 1988 Accord is not risk-sensitive enough; prefers internal modeling as basis for large banks' capital standards	Crisis reveals lack of liquidity regulation; Fed wants quantitative standards; SEC seeks to also set liquidity standard
Fragmented state regulator has strong incentives to pursue non-legally binding international standard	Soft law allows Fed to pose "either/or" option to other regulators, given that pursuing hard law is cost-prohibitive in the absence of domestic regulatory consensus	Same	Same
Fragmented state regulator makes first move at soft law international institution	Fed initiates bargaining at Basel Committee; joins with Bank of England in bilateral accord	Fed initiates bargaining at Basel Committee; allies with Bank of England and FSA	Same as Basel II
Recalcitrant actor prefers status quo on substance	German capital standards are most stringent in the G-10 (1985 Banking Law Amendments)	German officials prefer wide scope (as in 1988 Accord) for internal ratings-based approaches	German officials prefer lax quantitative liquidity standards (2006 LiqV)
Open decision-making rules advantage recalcitrant actor during bargaining; leads to shallow standard	US Fed agrees to adopt EU definition of capital; Germany gains side payments on *Pfandbrief* capital charge and Tier 2 capital definition	Multiple internal ratings-based approaches created to apply to all banks	Definition of liquid assets weakened; implementation timeline extended to 2019

Basel II: A Question of Scope

Despite the overwhelming focus of international political economists on the 1988 Accord, the politics of global capital regulation has not ceased. Indeed, after the first Basel Accord, it was just beginning—or, more accurately, beginning to repeat itself. By the mid-1990s, the Fed became dissatisfied with and again sought to change the US regulatory status quo. It became a first-mover at the Basel Committee, seeking to forge a non-legally binding international capital standard based on internal modeling for the largest US banks, to the strong opposition of the FDIC and OCC.

During bargaining, German officials held out from agreeing to a Basel II standard until it was sufficiently detailed so that internal models could be applied to *all* banks—not just the largest ones. This resulted in a substantively shallow, albeit extremely detailed, standard. Open decision-making rules helped Germany extract concessions again. Once the standard was concluded in 2004, the Fed stumbled at home—this time, the FDIC and OCC were far more reluctant to sign on for the sake of interagency harmony. The eventual agreement for US transition to Basel II was disrupted by the autumn 2008 global financial crisis, which prompted the Basel III revisions.

I. US regulatory status quo: 1988 Accord and a leverage ratio

The 1988 Basel Accord did nothing to help resolve the adversarial nature of the fragmented US regulatory structure. During implementation of the Accord, the Fed, FDIC, and OCC debated the merits of including a binding leverage ratio as a stop-gap measure; the leverage ratio would prevent capital levels from unexpectedly falling too much as a result of banks implementing the Accord.[224] In the early 1990s, a risk-insensitive leverage ratio (Tier 1 capital to total assets) was instituted at the urging of the FDIC. The leverage ratio was one of three ratios—the others being the Basel total risk-based ratio (Tier 1 plus Tier 2) and Basel Tier 1 risk-based ratio—that were used to determine the

[224] Rehm (1989).

capital thresholds that, if breached, would trigger "prompt regulatory actions" to be taken "to prevent or minimize losses to the deposit insurance funds from failures."[225]

At the same time, in the early 1990s, the Basel Committee was gradually moving beyond the risk-bucket approach of the 1988 Accord to a ratings-based approach. The Committee followed the European Union Capital Adequacy Directive (CAD) that established capital requirements for market risk, which was not addressed in the 1988 Accord. Called the Market Risk Amendment, the capital charge applied to market risk is *internally* generated, that is, a model developed by the bank calculates the amount of capital to be held against the risk of trading losses; according to the Market Risk Amendment, the model-generated amount of capital is arbitrarily multiplied by three as an ad-hoc backstop.[226] Before long, these developments towards ratings as the basis for capital requirements, instead of fixed risk weights, generated heated debates among US regulators. By the mid-1990s, the Fed had begun to sour on the 1988 Accord and leverage ratio.

II. The Fed is dissatisfied—again

In the mid-1990s, the Fed argued that the 1988 Accord—and the leverage ratio added during US implementation—were not risk-sensitive enough. Fed Chairman Alan Greenspan highlighted the perceived shortcomings: "Its sole focus on credit risk; its one-size-fits-all risk weight for non-mortgage loans; its inability to adjust weights for hedges, portfolio diversification, and management controls; and the difficulties of folding in interest rate risk, to name a few."[227]

The market was getting ahead of the regulators, Greenspan argued, and so far ahead that the only viable response would be to rely even *more* on banks to set their own capital levels. Greenspan favored banks' Value-at-Risk models which generate estimates of expected and unexpected losses and help allocate capital according to internally calculated risks: "These

[225] GAO (November 1996): 12.

[226] Tarullo (2008): 63.

[227] Greenspan (1996).

capital allocations, as I noted, are for internal management, not regulatory purposes. But I am impressed with what they teach us and what they imply for regulatory capital."[228] As I discuss later in the chapter, the Fed's receptiveness to banks' internal models as the basis for capital requirements runs counter to the argument that Basel II was an instance of private-sector capture.

The FDIC and OCC did not agree with the Fed on the usefulness of internal ratings-based (IRB) capital regulation. Their objections intensified over time. An FDIC study defended the 1988 Accord, arguing that "the Basle standards have some important advantages over internal models. Because capital standards—Basle or other—have legal standing, they must be both verifiable and uniform across time and institutions. They must therefore be based on simple, comprehensive calculations."[229]

Comptroller of the Currency John Hawke doubted how soon an internal ratings-based approach could be applied.[230] The OCC was worried that a technically complex IRB approach would make it very difficult to uphold the stated goals of maintaining adequate capital levels and incentivizing banks to invest in risk management systems. Hawke noted, "Some people at the Fed respond to criticisms of complexity by saying that 'we live in a complex world.' But I do not think that is a sufficient answer. You can't say we live in a complex world, therefore we have to have 700 pages of capital rules."[231]

III. The Fed goes global—again

The Fed's preferred internal ratings-based (IRB) approach had the potential to transform US capital standards. If the Fed were able to help produce a non-legally binding Basel standard with an IRB approach, then, as in the 1988 Accord, it could again present a difficult "either/or" option to the FDIC and OCC.

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[228] Ibid.

[229] Nuxoll (1999).

[230] *Banking Policy Report* (1999).

[231] *The Banker* (2002).

In the late 1990s, the Fed sparked a series of studies and consultative papers at the Basel Committee to explore how ratings could be used to increase the risk sensitivity of capital requirements. As current Fed Governor Daniel Tarullo recounts, "the Federal Reserve was still the only supervisory agency actively and publicly suggesting that modification—perhaps fundamental modification—of the Basel I standards was necessary."[232] The Basel Committee was not initially receptive to the Fed's initiative; Chairman Tom De Swaan of the Netherlands opposed any precipitous changes to fundamental approach of the 1988 Accord, stating "There are still an enormous amount of problems to be solved in coming years before you can say there is a clear robust system for modeling credit risks."[233]

But, the Fed soon came to the fore. At the urging of New York Fed chairman William McDonough, who became Basel Committee chairman in June 1998, the Committee issued a consultative paper in June 1999 that focused on the use of *external* credit ratings, and intimated that proposals based on internal models would be released soon; external ratings are those of credit rating agencies, such as Moody's or Standard & Poor's. Yet, the proposal was severely criticized because many small borrowers do not have assigned ratings nor do most European corporate borrowers.[234]

The Fed decided to bulldoze ahead with an IRB approach. Greenspan, who had given a number of speeches endorsing internal models, called upon his Vice Chairman Roger Ferguson: "Greenspan wanted to put a fire under the Basel process. Ferguson was directed to energize it."[235]

A Basel II standard, just as the 1988 Accord did, would help set the US domestic agenda at a time when neither the FDIC nor OCC were receptive to the use of internal models. The

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[232] Tarullo (2008): 90.

[233] Nielsen (1998).

[234] Tarullo (1998): 97.

[235] Not-for-attribution interview, Washington, DC (29 March 2011).

importance of Basel II for the Fed, even though the standard would be non-legally binding, for controlling the domestic agenda came out in congressional testimony:

> We now face three choices. [1a] We can reject Basel II or [1b] we can delay Basel II as an indirect way of sidetracking it. Or [2] we can continue the domestic and international process to make whatever changes are necessary to make Basel II work effectively and efficiently…. The first two options require staying on Basel I, which is not a viable option for our largest banks…. The Fed strongly supports the third option."[236]

The OCC's John Hawke, who vigorously opposed the detail and complexity of what the Basel Committee had drafted, agreed that a Basel II standard would present an either/or option for his agency and the FDIC: "Well, first of all, this is not a treaty where we have a legal obligation. But I think it is probably fair to say that once the Basel Committee goes out with its final paper, we either should object to it if we have fundamental reservations, or we should acquiesce in its being published."[237] In addition to its lack of legal obligation, any Basel II standard would almost certainly lack a compliance mechanism; Greenspan had previously resisted a basic cross-border information-sharing system, a prerequisite for monitoring and enforcement, that was favored by then-Basel Committee chairman Tom De Swaan of the Netherlands.[238]

IV. Bargaining

In this section, I detail how the US Federal Reserve made a number of concessions to recalcitrant German officials in order to achieve a non-legally binding international capital standard that included internal ratings as the basis for risk measurement. Interestingly, the Fed and Bundesbank and BaFin officials agreed on the merits of internal models—yet strongly differed on who should utilize them. As a result, I conceptualize bargaining over the substance of Basel II as fundamentally about scope of the internal ratings-based (IRB)

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[236] US House (2003): 10.

[237] Ibid.: 28.

[238] Seiberg (1997).

approach: the scope runs from all banks to large, internationally active banks. Based on the implementation of the 1988 Accord in both the United States and Europe, the status quo was all banks. The Fed preferred to implement the IRB approach for only large, internationally active banks, whereas German officials sought to allow all banks to use internal models. This German preference, which the Fed agreed to satisfy in order to achieve a standard under the Basel Committee's open decision-making rules, resulted in an exceptionally detailed Basel II agreement—but a substantively shallow standard in terms of scope. The detail and complexity of the Basel II standard, in turn, hampered the Fed's efforts to implement it domestically.

International status quo

Although the 1988 Accord stated that the "[Basel] Committee's framework is directed more specifically with banks undertaking international business in mind,"[239] the Board of Governors of the Federal Reserve voted 5-1 to implement the Accord for *all* banks.[240] Similarly, in Brussels, the EU Second Banking Directive, which endorsed the German universal banking model,[241] applied the Basel rules to all "credit institutions." Given that the status quo is the exogenous international policy outcome if bargaining failed, the outcome would have been the encompassing scope of all banks under the 1988 Accord.

The Fed sought to quickly change the status quo on scope at the Basel Committee. It allied, again with officials from the Bank of England, as well as those from the newly created UK Financial Services Authority. Andrew Crockett of the Bank of England simultaneously headed the Committee's host, the Bank for International Settlements, and shared the Fed's view that "I believe it's [Basel II IRB proposal] already much more discriminating [than the 1988 Accord] in the assessment of risks and the allocation of capital among those risks."[242] FSA chairman Sir Howard Davies agreed with the Fed on

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[239] Basel Committee (1988): 2.

[240] Nash (1988).

[241] Jabko (2006): 71.

[242] Quoted in Blount (2001): 41.

focusing the scope of the IRB approach: "All banks are equal, but some are more equal than others."[243] The Fed and UK officials together prodded the Committee to quickly conclude its work, preferring to set up a Basel II framework that would allow for considerable supervisory discretion. Directing his comments toward Germany and France, Davies stated that "in order to deliver on time, we shall have to take the risk that things change at a late stage."[244]

Along with the Fed, the Bank of England and the FSA led several working groups which produced the substance of Basel II.[245] Despite the length of negotiations and complexity of Basel II, a prominent participant recounts, "The UK was a natural ally. People from the Bank of England were also quants. One of them was architects of the foundation internal ratings approach. I cannot recall any fundamental differences between us and the Brits."[246]

German preference for the status quo

While the Fed attempted to focus the development and application of internal ratings-based (IRB) approaches on large, internationally active banks, German officials instead sought to maintain the status quo scope for all credit institutions, as defined by the EU Second Banking, Own Funds, and Solvency Ratio Directives that implemented the 1988 Accord.

More fundamentally, the all-encompassing scope reflected the long-standing nature of centralized German universal banking regulation that survived both world wars, above all, demonstrating the "reluctance of the Bundesbank, at the pinnacle of the German regulatory structure, to engage in intemperate experiments. The universal banking principle, where banks provide both commercial and investment services, applied to all. Legislation was

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[243] Quoted in Robinson (2001).

[244] FSA (2001).

[245] FSA (1999).

[246] Not-for-attribution interview, Washington, DC (29 March 2011).

concerned with general regulations involving the granting of licences, solvency ratios and ensuring liquidity for the system *as a whole*."[247]

German officials sought to apply any Basel II standard to all banks through EU implementation. In 1999, in the context of the nascent Financial Services Action Plan, reflecting the German view, the European Commission stressed that it anticipated the application of an IRB approach to all banks: "The Commission services are of the view that an approach building on institutions' own internal assessment systems should be capable of delivering a regime that can accommodate the needs of both more and less sophisticated institutions."[248] This scope was necessary for German officials to avoid disturbing the domestic competition among commercial, savings, and publicly owned banks, the latter two deeply resenting any international standard that would allow large commercial banks to reduce their capital requirements on the basis of internally calculated risks.[249]

Basel II gets detailed and the Fed keeps making concessions

For the Fed, if it wanted an international agreement, then it would have to help develop an all-encompassing Basel II standard, in line with the status quo, even though it preferred applying the IRB approaches to internationally active banks only. Thus, in June 2000, six months before the Basel Committee released its first IRB proposals, Committee chairman and New York Fed chairman William McDonough stated that "we are more committed than ever to an internal ratings-based approach" and that the Committee could "now envision extending the applicability of the internal ratings-based approach to banks of varying sizes, including small and medium-sized institutions."[250]

This decision to ensure that the scope of Basel II standard included all banks exploded the standard's detail and complexity. Whereas the 1988 Accord had been only thirty pages and

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[247] Emphasis added. Story and Walter (1997): 162.

[248] European Commission (1999): 18.

[249] Interview with Kai Spitzer, phone (11 November 2010).

[250] McDonough (2000).

the first external ratings-based Basel II proposal sixty pages, the Basel II proposals that included IRB approaches reached nearly 500 pages. This increase reflected the inclusion of two separate methodologies for internal calculation of risks: the foundation IRB (F-IRB) approach would allow smaller banks to use their own probabilities of default, while supervisors would supply estimates on exposure in event of default, loss given default, and maturity of sovereign, bank, and corporate exposure. However, under the advanced IRB (A-IRB) approach, the largest banks could use their own internal models to calculate these values, which would then convert into risk-weights under prescribed formulas and thus form the basis of new (and likely lower) capital requirements.[251] The same consultative paper that included the proposed IRB approaches also retained a "standardized" approach to adjust risk-weights, but did not rely on the calculations of internal models.

In maintaining a number of approaches in the substance of Basel II, the Fed had effectively agreed to an extremely detailed standard that de-emphasized supervisory discretion. Supervisory discretion to set individualized bank capital standards was antithetical to prevailing regulatory history in Germany that valued across-the-board rules. As the head of Dresdner Bank, Bernhard Walter, stated, "The proposed supervisory review process will only be acceptable for the German private banks when it is based on clearly defined rules and does not give discretionary powers to the supervisory authorities." [252] Detailed substance would be consistent with prevailing practice in Germany, where the auditing industry association also assesses banks' regulatory compliance.[253]

Accordingly, at the Basel Committee, supervisory principles on capital adequacy received scant attention, whereas the substance of the standardized and IRB approaches became the focus of years of technical work. As a result, Basel II amounted to hundreds of pages of rules, a "check the box" mentality that attempted to "address every single loophole. You

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[251] Basel Committee (2001). Regulators believed capital requirements should decrease by a certain amount (anywhere from 2 to 20 percent, depending on one's view) so as to incentivize the largest banks to reform their internal risk assessment and management systems.

[252] Quoted in *Retail Banker International* (1999).

[253] Tarullo (2008): 118.

could see them [German officials] sitting around thinking about loopholes, and then thinking of ways to fill them with more detail."[254]

German officials bargained aggressively to achieve a standard close to the status quo on scope (Figure 3.3). At one point, German negotiators handed confidential Committee draft proposals to their industry associations, creating "a sad and unnecessary row" with the US.[255] There still remained dichotomous standards for large versus smaller banks, in terms of the former being allowed to rely more on internal models than the latter, but the desire to accommodate an all-encompassing scope, as preferred by German officials, was clearly evident and the hard German stance won them several side payment from the Fed. One US participant elaborates:

> The Germans pushed for permissive treatment of commercial real estate. They said they were under instructions from their parliamentarians that if they don't get what they need, they should walk away…. We would spend a lot of time figuring out something to give the German delegates that would cover their marching orders. We wished Congress would be as interested.[256]

The exception for the *Pfandbrief* market, which includes a variety of real estate lending and on which outstanding bonds were cumulatively worth $957 billion,[257] was included: "The committee recognizes that, in exceptional circumstances, for well-established markets, mortgages on commercial real estate may have the potential to be recognized as collateral in the credit portfolio."[258]

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[254] Not-for-attribution interview, Washington, DC (29 March 2011).

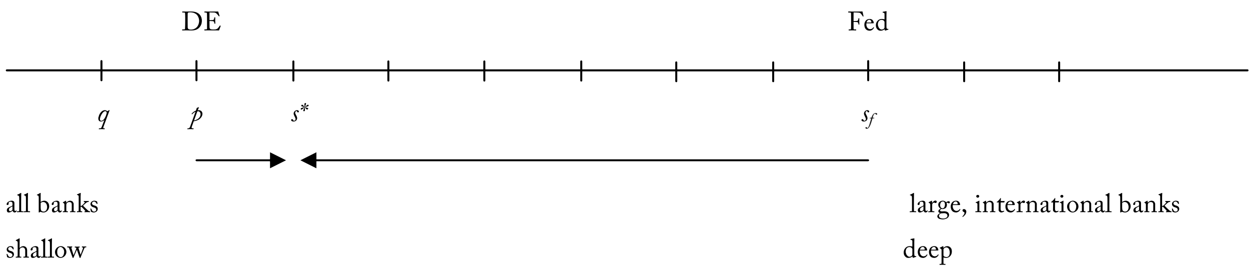
[255] Anonymous quoted in Graham (1999).

[256] Not-for-attribution interview, Washington, DC (29 March 2011).

[257] *The Economist* (1999).

[258] *Financial News* (2001).

Figure 3.3: Bargaining over the scope of Basel II



In exchange for their support for the final Basel II standard, German negotiators also gained an exception on lending to small and medium-sized enterprises, which comprise the export-oriented *Mittelstand*. In 2001, the politically powerful *Mittelstand* sputtered, and the German banking industry reduced lending to SMEs by 11 percent.[259] Chancellor Gerhard Schröder warned that Germany would veto any internal ratings-based approach that presumed SMEs presented higher risks than larger corporate firms, which would have meant that the former would be less likely to receive bank lending.[260]

Basel Committee chairman William McDonough (still serving then as President of the New York Fed) readily met these objections, stating in Cologne, "Like you, I recognize the need for small- and medium-sized enterprises to retain access to credit at reasonable and fair prices. Access to credit matters not just because credit can enable small business to grow, but more because small businesses enable the whole economy to grow."[261] The Committee officially responded with modifications—"more appropriate treatment"—that reduced the risk weightings for SME exposures compared to larger firms.[262] Despite McDonough's justification for the concession, US capital standards have no such SME exception.[263]

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[259] Williamson (2002).

[260] Wagner (2001).

[261] Quoted in *Market News International* (2002).

[262] Basel Committee (2002).

[263] GAO (2008).

The coordination and interdependence among German regulators and bankers proved especially valuable in the final stages of debate. The substantial cost in developing internal risk models was overcome through cooperation among German banks in industry associations. For example, Hamburgische Landesbank, the world's largest shipping bank, needed to develop a rating system for ships, similar to the modeling of risks associated with asset-backed securities. It shared the costs with other state-guaranteed *Landesbanks*.[264]

In the US, the costs of the IRB systems had persuaded the Fed not to apply Basel II to the roughly 8,000 smaller banks that would remain on a slightly modified version of the 1988 Accord. The lack of an encompassing industry association for smaller US banks meant that cost-sharing to develop IRB systems was simply not possible, a point highlighted by Bundesbank Director Edgar Meister: "It's a different situation in the United States. The costs [of IRB systems] here are not a decisive factor," citing that German savings and cooperative banking associations had also developed common IRB systems for their member banks to use.[265]

Once German representatives achieved substantial concessions, the Bundesbank, BaFin, and industry associations all pushed for agreement. In March 2002, the head of BaFin, Jochen Sanio, said, "Discussions have reached a point where it is in Germany's interests to wrap things up."[266] They then criticized the US for holding up agreement at the Committee. The US OCC's John Hawke (still Comptroller) countered that German negotiators were pursuing a "concerted effort … to ram this Basel proposal through at all costs" and had been under instructions to receive concessions on SME and commercial real estate lending: "They got their way on those issues, and now at this stage of the process when we're finally getting comments in a democratic [consultation] process, they're critical of us for being responsive to these comments."[267]

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[264] *Lloyd's List* (2003).

[265] Quoted in Antonovics (2003).

[266] Quoted in Antonovics (2002).

[267] Quoted in Felsenthal (2003).

Bundesbank President Ernst Weltke responded, “Many banks have already invested in new credit analysis techniques in preparation for Basel II. The planned Basel regulations have put in place a process that appears irreversible.”[268] Karl Heinz-Boos, head of the public banking industry association (VÖB), cited the cost of IRB implementation projects and added, “The Americans’ timing could have been better.”[269]

Once German representatives had successfully pulled the Committee towards an all-encompassing scope, they virtually ensured Basel II would take years of negotiations, as the consultation process engaged all aspects of the international and country-specific banking industries. The reason for four years of bargaining was also partly due to the lack of a systemic crisis at the time.[270] But the final standard meant that Germany could apply the internal ratings-based capital requirements across its banking market, as well as the EU: “It’s a very good decision and gives a level playing field in the industry. All groups are treated the same.”[271]

Final agreement did not emerge until the October 2003 meeting of the Basel Committee, which was now chaired by Jaime Caruana, Governor of the Bank of Spain. In the end, the 2004 Basel II standard retained the basic three-pillar structure that had been proposed under the New York Fed’s initiative back in 2000.

Pillar 1 focused on quantitative minimum capital requirements and included the standardized and IRB approaches for measuring credit and operational risks, in addition to market risk rules; it took up 145 pages in the final 2004 standard. Given the stringent objections of German negotiators to the Fed’s attempts to increase the role of supervisory monitoring in capital adequacy, the seventeen pages of Pillar 2 contained, at its center, only four short principles on (1) the need for banks to maintain sound capital adequacy assessment systems; (2) supervisory evaluation of internal models; (3) the need to operate

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[268] Quoted in Lalor and Atkins (2003).

[269] Ibid.

[270] Interview with US Treasury official, Washington, DC (31 December 2012).

[271] Spokesman for Association of German Public Sector Banks (VÖB) quoted in Jones (2005).

above minimum capital levels; and (4) early supervisory intervention. Finally, the fifteen pages of Pillar 3 dictated banks' disclosure requirements on capital adequacy, various risks, and IRB systems, intended to increase market discipline (presumably, more informed investors would penalize banks that took excessive risks).[272]

Basel II was, like the 1988 Accord it succeeded, non-legally binding. The Committee was careful not to refer to document as an "agreement" or suggest that it had even been signed or voted upon.

Post-bargaining outcomes for the first-mover Fed

When Basel II was officially issued in mid-2004, the domestic battle lines between the Fed, FDIC, and OCC were well drawn. A non-legally binding international standard had been achieved, and the Fed anticipated implementing the IRB approach in the largest US banks. But, the FDIC and OCC were not willing to acquiesce to the Fed's wishes as quickly as they did in 1988. They were concerned that the Committee had unreliably predicted the effect of the IRB approach on capital levels, especially given that the Committee's numerous quantitative impact studies produced inconsistent results:[273] "No one had any idea what would happen, how it would impact asset creation or the amount of bank capital."[274]

The uncertainty of Basel II's impact increased the focus on the considerable adjustment costs for banks. Two surveys suggested that the cost of implementing IRB approaches in the largest US banks would be anywhere between \$800 million and \$2 billion *per year* during the transition from the 1988 Accord to Basel II. A survey by US regulators indicated that each bank, on average, intended to spend \$42 million on initial implementation.[275]

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[272] Basel Committee (2004).

[273] Basel Committee (2006).

[274] Interview with John Hawke, Washington, DC (29 March 2011).

[275] Tarullo (2008): 167.

The FDIC and OCC were most concerned that community banks would be hurt by reduced regulatory capital at the biggest banks.[276] They argued for safeguards: a leverage ratio, transition floors, and an option for smaller banks to use a "standardized" approach that increased the risk sensitivity compared to the buckets approach in the 1988 Accord.

The OCC blasted Basel II's substantive complexity, which was the result of its wide scope and requisite detail in outlining the IRB methodologies. For example, the standard includes mathematical formulas to calculate operational risk, which is an extremely broad concept: it can apply to anything from internal fraud to external events such as terrorist attacks. Comptroller Hawke called the operational risk formulas "preposterous rules" that should have been left to supervisory discretion, which German officials had strongly resisted.[277] More generally, Hawke stated that the "the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not endorse a final Basel II framework for US banks until we have determined … that any changes to our capital regulations are practical, effective and in the best interests of the US public and our banking system."[278]

No one believed the Fed, FDIC, and OCC when they testified before Congress that they were working well together on implementing Basel II. This façade of unity sought to ward off legislation that would have required them to form a unified position at Basel; otherwise, as the proposed legislation mandated, their policy position would be determined by the Secretary of the Treasury. Congressman Barney Frank cracked, "If this is an agreement, if you guys ever disagree, sell tickets because it will be a hell of a show."[279]

The most high-profile disagreement was over the risk-insensitive leverage ratio, which was part of the US regulatory status quo—and which Greenspan and Fed Governor Susan Bies

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[276] Garver (2003).

[277] Interview, Washington, DC (29 March 2011).

[278] US House (2003): 11.

[279] US House (2003): 21.

sought to replace with the IRB approach. The FDIC and OCC supported the leverage ratio, which was part of the FDIC Improvement Act of 1991.[280] Comptroller Hawke explained to me, "As capital falls through different levels, we take increasingly intrusive action…. So, we want to know how much real capital is left [in the struggling bank]. I would get hooted down at the Basel Committee for suggesting that we needed a leverage ratio. Most Europeans didn't have it. It is our foundation of supervision. Greenspan and Bies believed that a leverage ratio was fundamentally inconsistent with an approach based on internal ratings."[281]

The Fed backed down—nearly two years after Basel II had been completed and after the EU had passed its Capital Requirements Directive and begun implementation for all banks.[282] The Fed agreed to higher capital floors while the largest US banks transitioned to Basel II. A bank transitioning to the advanced IRB approach would not be allowed to have its capital level drop more than 5, 10, and 15 percent compared to the capital levels required by smaller non-IRB banks in the first three years of implementation.[283] As one official maintains, "The Fed was the antagonist during Basel II implementation. They have people who are modelers and they wanted to shift to internal ratings. The transition floors are there because of the FDIC, and are tougher than the floors in Basel [II]."[284] A final US rule in December 2007 includes a leverage ratio and tough transition floors, but "the Fed was resisting the option of banks to apply the standardized approach regardless of size."[285]

While the FDIC and OCC were more concerned than the Fed on the competitive effects of Basel II on small banks within the US market, none of the three regulators considered *international* competitiveness a high priority:

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[280] Interview with Nancy Hunt, Washington, DC (29 March 2011).

[281] Interview, Washington, DC (29 March 2011).

[282] See US Senate (2006).

[283] Board of Governors (2007). This is known as the "Basel II parallel run."

[284] Interview with Nancy Hunt, Washington, DC (29 March 2011).

[285] Ibid.

> The regulators did less analysis regarding the international competitive impact of the new rules. At the time that the capital rules were being developed, OMB [Office of Management and Budget] provided little guidance on analyzing the international impact of US rules and the agencies did not discuss international competition issues in their analyses.[286]

The FDIC and OCC continued to press for smaller American banks to have the ability to implement a customized version of Basel II, thus expanding the scope beyond what the Fed preferred. The Fed finally agreed to solicit comments in July 2008 on a rule to allow smaller non-IRB banks in the US to use the standardized approach of Basel II, which partially relies on external ratings. But, no rule was issued. Why?

"The markets crashed."[287]

By the heady year of 2008, the Fed had helped set a non-legally binding international standard on internal ratings-based capital regulation. It had sought to change the US regulatory status quo, which was defined by the 1988 Accord, and was only partially successful: the largest US banks still have not fully implemented Basel II. The Fed wanted a limited scope for Basel II to ensure that only the largest and most internationally active US banks would use internal risk models to calculate their required regulatory capital. Negotiating under open decision-making rules, the Fed was forced to concede to German representatives at the Basel Committee who preferred an encompassing scope (the international status quo) that permitted all banks to use IRB approaches. This German preference for a wide scope necessitated shallow yet complex substance in the Basel II standard, as the Committee attempted to tailor various approaches to different types of banks and account for myriad risks. The Fed conceded to the wide scope of Basel II, but the detail and complexity of the ensuing international standard bedeviled its implementation efforts at home.

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[286] GAO (2008): 23.

[287] Interview with Nancy Hunt, Washington, DC (29 March 2011).

Conclusion

In this conclusion, I summarize the chapter's main empirical findings on why and how the US Federal Reserve has negotiated soft and shallow risk-based capital standards at the Basel Committee on Banking Supervision, and then discuss alternative explanations for the standards' form and substance. I also explain how the two-step theory informs our understanding of actors' incentives for and bargaining over the Basel III liquidity standards, which were only finalized in January 2013 as part of international regulatory reform in the aftermath of the 2007 and '08 global financial panic.

The US Federal Reserve has spurred the Basel Committee three times in the past thirty years to produce soft risk-based capital standards that bolster its domestic political position. Each time, bargaining under open rules, German officials from the Bundesbank and banking regulator (previously BaKred, now BaFin) have successfully resisted significant changes to the international status quo on key substantive dimensions: the stringency of capital in the 1988 Accord, the scope of internal ratings-based capital requirements in Basel II, and, as I discuss below, the stringency of liquidity regulation in Basel III.

It would have been troublesome for the two-step theory if the Fed sought legally binding standards and the substance of the Basel agreements was deep. As a "most-likely" case, the primary factors I highlight are at very high values: the US is extremely fragmented in its banking regulation and markets, while the Basel Committee uses an open, consensus-based decision-making rule. In this setting, first moves by a major player, such as the Fed, should be neutralized by a recalcitrant actor, such as Germany, during bargaining.

This case study has made two key contributions to the literature. I have tried to systematically unpack the "black box" within the US and Germany to understand actors' strategic motivations to pursue soft or hard law, an exercise that has been so far only theoretically generalized by international political economists. Second, the simple bargaining model I present of the Committee's debate runs counter to scholars' prevailing reliance on arguments about market power and private-sector influence to explain substantive outcomes. I am especially indebted to Charles Goodhart's meticulous history of the Committee in the 1970s and 1980s, an encyclopedic book that previous studies did not have the benefit of.

While my explanation of substance rests on the influence of the German preference for positions close to the status quo and the open decision-making rule used at the Basel Committee, the simple bargaining model does not illustrate the positions taken at the Committee by the FDIC or OCC. In Goodhart's comprehensive history, he does not note the policy positions taken at the Committee by these regulators' representatives, and the attendance records of meetings include country affiliations only (not institutional affiliation).[288] Similarly, Daniel Tarullo's account portrays the Fed's policy positions expressed at the Basel Committee, but not those of the FDIC or OCC. The FDIC and OCC's policy preferences expressed *domestically* have been recorded. But because of this empirical gap, my bargaining model does not include their international policy preferences and assumes they acquiesced to the Fed's initiatives or were silent at the Committee (an admittedly dubious assumption).

Alternative explanations of form and substance in the Basel capital standards

Of all international financial standards, the 1988 Basel Accord is one of the most studied. Yet, despite many insightful contributions, none of the major studies link regulatory politics within the US and other countries to the *form* of the standard, though a number do focus on US market power as the primary explanation for the substance of the standard.

<u>Form</u>

The major alternative explanation for the form of the 1988 Accord, as well as Basel II and Basel III, is based on the rationalist/legalization perspective, which argues that actors

[288] Goodhart (2011): 92-3.

negotiate hard or soft law in order to achieve "superior institutional solutions."[289] The predictions of this perspective are based on comparative statics; that is, "assuming an exogenous change in one element will result in an endogenous change in one or more elements. But the choice of what is fixed and what fluctuates is not inherent to rational choice but to the interpretation put on the model."[290]

In particular, soft law appeals when the effects of a standard are uncertain and when actors' interests, values, and time horizons fall across a wide spectrum. Hard law, however, increases the credibility of commitments when opportunism is likely and when it is difficult to detect shirking by actors. I referred to the indeterminateness of the rationalist/legalization perspective in the Introduction: given the similarity of major players' divergences in interests, values, and time horizons across the Basel Committee and European Union, why should French and German regulators and industry value the certainty of settled, legally binding standards more so than their US or UK counterparts? Given the generality of actors in its model, the rationalist/legalization perspective is silent on this question.

The rationalist/legalization authors explain the non-legally binding form of the Basel capital standards by asserting that self-interested regulators use certain international

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[289] Abbott and Snidal (2000). I only look at one dimension of the rationalist/legalization perspective, legal obligation (not precision or delegation), similar to the binary distinction on legally versus non-legally binding obligation drawn by Raustiala (2005). I consider Abbott and Snidal's rational choice framework as the main alternative explanation for form because Simmons (2001) and Drezner (2007) consider an actor's preference at the international level to be either (in Simmons' theory) an exogenously determined "preferred regulatory innovation" or (in Drezner's theory) the "domestic status quo." The evidence in this chapter demonstrates that it is difficult to apply the unitary actor assumption used in Simmons' and Drezner's theories to explain the form of international financial standards. Given the divergent preferences among the FDIC, OCC, and Fed, no single "preferred regulatory innovation" existed. Given that no common approach existed, the Fed was not advocating the "domestic status quo" at the Basel Committee. Similarly, this chapter's evidence points to the inapplicability of a model that assumes a stable domestic regulatory equilibrium, as in Oatley and Nabors (1998).

[290] Snidal (2002): 76.

organizations to reinforce their positions and policy preferences.[291] In other words, according to the rationalist/legalization perspective and consistent with the theory I propose, soft or hard law can result from regulators' domestic political motivations. The major distinguishing factor in the rationalist/legalization perspective is whether regulators have the authority to negotiate hard law.[292]

I argue that the authority of actors to negotiate hard law is moot. Where a domestic consensus exists on regulation of a given financial market, actors in coordinated states are incentivized to pursue hard standards because delegation to negotiate internationally is easily achieved. Any coordinated state actor can thus represent the state's preference internationally. A coordinated state representative, say in Brussels or anywhere else, can represent the interests of regulators and industry associations, who project a single voice—this *same* preference is projected in soft law institutions, such as the Basel Committee, where in the 1980s German officials preferred using the forthcoming legally binding EC standards to serve as the *de facto* global standards. Without such a domestic consensus among US regulators—and thus no single US voice that could be expressed by any US actor—the first-mover Fed was unable to credibly commit to a hard standard. Previous studies, such as Singer (2007), Oatley and Nabors (1998), and Zaring (1998), have pointed to domestic political motivations for the 1988 Accord, but none theorized the variety of those motivations across states and linked them to the pursuit of non-legally binding standards.

Substance

Previous scholarship on the 1988 Accord focuses on the market power of the US as the primary explanation for the fact that an agreement was achieved. It is hard to dispute that once the Fed and Bank of England strongly push at the Basel Committee, *some* outcome will result—but on whose terms? How credible were their implicit threats of denying market access to European or Asian banks when the Fed could not persuade the FDIC or

[291] Abbott and Snidal (2000): 453; Macey and Colombatto (1996).

[292] Abbott and Snidal (2000): 430.

OCC on a common capital adequacy approach and the Bank of England was attempting to ward off Her Majesty's Treasury from slimming down its regulatory role? Not very credible, I argue.

German officials' success in shaping a shallower standard than that preferred by the Fed or Bank of England is all the more remarkable when one considers measures of market size. To use the same measure as Simmons (2001): US banks provided domestic credit relative to GDP of 150 percent in 1988, while the corresponding figures for the UK (101 percent), Germany (97 percent), and France (95 percent) were all much lower.[293]

While arguing that the US and UK alliance explain the *fact* of the 1988 Accord, Ethan Kapstein's 1992 article accurately portrays German recalcitrance, French hesitation, and Japanese willingness to sign up to the Accord.[294] But, Kapstein does not specify these preferences according to policy dimensions in a bargaining model. With the benefit of Committee documents reproduced in Goodhart's history, I demonstrate that the Fed accepted the EC-Brussels framework for the definition of capital, affirmed during the Gerzensee meetings in April 1987.

Beth Simmons notes that "by some accounts, Japan, Germany, and France accepted the U.S./U.K. framework (with minor changes) because they were concerned that, without adjustment, their banks might not meet standards prevailing in the two dominant centers."[295] However, I argue that the US and UK *appeared* to leverage their collective market power so successfully because they moved to the continental European position on the capital definition—and made further concessions to placate German officials.

[293] World Bank dataset, http://data.worldbank.org (accessed 28 January 2013).

[294] Kapstein (1992).

[295] Simmons (2001): 603. Simmons states that the 1988 Accord was implemented through the EU Capital Adequacy Directive (604). The 1988 Accord was implemented through the Solvency Ratio and Own Funds Directives.

Finally, the substance of the 1988 Accord *does not* reflect the desire of the Fed to correct an international market failure and establish an optimal level playing field among American, European, and Japanese banks, as I argue above (pp. 89-90). This is perhaps most strikingly shown in Charles Goodhart's review of the Basel Committee documents:[296]

> There was no analysis, nor attempt made to assess what the optimal capital ratio should be. Instead, the actual numbers, 4 percent Tier 1 and 8 percent overall, largely fell out of the data, since the aim was to push up ratios somewhat everywhere, but not to do so by so much as to make it too difficult for large international banks to comply…. There were no attempts to relate the measures to underlying theory, such as 'Why do banks need capital?', or 'What is the market inefficiency (failure) which justifies regulatory intervention?'

Although national regulators at the Committee did not want to over-burden banks—though adjustment costs have been high for US banks under the 1988 Accord, Basel II, and Basel III—this *does not* provide proof of private capture of the Basel Committee.

Other scholars place more emphasis on the influence of global banks. In his compelling comparison of private-sector preferences and Basel II and III outcomes, Ranjit Lall demonstrates the influence of timely, well-resourced banking industry associations who sought to shape the substance of Basel II according to global banks' preferences.[297]

Yet, as I noted on pp. 95-96, Fed chairman Alan Greenspan *invited* the influence of large US banks, a point stressed in the account by Daniel Tarullo, who is now on the Fed Board of Governors: "Other officials, including [New York Fed President William] McDonough and Greenspan, emphasized the importance of a collaborative effort between supervisors and banks to develop the IRB approach. Greenspan explicitly invited banks to pay close

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[296] Goodhart (2011): 195-6.

[297] One of the conditions in Lall (2012) for the influence of first-mover banking industry associations is that the Basel standards are negotiated by "unelected regulators whose agreements did not require meaningful ratification by domestic stakeholders" (615). The evidence I have presented for the post-bargaining outcomes of the 1988 Accord and Basel II demonstrates that the US Fed faces considerable domestic hurdles in achieving agreement with the FDIC and OCC in the fragmented US structure.

attention to the work of the Basel Committee in order to 'influence the eventual outcome of the deliberations.'"[298] Unsurprisingly, large, well-resourced US commercial banks were extremely receptive to Greenspan's call for "flexibility" in capital standards.[299]

By contrast, in negotiations with his G-10 counterparts over the substance of the 1988 Accord, Fed chairman Paul Volcker kept banks at arm's-length from the Committee's deliberations. One former Bank of England official recalled, "We [the Bank of England] had to help the Fed argue with large US banks, like Citibank, 'Why *wouldn't* you want to run your banks in a risk-based way?'"[300] The stiff opposition from large US commercial banks, the FDIC, OCC, and Reagan Administration all served to spur Volcker towards increased capital levels—and not towards capture.

It is thus difficult to conclude that global banking standards are a straightforward instance of private-sector capture: global banks and their primary industry association (the Institute of International Finance) have consistently preferred less stringent capital standards to boost their returns on equity capital,[301] but their effectiveness at the Basel Committee appears contingent on whether their preferences align with those of the Fed and other regulators. Indeed, many of the continental European-based banks that are members of global banking industry associations are also embedded in coordinated states. Thus, I propose a different causal path than Lall (2012) does: the transmission of private-sector influence is *not* through direct international-level lobbying of the Basel Committee, but through convergent interests with *national* regulators that wield considerable power under open decision-making rules.

Given that coordinated states feature routine collaboration between regulators and industry associations, convergent public-private preferences are far more likely in France or Germany. On the substance of the 1988 Accord, the Volcker-led Fed was opposed by

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[298] Tarullo (2008) cites Greenspan (1999).

[299] Gordon (1999).

[300] Not-for-attribution interview, London (23 February 2012).

[301] Crook (2011).

major US banks—but French and German banks did arrive at a consensus with their regulators (the French officials preferring much laxer standards than the German officials). In Basel II, it so happened that the Greenspan-led Fed agreed with major US banks on the utility of internal models—thus the appearance of capture. In Basel III, French and German banks *and* their regulators strongly opposed the introduction of a risk-insensitive leverage ratio (as did large US banks), which the Fed and FDIC supported together in the aftermath of a global financial crisis that revealed the inadequacy of internal risk ratings.[302]

I have so far considered market power and private-sector influence as alternative explanations for substance. Domestic constraints can also provide a possible explanation. Thomas Schelling suggested in 1960 that a state is advantaged in inter-state negotiations when it can credibly point to a domestic constraint, such as a hawkish legislature that has limited the state representative's freedom to bargain. When the state does not have such a constraint, it is more likely to concede substantive points to its counterparts, who believe that the state would rather find agreement than end negotiations.[303] In a similar vein, Robert Putnam hypothesized: "[A] small win-set can be a bargaining advantage: 'I'd like to accept your proposal, but I could never get it accepted at home.'"[304]

However, Schelling's conjecture and Putnam's hypothesis assume that only one actor in a two-actor model is domestically constrained. It appears that both strong structural coordination and extreme fragmentation can constrain state actors. Who is more domestically constrained in the case of the Fed vis-à-vis the Bundesbank and BaKred (or BaFin) at the Basel Committee? Given its rancorous disputes with the FDIC and OCC, the Fed cannot credibly commit to faithfully implementing the Basel capital standards, thus generating uncertainty about the size of its win-set among its German counterparts. The Bundesbank and BaKred/BaFin, on the other hand, have a domestic regulatory consensus

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[302] Tarullo strongly supported the FDIC's preference for a leverage ratio before he became Fed Governor; see US Senate (2006). Once he was appointed Governor in January 2009, Tarullo supported FDIC chairman Sheila Bair's efforts to adopt a Basel III leverage ratio over the opposition of US banks.

[303] Schelling (1960).

[304] Putnam (1988): 440.

that would be extremely costly for them to adjust. The US and Germany are equally domestically constrained. It is thus difficult to explain a shallow Basel capital standard on the basis of domestic constraints without considering the role of an open decision-making rule.

Basel III liquidity standards and the two-step theory

Four days before its failure in September 2008 proved to be the tinder that lit global financial panic, the US investment bank Lehman Brothers declared that its Tier 1 capital ratio was 11.2 percent.[305] Despite accounting gimmicks, this figure was still nearly three times its required level. The precipitating event of the 2008 financial crisis was not a problem of capital, but of *liquidity*. It occurred not in the supervised banking sector, but in the "shadow" banking market, in which non-banks used securitization to perform bank-like functions, such as maturity transformation, without regulatory scrutiny.[306] When creditors lost confidence in the value of Lehman's assets, its liquidity "dried up"—it could no longer attract the overnight funding that financed its operations and its trading business, and soon failed.

Neither the 1988 Accord nor the 2004 Basel II standard came in the aftermath of a global financial crisis that matched the scale and intensity of the panic beginning in summer 2007 and peaking through early 2009. The early 1980s Latin American debt crisis did focus the Fed and other US regulators' attention on deteriorating capital adequacy in US commercial banks. But, the 1997 and '98 East Asian financial crisis spurred advanced countries' regulators and finance ministries to urge developing countries to adopt the 1988 Accord and other existing standards or principles for securities firms and insurance companies[307]—and did not serve as the primary impetus for the development of Basel II. The Fed's actions to support US and worldwide financial markets beginning in late 2007 through the present day have been unprecedented in American economic history. What does such a

[305] Jenner and Block (2008), the bankruptcy examiner.

[306] See Gorton and Metrick (2010).

[307] See Chapter 5 in Drezner (2007).

massive shock mean for the two-step theory? Do a fragmented state actor's incentives change in light of such a crisis? Does the crisis reduce the influence of bargaining rules?

With considerable blame placed on the laxity of national and international financial standards in the midst and aftermath of this latest crisis, central bankers, financial supervisors, and finance ministers had to respond. But, whereas the scale of the crisis necessitated the *fact* of international regulatory reform, it did not necessarily determine the form or substance of Basel III.

An alternative explanation based on institutional path dependence may also explain why central bankers and financial supervisors returned to the Basel Committee to negotiate soft capital and liquidity standards: the Committee was firmly entrenched as a focal point institution with an expert secretariat, financial resources, and a history of producing detailed standards whose implementation were monitored by the IMF.[308] For the remainder of this conclusion, I analyze strategic interaction among actors in the Basel III debate from the perspective of my two-step theory, and thus in a way that other scholars and observers have not yet done.

Structural fragmentation and enduring turf wars among regulators in the US incentivized the Federal Reserve to pursue a soft Basel III liquidity standard. At the time of Lehman's failure, no quantitative liquidity standards existed in the United States.[309] Both the Fed and Securities and Exchange Commission (SEC) sought to fill this regulatory vacuum. Although the sale of Bear Stearns to JP Morgan in early 2008 was facilitated by the Fed, investment banks' broker-dealers were primarily supervised by the SEC. As broker-dealers faltered over the course of 2007 and 2008, the SEC began to increase its work on liquidity risk management. At the same time, the Fed opened its discount window to allow investment banks, instead of only commercial banks, to benefit from emergency funding. Both regulators had stakes in setting liquidity standards.

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[308] E.g. Jupille et al. (2013).

[309] Hemel (2009) notes that liquidity regulation falls under the purview of the Federal Reserve, but does not mention that no quantitative liquidity regulation in the US existed in 2007 or 2008.

In congressional testimony, SEC Chairman Christopher Cox stated that his agency was attempting to negotiate a Memorandum of Understanding with the Fed on investment bank supervision and stress testing—and added that the SEC had reached out to the Basel Committee to become directly involved in liquidity standard-setting.[310] Despite the SEC's collaboration with the Fed, Cox argued that Congress should directly grant the SEC authority to set consolidated liquidity standards and leverage requirements for investment bank holding companies.[311] Cox sought to defend the investment banking model, whose demise would reduce the SEC's influence—but the investment banks re-organized as bank holding companies and thus came under Fed supervision after Lehman failed.

With the SEC interested in enforcing liquidity standards at the former investment banks and angling for input at the Basel Committee, the Fed had strong incentives to quickly pursue a new global liquidity standard. At the Basel Committee, the New York Fed and Bank of England co-chaired the Working Group on Liquidity and developed the detailed substance for a new quantitative liquidity standard. The Liquidity Coverage Ratio (LCR) requires banks to hold a certain minimum amount of liquid assets (usually government securities) to survive an "acute stress scenario."[312]

The purpose of the LCR is to require banks to hold assets that can be readily sold for cash in order to cover outflows.[313] Reflecting the preferences of the New York Fed and Bank of England,[314] the Working Group on Liquidity defined "high quality liquid assets" (HQLA)

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[310] Cox (15 July 2008).

[311] Cox (24 July 2008).

[312] The other ratio the group produced, the Net Stable Funding Ratio, would require banks to improve their maturity management by financing less-liquid, longer-term assets with more stable funding. A preliminary framework for the Net Stable Funding Ratio was released in December 2010, but further work will continue over the next two years. See Basel Committee (January 2013).

[313] Basel Committee (December 2010): 3. The LCR is equal to the stock of high-quality liquid assets divided by the anticipated total net cash outflows over 30 days. This ratio must be equal to or greater than 100 percent.

[314] Interview with US Treasury official, Washington, DC (31 December 2012).

narrowly and stringently.[315] The other half of the LCR—cash outflows over thirty days—was largely based on supervisory judgment and assumptions and based on the extreme stress observed in the retail depositor run on the Northern Rock bank in the UK and the "run on repo" on Wall Street banks in the US. [316]

However, when the Committee issued the Basel III framework in December 2010, it published final versions of the capital standards, but maintained that the Liquidity Coverage Ratio would have to undergo continued observation before the Committee could endorse its use. As a result, the Committee did not issue a final LCR standard until January 2013. What happened?

During bargaining, it quickly became clear that the Bundesbank and BaFin did not see the same merits as the Fed and Bank of England in the proposed quantitative liquidity standards. Considering the international status quo and key actors' preferences, the bargaining model I have presented in this chapter illustrates how open rules affected the substantive outcome. It would be foolish to suggest that the eurozone banking crisis did not affect bargaining at the Basel Committee; I offer the following as preliminary evidence consistent with propositions of the two-step theory.

What would be the international status quo if bargaining failed on a new Basel III liquidity ratio? The status quo, as defined by Basel II, entailed that banks "must have adequate systems for measuring, monitoring and controlling liquidity risk."[317] Liquidity risk was regarded as a "residual risk" resulting from credit mitigation techniques, such as collateral, guarantees, or credit derivatives, but subject not to any quantitative requirements, only

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[315] Basel Committee (December 2010): 5, 8-10. The Working Group defined HQLA as central bank eligible assets, featuring low credit and market risk, ability to be easily valued, minimal correlation with risky assets, and exchange-listed. HQLA were then split into two types. Level 1 assets included cash, accessible central bank reserves, sovereign-guaranteed securities, and a variety of zero-risk-weighted assets. Level 2 assets included different types of corporate and covered bonds subject to a haircut to simulate decreases in value during stressful times, as well as assets that had credit ratings of at least AA-.

[316] Ibid.: 4.

[317] Basel Committee (2004): 161.

supervisory assessment.[318] In other words, the international status quo was a lax supervisory guideline on liquidity, far from the quantitative liquidity standard supported by US Fed and UK officials.

Germany had actually moved beyond the international status quo, from qualitative requirements to quantitative standards.[319] German representatives believed their existing domestic liquidity standards, known as the 2006 Regulation on Liquidity (LiqV), were sufficient—especially during a time of extreme market stress when traditionally "high quality" liquid assets, such as sovereign debt, appeared far less marketable. Furthermore, the German liquidity standards placed much more emphasis on *internal* modeling of liquidity risks than the proposed Liquidity Coverage Ratio.[320]

Crucially, the German liquidity standard was relatively lax compared to the stringent definition of "high quality" liquid assets in the proposed LCR. The European Banking Authority's Banking Stakeholder Group, which includes bank representatives, corporate executives, and academics, regarded the German standard as an "uneven, sometimes weak regulatory framework [that] reflects an era of 'easy money', with excess liquidity flowing throughout financial markets."[321]

At the Basel Committee, German representatives were joined by French officials in pushing against a stringent Liquidity Coverage Ratio. In France, officials regarded the US and UK proposals for new global liquidity standards as reflecting a failure of the "Anglo-Saxon" model of finance.[322] As illustrated in Figure 3.4 below, they bargained aggressively versus the Fed and Bank of England to gain concessions in exchange for supporting the preliminary Committee endorsement in December 2010 of quantitative liquidity ratios.

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[318] Ibid.: 166.

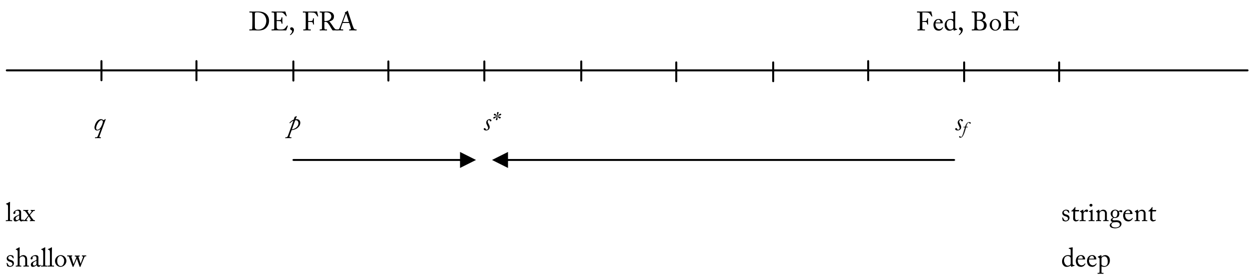
[319] Hartlage (2012).

[320] Bundesbank (2006).

[321] EBA Banking Stakeholder Group (2012): 19.

[322] Laurent (2011).

Figure 3.4: Bargaining over the Basel III Liquidity Coverage Ratio



By the time the final LCR standard was issued in January 2013, German and French officials were successful in forcing the Fed to expand the definition of "high quality liquid assets" and reduce the severity of "run-off rates" used in stress scenarios.[323] And the implementation timeline was extended even further, so the LCR will not be fully implemented until *2019*.[324]

Therefore, despite the scale and intensity of the global financial crisis, the bargaining over Basel III reflects the enduring influence of recalcitrant actors' preferences under open decision-making rules. But through its work on a Basel III Liquidity Coverage Ratio, the Fed intends to steer implementation of the corresponding US standard:

> The Board intends, in conjunction with other federal banking agencies, to implement these standards in the United States through one or more separate rulemakings. Through implementation of these standards in the United States, the Board anticipates that the Basel III liquidity rules would then become a central component of the enhanced liquidity requirements for covered companies, or a subset of covered companies, under section 165 of the Dodd-Frank Act.[325]

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[323] "Severity of stress scenarios" refers to assumptions on run-off, which is the rate at which supervisors expect certain types of funding (such as retail and corporate depositors) to leave the bank in a given timeframe. See Annex 2 in Basel Committee (6 January 2013).

[324] This means the LCR would not have to equal 100% until 2019. Instead, the minimum standard would be 60% in 2015 and increase by ten percentage points each year thereafter. Gifford (2013) argues why the LCR is a misconceived response to liquidity risk.

[325] Board of Governors (2012): 600.

This dull paragraph, from the Fed's January 2012 Proposed Rule, belies the implications of strategic interaction within the US financial regulatory structure. Pursuit of a soft Basel III liquidity standard is consistent with the incentives and ability of the Fed in guarding against the SEC's efforts to develop US quantitative liquidity standards. Despite the recent instability in global finance and concomitant demands for significant regulatory change in the US, domestic institutional structure still shapes the intermediation of actors' interests.

At one point during my research, I interviewed a staffer from the Senate Banking Committee in Washington, DC about the post-crisis reforms. She said, "We did Dodd-Frank in a hasty fashion. Substantial changes were being made at four in the morning of the final day of debate. We gave simple directions to the regulators, for them to figure out."[326]

Setting capital and liquidity standards—the core of financial regulation today—is rarely simple in a fragmented state such as the US. Given the entrenched arm's-length relations between the Fed, FDIC, and OCC, as well as the lack of encompassing industry associations, the temptation for the Fed to "use" the Basel Committee—to negotiate with foreign central bankers and regulators to further its own domestic political interests—is ever present. It is conceivable that inter-state cooperation within the Basel Committee may actually grow stronger over time even as intra-state cooperation within the US suffers.

[326] Interview with Ellen Chube, Washington, DC (8 September 2010).

CHAPTER FOUR

C'est incroyable!
Paris Sets the Pace on Alternative Investment Fund Regulation

On 29 April 2009, the City of London woke up to a shock from Brussels. By putting forward the Alternative Investment Fund Managers (AIFM) Directive, the European Commission (EC) proposed regulating hedge fund managers, in addition to private equity, venture capital, and real estate groups. The prospect of the Directive worried not only the City of London, but also fund managers in New York. Their funds, like those of London managers, are legally domiciled in different jurisdictions, such as the Cayman Islands, around the world. The fund managers would be barred from gaining investors in the European Union (EU) market if they and their funds failed to meet "equivalent" standards, as judged by the EC.

Accustomed to the light regulatory touch of the UK Financial Services Authority, London fund managers had paid little attention to rumors about the proposal. In 2009, the UK accounted for 76 percent of European assets managed in hedge funds, amounting to nearly $382 billion.[327] Infuriatingly, *French* officials—with a pitifully sized industry—led the charge, gaining significant support from other EU states, for the AIFM Directive. How could this happen?

International political economists have not explained how non-hegemonic states can set international standards,[328] let alone anticipated that such standards would be legally

[327] IFSL (2010).

[328] Simmons (2001); Singer (2007); Drezner (2007). Fioretos (2010) focuses on the non-legally binding G20 Leaders communiqué of April 2009 that endorses direct or indirect regulation of hedge funds.

binding.[329] The two-step theory expounded in Chapter 2 suggests a compelling answer on the basis of previously undocumented primary evidence.

In coordinated states, regulators have well-defined mandates, avoid systematically undermining each other, and share some public authority with industry associations, which are hierarchically organized. Regulators and industry routinely collaborate on domestic standard-setting by sharing information and drafting proposals together; it is the opposite of the arm's-length relationship found in fragmented states. This coordination increases the likelihood that regulators and industry will come to a domestic consensus on how to regulate certain financial firms or markets. In turn, a coordinated state actor is incentivized to export the standard which reflects this consensus because having other states adjust to its preferred standard entails distributional gains. As legally binding obligations demonstrate a stronger credible commitment than non-legally binding obligations, the coordinated state actor prefers a hard standard to bind other states.

As a coordinated state, France had a regulatory consensus in its 2003 Financial Security Law, which set forth an all-encompassing framework for alternative investments. France sought a legally binding EU standard that would increase the regulatory burden not only on the UK, but also on the United States through the third-country "equivalence" process for accessing the EU internal market. The EU has become a focal point hard law institution whose financial standards on the supervision of financial conglomerates and data privacy have become *de facto* global standards.[330]

A French-crafted EU standard would benefit large French universal banks and the nascent asset management industry in Paris. French regulators and industry associations, though,

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329 Ferran (2011); Woll (forthcoming).

330 And in other issue-areas, such as environmental and consumer safety; see Vogel (2012). The US is not a member of the EU, but US Treasury, the Federal Reserve, Securities and Exchange Commission, and other bodies participate in the transatlantic Financial Markets Regulatory Dialogue, through which US and EU officials exchange views on proposed regulations and attempt to negotiate compromises on US and EU standards through equivalence/mutual recognition agreements. During two summers at the US Treasury, I worked directly on FMRD issues. Bach and Newman (2007); Hellwig (2005).

could not gain these distributional benefits through non-legally binding principles developed at the International Organization of Securities Commissions. Thus, if successfully enacted, hard EU law would reflect French efforts to credibly commit other states (including the US) and market participants to its preferred international standard.

The second part of the two-step theory proposes that restrictive decision-making rules at the international standard-setting institution lead to deeper standards than open rules. That is, rules such as majority or supermajority voting lead to a greater change from the status quo as measured on a single policy dimension than open rules do.

The opportune moment for French officials to initiate standard-setting in the EU under its semi-restrictive decision-making rules came in the aftermath of Lehman Brothers' collapse in September 2008. These rules were devised in the 1980s and entrenched in the 2000s to speed up European financial market integration. With their preference for a legally binding and substantively deep standard, French representatives at the EU found support among German officials and pressured the European Commission to propose the AIFM Directive.

Until 2008, Britain greatly benefited from the status quo of minimal and indirect regulation of alternative investment fund managers; in London, neither regulators nor industry officials considered hedge funds a cause of the global financial crisis. But once French representatives and their allies coalesced, British representatives found themselves easily outnumbered during bargaining under qualified majority voting (QMV) rules. Under QMV rules, the French-led coalition did not have to concede to British objections to the substance of the proposed standard.[331] Despite its low market power, as a first-mover, France was highly successful in setting the hard form and deep substance of an EU

[331] As explained below, I consider the substance of the prudential AIFM standard to be measured on a single dimension of "laxity" to "stringency" in regulation of alternative investment fund managers—not on a dimension of coordination versus no coordination (i.e. harmonization versus fragmentation in the EU internal market for alternative investments). I also briefly discuss the bargaining over access for non-EU fund managers and funds to the EU market, a debate which received much more journalistic attention than the bargaining over the detailed substance of the prudential regulations contained in the AIFM Directive.

prudential standard on alternative investments that simultaneously serves as *global* hedge fund regulation. Although bargaining dragged on regarding third-country access (and on this the British were more successful), the French-preferred deep and stringent prudential substance of the standard was an early *fait accompli*.

In the conclusion, I consider a number of competing explanations. Given that alternative investment funds and their managers had never before been subject to prudential supervision at the international level (let alone stringent regulation), the rationalist/legalization perspective reasonably predicts that soft law would be appropriate. I also consider how my approach is similar to, and how it crucially differs from, a Varieties of Capitalism approach to explaining new international hedge fund standards. On substance, the market power argument falls short in light of French officials' success as first-movers. I explore the conditions necessary for an actor to make a successful first move under restrictive decision-making rules at an international standard-setting institution. I note how the deep substance of the prudential AIFM standard can also be explained by considering domestic constraints, but a counter-perspective based on the influence of supranational actors is not consistent with the evidence I present.

A brief note on alternative investment regulation

Hedge funds are perhaps the most popularly recognized type of alternative investment fund, although the category also includes private equity, venture capital, and real estate funds. This brief sidebar focuses on hedge fund regulation, but similar prudential issues apply across types of alternative investment funds.[332]

The first hedge fund was launched in the United States by Alfred W. Jones in 1949, a half-century before the implosion of Long Term Capital Management (LTCM) in 1998 sparked the first calls for monitoring of the expanding industry. Hedge funds are privately

[332] FSA (November 2006).

managed pools of funds that trade instruments ranging from securities to derivatives, use leverage to amplify returns, conduct short-selling, and generally face different regulatory requirements than investment funds (such as mutual funds) available to retail customers. Funds employ different investment strategies, from "long-short" to "event-driven," and generally seek absolute returns whether a bull or bear market exists. Fund managers are well-remunerated through a conventional, incentive-based fee structure (2% of assets under management plus 20% of positive returns charged).[333] Growing from under $600 billion in assets under management as of 2000, the global industry managed $1.67 trillion in assets in 2010.[334]

The rationale for regulation of hedge funds rests on concerns about systemic risk and investor protection. Similar investment strategies pursued by many fund managers—"herd behavior"—could leave a large number of hedge funds exposed to losses in particular assets; common selling of failing assets by several funds could worsen a financial crisis. A fund's counterparties, such as banks, could be exposed to considerable losses if the fund fails, indirectly leaving vulnerable the banks' customers. Moreover, institutional investors, such as pension funds, are some of hedge funds' largest investors, raising the salience of the funds' soundness for everyday individuals, beyond the usual class of affluent investors.

Hedge fund regulation can focus on either the fund manager or funds, and can be generally characterized as either *direct* or *indirect*. A single fund manager in New York, for example, can run funds that are legally domiciled in the Cayman Islands, Delaware, or Ireland (or elsewhere). Direct regulation of a fund manager or fund focuses on ensuring balance sheet solvency. Minimum investment levels can limit access to high net-worth investors, who are presumed to be sophisticated enough to forego robust investor protection rules. However, retail investors with relatively lower minimum investment thresholds can purchase funds composed of different hedge funds (known as funds-of-funds), as in France. Regulation of a fund manager's or fund's assets can thus conceivably range from simple registration requirements, as in the UK or US, to capital and leverage requirements.

[333] Crockett (2007): 20-3.

[334] Cole et al. (2007): 8.

Indirect regulation focuses on the fund manager or fund's counterparties (known as the "prime brokers" that lend to hedge funds), ensuring that they have the ability to monitor exposures to potential losses, adequate collateral requirements, and enough capital.[335] According to the indirect approach, investors in hedge funds are expected to conduct their own assessment and due diligence of the fund's worthiness.

I. Coordination prevails: the French governance of securities markets and domestic regulatory consensus on alternative investments

Regulators and industry associations in France operate in a coordinated institutional structure. The interdependent relationship between regulators and industry associations today in France reflects the legacy of a state-directed, bank-based financial system. The rise of capital markets and growing recognition of shareholder value have not destroyed this structural coordination. Rather, these trends demonstrate the French commitment to "managed globalization" over *laissez faire* liberalization.[336] Indeed, for three decades, the French state has deliberately sought to position Paris closer to the center of international capital markets.

In the 1980s, the French state sought to reshape the country's financial regulatory structure. Alongside President Mitterand's bank nationalization, the far-reaching 1984 Banking Act transformed the French financial legal framework and created regulators which received strictly delineated mandates for rule-writing, licensing, and implementation. A key part of the French finance ministry (*Trésor*) and banking regulators worked with the new securities regulator, which in turn implemented standards with the securities industry association.[337]

The French state also deliberately created peak-level, encompassing industry associations. These associations complemented legal reforms that lessened the distinctions between inter-market brokers, securities firms, commercial banks, merchant banks, savings banks,

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[335] Crockett (2007): 25-6.

[336] Abdelal (2007); Bertero (1994); Coleman (1996); Zysman (1983); Hall (1986).

[337] de Boissieu (1990).

and cooperative banks (active in agricultural, small business, and housing finance). As the case was then and is now, French banks are legally required to belong to an industry association that matches their activities. In 1984, the *Association Française des Banques* (AFB) held this legal "monopoly" for retail banks and joined industry associations representing mutual savings banks and securities firms in the integrated *Association Française des Etablissements de Crédit* (AFEC).[338]

In the 1990s, structural coordination in France did not erode in the face of financial globalization. French securities markets became some of the most internationalized in the world and a popular destination for Anglo-American mutual and pension funds.[339] Between 1985 and 1997, the share of French stock exchange capitalization held by foreign investors increased from 10 to 35 percent.[340] Internationalization of French securities markets was the intended outcome, as regulators and industry alike sought to attract foreign portfolio investment and a wide array of French corporations, such as Alcatel, Vivendi, LVMH, and Axa, pursued global acquisition strategies.[341]

French securities markets liberalization

In this section, I place the French regulation of alternative investment fund managers in the context of the broader history of French securities markets liberalization, which occurred through coordinated efforts by regulators and industry officials. I then outline the domestic regulatory structure in French securities markets that helped shape a consensus on alternative investments, which in turn formed the basis of the French push for a legally binding EU standard.

The French political and financial elite jointly dismantled arcane regulation of capital markets in Paris. This was an undertaking propelled by the purposeful coordination of the

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[338]Ibid.: 80.

[339] Goyer (2006).

[340] Morin (2000): 42.

[341] O'Sullivan (2007): 426.

finance ministry (through its *Trésor* arm) alongside Crédit Agricole and other, mostly state-guaranteed banks. A series of reforms in the 1980s introduced new financial instruments and ended the monopoly of *agents de change*. Granted a monopoly by Napoleon in 1807, these stockbrokers had controlled trade on the Paris Bourse. Breaking their reign allowed universal banks and securities firms to take advantage of reform. *Trésor* directly initiated trading in certificates of deposit, commercial paper, and *bons de Trésor* (T-bills) on liberalized exchanges, and it constructed the Paris futures market to compete with London's.[342] Liberalization facilitated sales of the state's stakes in firms, helped service debts, and underpinned the growth of the bond market, on which the state's share of total issues rose from 25 percent in the mid-1980s to about 70 percent in 1998.[343]

The French state ensured that households, too, participated in this centrally managed process of capital markets liberalization. Indeed, the seeds of the French push for EU alternative investment standards in 2008 began with reforms taken by the *Trésor*, regulators, and industry officials to build the European mutual fund industry in order to benefit French households. In the 1970s, French households placed deposits in banks, but could neither easily withdraw them nor receive much interest on their illiquid deposits. In 1978, the finance ministry instituted a tax deduction of 5,000 francs for new household investment in securities. Households bought mutual funds, which quickly became the dominant way in which French citizens owned stocks.[344] French mutual funds (*organismes de placements collectifs en valeurs mobilieres*, or OPCVMs) soon became extremely popular,[345] stimulating investment in the two main forms of OPCVMs: SICAVs (*sociétés d'investissement à capital variable*) and FCPs (*fonds communs de placement*).

In turn, French regulators and industry officials promoted their domestic consensus on mutual fund regulation at the European Union. The European Commission first proposed an EU common market in mutual funds in 1976, when French financial liberalization had

[342] Story and Walter (1997): 214-215; Marsh (1985).

[343] O'Sullivan (1997): 414.

[344] Cerny (1989): 177.

[345] Marsh (1982).

not yet occurred. Although EU member states agreed on the terms of admission, listings, and information publication for integrated capital markets in the early 1980s, French representatives waited until 1985 to finally agree to an EU directive on mutual funds.

The 1985 directive established a common market for Undertakings for Collective Investment in Transferable Securities (UCITS), which mirrored the French 1979 law on OPCVMs that specified the different securities allowed as investment assets. The UCITS Directive restricted the single EU market in mutual funds to European fund managers, who operated across member states on the basis of mutual recognition.[346] French regulators shortly thereafter innovated beyond this first basic UCITS directive. In 1987, French legislation created the first European mutual funds that permitted the use of derivatives and leverage to boost returns, in exchange for strict rules on liquidity and valuation (known as futures funds or FCIMT).[347]

The French initiative to export their domestic standards to the European Union wildly succeeded. By 1988, SICAVs hit the trillion franc milestone. Large French banks led the way in marketing and distributing the funds to their existing retail customers: Crédit Agricole, Banque Nationale de Paris, the Post Office, Crédit Lyonnais, and Société Générale accounted for selling 54 percent of SICAVs.[348] By September 1990, the French UCITS industry was the largest in Europe at 1.414 trillion francs,[349] and by June 1995, Crédit Agricole led with 10.5 percent of the total European market share. The Caisse des Dépôts et Consignations, still largely state-run by the *Trésor*, was fourth with 7.4 percent of the European mutual fund market.[350]

Across areas of the financial services industry, French regulators and industry officials attempted to craft EU standards on the basis of their domestic standards. To some

[346] Story and Walter (1997): 257.

[347] Morio (2001).

[348] Graham (1988).

[349] Graham (1990).

[350] *Les Echos* (1995).

observers, this coordination seemed protectionist or indicated private capture of public regulation: "This would at once give French companies larger markets to grow in while insulating them from the fierce international competition that full liberalization would imply."[351] Elements of the UCITS success story appeared in other directives. The UCITS Directive firmly established the principle of mutual recognition, a key precedent for the comprehensive Second Banking Directive, which member states negotiated in the late 1980s. French officials protected their *bancassurance* model in insurance directives, while promoting brokerage and related services in the Investment Services Directive. French officials were less successful in these efforts in the 1990s, but they scarcely relented in attempting to construct the EU single financial market according to their domestic consensus.

French securities market: coordination between regulators and industry

Structural coordination between French regulators and industry associations remains strong.[352] Regulatory agencies are well-integrated and set standards collaboratively with industry officials. In 2003, the *Autorité des Marchés Financiers* (AMF) was formed by a merger of the *Commission des Opérations de Bourse* (COB), the stock market regulator; the *Conseil des Marchés Financiers* (CMF), a self-regulatory organization; and the *Conseil de Discipline de la Gestion Financière* (CDGF), regulator of the asset management industry.[353] When the European Commission proposed the AIFM Directive in 2009,[354] the AMF was the sole French securities market regulator and worked with both the banking regulator and the Banque de France.

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[351] Lalone (2005): 218.

[352] Jabko and Massoc (2012) is a sociological/institutional narrative applied to the 2008 bank bailout. It is complementary to my argument about France as a coordinated state. It usefully analyzes the informal coordination between the Fédération Bancaire Française industry association with banking regulators and the Ministry of Finance.

[353] Iskandar (2003).

[354] Further consolidation of the banking and insurance regulators was being implemented when the AIFM Directive was proposed.

The board of the AMF reflects the collaborative nature of French financial regulation. In addition to judges, regulators, a representative from the central bank, and appointees of the presidents of the Senate and the National Assembly, the sixteen-member board also includes six industry representatives “appointed by the finance minister, after consultation with organizations representing … firms managing collective investment schemes,” among other types of securities firms.[355] The AMF Secretary-General suggests that broad representation deepens the legitimacy, rather than loosening the stringency, of its standards:

> When our board adopts rules in individual decisions, I only have the power to propose to the board. Much of our board is professionals. Our board of sixteen includes two asset management officials, current and retired. What is funny is that despite the professionals [on the board], it does not mean we are not harsher. This balance of power is a filter. There are several filters. The finance minister’s approval is the last one.[356]

This description reflects how the AMF formally works closely with industry associations on the *Comité Consultatif de la Législation et de la Réglementation Financières* (CCLRF), which must be consulted on *all* national and EU legislation and which can only be overridden by the Finance Minister in the case of disagreement after a second round of consultation.[357]

Below high-level exchanges, formal collaboration in rule-writing has entrenched credible commitments between the AMF and the asset management industry. Within the AMF, regulator-industry working groups, such as the Consultative Commission on Individual and Collective Asset Management, were set up in 2004 to examine prevailing practices and propose reforms.

The asset management industry, which includes “hedge funds” (a word alien to the French language), is represented by *Association Française de Gestion Financière* (AFG), a highly

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355 AMF (November 2010).

356 Interview with Thierry Francq, Paris (12 January 2011).

357 Economist Intelligence Unit (2009).

integrated, *non-profit* industry association that faces no competition for members. It has 409 members, either independent or belonging to French or foreign banking or insurance groups. AFG encompasses fund managers running mutual funds, the employee savings schemes, hedge funds, funds-of-funds, private equity funds, and real estate funds. AFG has the authority, granted by the Monetary and Financial Code, to represent and advocate on behalf of its members:[358]

> Each investment firm, each market undertaking and each clearing house belongs to an association of its choice which is responsible for the collective representation and the defence of the rights and interests of its members. Any association thus constituted is affiliated to the association referred to in Article L. 511-29 (the Association Française des Etablissements de Crédit et des Entreprises d'Investissement - AFECEI). AFG is a member of AFECEI since September 5th 1996.

Asset managers in France are regulated by the Monetary and Financial Code and the General Regulations of the AMF, *as well as* conduct of business rules issued by AFG.

Banks and asset management companies are often intertwined, as the largest French universal banks have major stakes in the asset management industry. For example, Amundi Asset Management is the product of a merger between the asset management arms of Crédit Agricole and Société Générale. Amundi is the world's ninth largest asset management firm with nearly €700 billion in managed assets.[359] Firms such as Amundi widely distribute alternative investments through funds-of-funds, which are thought to reduce the risk exposure to any given hedge fund, and are consequently popular among retail investors.

The big banks' asset management companies are represented through the AFG, which is itself represented by the peak-level AFECEI. Lobbying is "*un gros mot*" because of its adversarial connotation, but is also a moot concept in France because regulators and

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[358] AFG (2013).

[359] Amundi (2013).

industry associations are deeply ensconced in collaboration.[360] The French state strongly supports AFECEI's efforts to find consensus across banks of various sizes and specialties, and AFECEI directly participates in the policymaking process.[361]

Domestic regulatory consensus: 2003 Financial Security Law

The 2003 Financial Security Law addressed a range of issues, including structural regulatory reform, corporate governance, and—important to my purpose here—prudential standards for investment funds. This section describes the comprehensive and encompassing legal framework for UCITS and alternative investments in France that underpinned French representatives' push for legally binding standards at the international level.

In the early 2000s, corporate malfeasance and accounting scandals dominated discussion of financial reporting and regulation. The failures of Enron and WorldCom in the United States sparked corporate governance reform, and major losses at Vivendi Universal and France Telecom led to investigations by the French stock market regulator COB.[362] Legislatively, the French government responded by proposing: the creation of the *Autorité des Marchés Financiers* (AMF); new protections for savers and insurance policy holders; and new corporate governance rules to oversee auditors and improve financial transparency.[363]

Additionally, the 2003 Financial Security Law reformed standards on mutual funds (UCITS) and developed a framework for alternative investment funds that was much more detailed and rule-based than corresponding legislation in the US or Britain. French officials crafted a new EU Directive (UCITS III) that expanded the definition of eligible assets to include bank deposits, allowed for the use of derivatives, and permitted issuance of both retail and institutional shares, all of which increased the size of the funds. These

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[360] Interview with industry official, Paris (12 January 2011).

[361] Coleman (1996): 118.

[362] Curtin (2002).

[363] Mallet (2002).

reforms put French mutual funds under rules similar to those governing their primary mutual fund competitors in Luxembourg.[364]

French regulators and industry officials alike viewed implementation of the UCITS III Directive as an opportunity to develop alternative investment funds that could be marketed to "qualified" investors—not just UCITS retail investors—and could be offered by asset management firms. Average individuals would invest in the funds usually through institutional investors, such as pension funds or insurance groups. Further, asset management firms also clamored for a type of contractual fund (OPCVM *contractuel*) that would allow them to compete with the funds domiciled in Ireland or Luxembourg that had far fewer restrictions on leverage and investment strategies.

Responding to these demands from investors and firms, French regulators and industry associations began to draft standards for hedge funds and other alternative investment funds. While the AMF was being established, the COB, *Trésor*, and AFG industry group formed a 40-member body which oversaw four separate working groups on eligible assets, the use of derivatives, ethics, and disclosure.[365] According to a senior AMF official, "If there is a clear law, it will create more confidence in the industry. They want tax advantages, and it could be good to have them. But, this needs a legal vehicle, an *enveloppe*. We like to have everything in well-established boxes. Otherwise, *ce n'est pas normal*."[366]

This approach led in 2003 to a proliferation of different alternative investment funds following specific regulations established in awkwardly worded legal *enveloppes*. The 2003 Law not only incorporated asset management firms' preference for a lightly regulated contractual fund (OPCVM *contractuel*), but also created a plethora of other legal vehicles: funds of hedge funds (OPCVM *de fonds alternatives*); lightly-regulated/non-leveraged funds of hedge funds (OPCVM *agréés à règles d'investissement allégées sans effet de levier*,

[364] Economist Intelligence Unit (2004).

[365] Le Page (2003).

[366] Interview with Thierry Francq, Paris (12 January 2011).

OPCVM ARIA SEL); lightly-regulated/leveraged funds of funds (OPCVM ARIA EL); and new futures funds (FCIMT).[367]

The scope of the standards quickly expanded beyond hedge funds. Under the 2003 standards, corporate pension plans could invest in company-specific funds (*fonds commun de placement d'entreprise* or FCPE), while other fund managers could operate regional private equity funds or invest in local SMEs (*fonds d'investissement de proximité*) and real-estate funds (*société civile de placement immobilier* or SCPI).[368] Francq explained, "There is a jealousy between Paris and the rest of France. Many thought that private equity was too focused on Paris, so we had to create something, regional private equity funds. And we created two more specific funds that are not-for-profit, investing in international development and another [type] led by non-French nationals."[369]

Each of the legal *enveloppes* for the funds specifies corresponding rules on leverage, asset valuation, transparency, and marketing. The stringency of these rules generally increased as one moved from contractual funds (OPCVM *contractuels*) to OPCVM ARIA, FCIMT, and retail UCITS. The funds most similar to US-managed hedge funds are contractual funds, which are marketed mainly to institutional investors, can pursue virtually any portfolio strategy, and have lower reporting requirements to the AMF. Contractual funds are not restricted in leverage and eligible financial instruments. However, the asset management firm offering contractual funds must have been previously authorized with the AMF.[370]

The 2003 legal framework was not hospitable to offshore funds. The AMF must authorize the fund manager to market offshore funds, such as those domiciled in the Cayman Islands

[367] Le Page (2003).

[368] Economist Intelligence Unit (2005).

[369] Interview, Paris (12 January 2011).

[370] *L'Agefi Actifs* (2003).

and elsewhere, among French investors. According to lawyers, "this authorization is, in practice, almost impossible to obtain."[371]

Discussions between the AMF and AFG did not proceed smoothly on one crucial issue: the security of assets and the role of the prime broker. In the US or Britain, prime brokers provide lines of credit to hedge funds and help facilitate settlement and delivery of trades. But, the prime broker did not have a functional equivalent in the French asset management industry, which usually placed liability on depositaries to safeguard assets and indirectly supervise the fund manager. Whereas prime brokers are often international investment banks, such as JP Morgan or Goldman Sachs, in France, depositaries are usually the major universal banks—for example, the leading French depositary, CACEIS, is owned by Crédit Agricole.[372]

It was initially unclear what the liability of a prime broker should be. The AFG delicately noted the difficulty: "You can lose a little time on this issue because the problem is not simple…. The AMF does not want prime brokers which would allow investments that would not be secured."[373] In the end, regulators and industry agreed that while depositaries are liable for the assets invested by the fund manager, prime brokers must meet requirements on capital, minimum credit ratings, re-hypothecation limits, and collateral. The 2003 standard is much more stringent than those in the US or UK: the 2003 law dictates that the depositary is fully liable for the fund's regulatory compliance, even when the depositary delegates some or all of its functions to a third party.

Soon after the 2003 law took effect, regulators worried about the complexity of the framework and the vulnerability for widespread losses as the result of confused compliance. Worries about systemic risk grew after Amaranth Advisors, a $6 billion US hedge fund, collapsed in 2006. It was not difficult for French retail investors to gain exposure to such funds. For example, retail investors with a minimum investment of €10,000 could invest in

[371] Puel et al. (2010): 75.

[372] CACEIS (2011).

[373] Quoted in Denis (2004). Author's translation.

hedge funds (called ARIA III funds). Thus, major losses among hedge funds could affect investors beyond the most affluent.

Recognizing such risks, the AMF sought to streamline the 2003 framework. The AMF commissioned a report by Philippe Adhémar, an AMF Board Member, and several industry representatives from Crédit Agricole Asset Management, Rothschild Multi Management, and other firms to recommend how to streamline the French legal framework for alternative investments. In implementing the report's recommendations, the AMF consolidated various rules into more general standards, whose stringency nevertheless still easily exceeded those in the US or Britain. For example, under the revised rules, ARIA III fund managers would have to demonstrate to the regulator that it could conduct regular, accurate, and independent valuation of hedge fund derivatives and detail in its investor prospectus how such derivatives would affect the risk profile of the ARIA III fund.[374] The AMF further refined the rules governing depositaries and auditors, and issued mandates for disclosure regarding fees and undiversified risks. Tellingly, the report noted that "these recommendations could serve as guidelines for the AMF's position in international discussions on FoHFs [funds of hedge funds] and, in particular, for the creation of a European vehicle for funds of hedge funds."[375]

The AMF continued to address investor protection in the alternative investment market. In November 2007, the AMF used the opportunity when implementing the Markets in Financial Instruments Directive to strengthen French standards on marketing, compliance, and internal organization to prevent conflicts of interests and risky practices.[376] Another collaborative, AMF-commissioned report inspired these reforms, which highlighted "the need to meet a growing demand for information and advice by consumers on savings investments, notably for the purpose of retirement as well as preventing a recurrence of incidents of mis-selling."[377]

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[374] AMF (September 2007): 4.

[375] Ibid.: 5.

[376] Dumas and Vodjevic (2010).

[377] AMF (2005): 1.

In sum, the French legal framework for alternative investment funds is a domestic regulatory consensus which reflects three concerns. Prudential standards for fund managers and funds set requirements for leverage limits, depositary liability, disclosure, and valuation. Investor protection rules set minimum investment thresholds and prevent mis-selling to retail investors. The third concern is for the competitiveness of non-bank-owned French asset management firms as they seek to expand their market share in France, Europe, and the world through standards that prevent the intrusion of offshore funds.

The development of the French regulatory consensus on alternative investment standards was the product of debate between the AMF, AFG industry group, and the largest universal banks. As AMF Secretary-General Thierry Francq believes: "When there is something new, or something so-called new like hedge funds, the first reaction in France is precaution, especially when it applies to something that could reach the retail investor. It's something different to understand."[378] Precaution is the reaction of a coordinated state. A former AMF chairman half-joked, "If you put the US at one end and China at the other, we're somewhere in the middle."[379]

II. Incentives for legally binding international standards

French regulators and industry associations had a consensus on alternative investment standards that was first established in 2003. By 2007, assets in funds-of-hedge funds comprised more than one-third of all investment in hedge funds worldwide: $700 billion.[380] At the same time, French funds-of-hedge funds grew rapidly. Between 2002 and 2007, assets in funds-of-funds increased 25 to 30 percent per year.[381]

In terms of the two-step theory presented in Chapter 2, the 2003 legal framework for alternative investment funds evidenced a high degree of credible commitment between the

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[378] Interview, Paris (12 January 2011).

[379] Interview with Michel Prada, Paris (20 November 2012).

[380] AMF (Fourth Quarter 2007).

[381] AMF (Second Quarter 2008).

AMF, as securities regulator, and the asset management industry. Once deliberations on the legal framework for alternative investment funds finished, industry officials did not seek to overturn the standards they collaboratively set with regulators. Instead, they sought to export those standards, transforming their highly credible domestic commitments into international ones. As Michel Prada, AMF chairman at the time, characterized it to me:

> The Minister of Finance would work with AMF and firms to design orientation. In some cases, we might disagree and would tell them. But, we wouldn't have this kind of perverse situation where we would fight with each other at the EU level. It was coordinated. We would arrive at important points where we thought we shouldn't yield [to other countries].[382]

But, how could French regulators and industry raise the standards of other jurisdictions and begin to expand in European and global markets?

In 2006, the European Commission expressed interest in regulating alternative investment funds and providing them a passport to operate throughout the EU internal market, instead of re-registering in each member state. Citing global competition in alternative investment funds, the Commission noted that the existing UCITS framework did not suffice because of the funds' investment strategies and complex structures; this was the case not only for hedge funds or private equity funds, but also open-ended real-estate funds, which managed €150 billion in assets in the mid-2000s. Further, it recognized that "there is no common European approach to distinguish products which are suitable for the retail public from products which should remain the preserve of sophisticated investors. National experience has shown that there is no fully satisfactory basis for making a cast-iron distinction."[383]

Prodded by France and other Member States, the Commission explored how to create a European brand for hedge funds, on par with the popular UCITS retail brand, to compete globally.[384] In April 2008, the European Commission held a hearing to discuss a single

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[382] Interview, Paris (20 November 2012).

[383] European Commission (2006): 13.

[384] AMF (Second Quarter 2008).

European market for non-UCITS funds, including hedge funds, private equity, venture capital, and open-ended real estate funds. The Commission discussed three options. The first option entailed extending the UCITS framework to hedge funds and other alternative investment funds. The second option would create a new directive modeled on the UCITS directive. The third option offered a change from "product-based" regulation to a "straightforward 'player' approach" for non-UCITS fund managers, i.e. *all* alternative investment fund managers (hedge, private equity, venture capital, real estate). The AIFM Directive corresponds to the third option.

Given that it originated in French law, UCITS is synonymous with the French asset management industry. For example, in the increasingly popular category of UCITS Absolute Return Funds, which feature strategies similar to those of hedge funds, in 2010, France had 21 funds managing $4.6 billion, second only to Britain.[385]

The French regulatory consensus would be distributionally valuable for French firms if it served as the backbone of EU alternative investment standards. It was even more valuable if French rules somehow shaped regulation of the *global* hedge fund industry. By making London and New York managers—and their Cayman-domiciled funds—play by French rules to access the European market, Paris would boost its banks' funds-of-funds business and the asset management industry, whose regulatory burden would not change. This could be done though an EU directive with extraterritorial effect.

EU directives have extraterritorial effect through the *equivalence* process. Some directives that employ the equivalence principle have become notable. Despite Europe's small share of the global information technology market, the Privacy Directive comprises the "de facto international privacy standard."[386] The Financial Conglomerates Directive allows the EU to judge third-countries' regulations (such as US or Japan), in order to induce change in those countries' standards; in this case, the equivalence process aimed to put US securities firms under consolidated supervision, which is the prevailing standard for European

[385] IFSL (2010): 3.

[386] Bach and Newman (2007): 836. See Birnhack (2008) and George et al. (1997).

universal banks.[387] US financial services firms are often late to recognize the impact of equivalence until they realize the newly increased compliance costs of accessing the EU market. As one US Treasury official commented, "Firms come into my office and say, 'Who is Europe to tell us that we are not equivalent?!'"[388]

Equivalence is powerful because of the depth and wealth of the European single financial market.[389] Financial depth in the eurozone was 356 percent compared to 424 percent for the US in 2006.[390] The size of EU capital markets was nearly $52 trillion in 2002, compared to $54 trillion for the US.[391] As a result, a European Commission official stated that "we can be leaders in international regulation," citing how China, Japan, and Hong Kong have followed standards established in directives on UCITS funds and investment services.[392]

However, hedge funds and other alternative investment funds are mostly concentrated outside the EU. Globally, only 5 percent of hedge funds are registered in the EU, mostly in Ireland and Luxembourg. Most London-managed funds are legally domiciled in tax-friendly jurisdictions, such as the Cayman Islands (39 percent), Delaware (27 percent), British Virgin Islands (7 percent), and Bermuda (5 percent). Global fund managers' compliance costs would rise significantly if they had to follow EU standards for marketing their funds to EU investors. Such a directive would similarly affect New York managers, who comprised 47 percent of the global market in 2009.[393]

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[387] Draghi and Pozen (2003).

[388] Not for attribution comment, Oxford (15 March 2011).

[389] Nicolaïdis and Shaffer (2005); Posner (2007).

[390] Farrell et al. (2008): 12. Financial depth is equal to financial assets as percent of GDP.

[391] Drezner (2007): 36.

[392] Interview with Chris Becher, Brussels (23 November 2010).

[393] IFSL (2010): 36.

This means that the "California effect" is widespread and pronounced for New York and London fund managers.[394] If an EU directive dictates higher standards than those in the US and elsewhere through the equivalence process, then fund managers are incentivized to design funds which follow the higher European standard—lest they be shut out of the massive European market. Otherwise, London and New York fund managers—with much lower domestic compliance costs—would pour into the European market, while French firms—much more tightly regulated—would be disadvantaged. In this way, as in the cases of information privacy and consolidated financial supervision, an EU directive could set the bar for legally binding international standards for the global alternative investment fund industry.

III. The EU: international focal point standard-setter in finance

Bargaining to set legally binding international standards is usually a costly and protracted process. European Union directives are no exception—negotiations can be long and tedious. However, France had a strong domestic regulatory consensus and ample incentive to see through difficult bargaining: its credible commitments between regulators and industry officials on the regulation of alternative investment funds would be distributionally valuable if legally binding international standards were set.

The EU offered an appealing environment for French officials to establish a legally binding alternative investment standard *and* to benefit from semi-restrictive decision-making rules that advantage first-movers. In the remainder of this section, I briefly describe the origin of semi-restrictive Qualified Majority Voting rules, as well as the "Lamfalussy process," a multi-stage standard-setting implementation and enforcement process that highlights the importance of effective first moves. I then detail the decision-making process within the EU when it considers financial standards proposed by the European Commission. Finally,

[394] Vogel (1997); (2012). US car standards reflect the logic of the "California effect." Although they export to a variety of markets, Detroit automobile manufacturers follow California regulatory standards, which are more stringent than those of smaller US markets, instead of customizing exports for each desired market.

I describe how French officials made an effective first move to initiate standard-setting in the EU on alternative investment regulation.

Single European Act

With the displeasing background of stagnant growth and uncomfortably high unemployment, EU Member States led by Britain, France, and Germany developed proposals in the 1980s on how to complete the EU single market in goods and services by 1992.[395] Correspondingly, the European Commission presented 279 proposals in a 1985 White Paper, some of which directly tackled financial services liberalization on the basis of mutual recognition, home-country control, and minimum harmonization of the most essential regulatory requirements. These comprised the policy component of the Single European Act (SEA).

The SEA also had a major procedural reform: the application of Qualified Majority Voting (QMV) rules in the Council of Ministers to matters pertaining to the internal market, allowing Member States to overcome a bias for the status quo created by the need for unanimity. Under QMV rules, member states' votes are weighted according to country size.

Until the SEA, the unanimity rule of the "Luxembourg compromise" was in effect. In 1966, French representatives declared that they could veto any proposal in the Council of Ministers if it was contrary to a "vital national interest." Thus, bargaining under early EU directives on financial standards, such as the First Banking Directive or various insurance directives, imposed few adjustment costs on Member States—unless they *all* agreed to move away from the status quo. Expecting the City of London to dominate the policy debate on financial services liberalization, UK Prime Minister Margaret Thatcher and her British negotiators threw their support behind QMV rules for internal capital market

[395] Moravcsik (1991) and (1998); Garrett (1992).

issues,[396] while issues for which they did not support the use of QMV, such as taxation, immigration, and health, remained subject to unanimity rules.[397]

The Lamfalussy process

In the early 2000s, the creation of a multi-stage standard-setting process based on restrictive decision-making rules (known as the "Lamfalussy process") made first moves in EU financial policy bargaining even more important.[398] The multi-stage Lamfalussy process has sought to address the need for better implementation by Member States and for better enforcement of standards. Originally implemented for securities standards in 2001, the Lamfalussy process was extended to the banking, insurance, and pensions sectors in 2003.

Political decisions on the regulatory framework for a market or issue-area are decided at Level 1 by the Commission, Council (under QMV rules), and Parliament (under simple majority rules). National representatives and technical experts (one of each per Member State) sitting on sector-specific committees at Level 2 provide the necessarily detailed definitions and criteria within the agreed standards. At Level 3, EU-level regulatory bodies coordinate implementation of the agreed standards by Member States; they may be delegated additional responsibilities for rule-writing by the Commission. Levels 2 and 3 do not have formally specified voting rules; instead, committee chairs attempt to achieve consensus based on a preponderance of members' views. At Level 4, the Commission reviews and enforces implementation by Member States.

[396] *The Times* (1985).

[397] Owen (1985).

[398] For reasons of space, I do not discuss the history and politics behind the creation of the Lamfalussy process. See Jabko (2006); Ferran (2011); Lalone (2005); Posner (2007); Woolcock (2012); European Commission (2005).

EU decision-making on proposed financial standards

A first-mover advantage exists in the Lamfalussy process because of the influence of decision-making at Level 1—and this is the level of the Lamfalussy process on which this case study of the AIFM Directive focuses. The substantive difference between "framework principles" decided at Level 1 and "implementing measures" at Level 2 is not self-evident. One official closely involved in the Lamfalussy process at Levels 2 and 3 noted, "We would try to draft the best possible standards given what was decided at Level 1, and we would obviously have to take full stock of member [states'] views at Level 1 even though we would try not to vote."[399] Thus, well-prepared and motivated actors can seek to shape the final EU directive, as well as its implementation and enforcement, by pushing for as much detail as possible in the proposed financial standards at the beginning of Level 1. Other actors' switching costs increase as a detailed draft directive moves successively through the legislative process.

Level 1 operates according to the *ordinary legislative procedure* (previously and formally known as "co-decision"). The Commission retains the right to propose legislation, although Parliament can call upon the Commission to do so. When considering whether to propose a legislation, the Commission has committed (though it is not bound) to conduct public consultations with stakeholders, such as national regulators, industry groups, non-financial corporations, academics, and consumers; it can also conduct quantitative and qualitative assessments of the standards it is considering for proposal.

Formally, the Commission then submits its proposal to the European Parliament, which considers amendments. The Economic and Monetary Affairs Committee (ECON) shapes Parliament's position and occasionally consults the Legal Committee. The entire Parliament votes to accept or amend the Commission's proposal on the basis of simple majority rules. The Parliament thus adopts its position and then submits the legislation to the Council of Ministers for its official consideration (in its formation as the Council of

[399] Interview with Michel Prada, Paris (20 November 2012).

Economic and Finance Ministers, ECOFIN). ECOFIN votes according to QMV rules. Before the legislative proposal is considered at the ministerial level at ECOFIN, the Commission's proposal goes through the Working Party on Financial Services, which begins to develop the Council's position, and then through the Committee of Permanent Representatives (COREPER).

In practice, the Parliament and Council work in parallel, each adopting positions on the Commission's proposal and informally communicating with each other. COREPER is crucial to this decision-making process at the "engine room level," where the work focuses on narrowing divergent national positions and reaching compromises.[400]

The Parliament and Council then attempt to reach a common position that can pass both the Parliament and Council at first reading—otherwise disagreement can result in a protracted process of second and third readings. Informal meetings known as "trialogues," attended by representatives of the Commission, Parliament, and Council, attempt to reconcile contrasting positions at first reading. Trialogues are usually successful: as of July 2009, the EU institutions adopted 72 percent of legislative proposals at first reading.[401]

While the Parliament and Council each work to adopt positions in parallel, a first-mover seeks to persuade a qualified majority in the Council of Ministers—without a qualified majority in ECOFIN, a simple majority in Parliament will not suffice to pass a directive. Presently, with 27 Member States, a qualified majority consists of 14 states voting in favor and 255 votes in favor out of 345 total votes. (A majority population of 62 percent is also necessary, but only verified upon a Member State's request.) The largest Member States have 27 to 29 votes, medium have 7 to 14, and small 3 or 4. Germany, France, Britain, and Italy each have 29 votes, while Spain and Poland have 27.

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[400] Ferran (2004).

[401] European Commission (August 2009)

The EU has assumed regulatory competence in myriad areas of financial services; in the process, some argue, it has become a "regulatory state."[402] In practice, three Member States are most important to the passage of EU financial standards: Britain, France, and Germany. With well-resourced finance ministries, this trio dominates debates on financial regulation. As a senior Commission official put it simply: "Financial regulation in Europe is determined by a triangle of Britain, France, and Germany."[403] A senior official in Her Majesty's Treasury elaborated, "I have two, three guys working full time on one piece of regulation. Other finance ministries have twenty people total. Seventy, eighty percent of the countries don't do any talking. Only France and Germany matter too."[404]

In sum, EU Member States bargain over the substance of financial standards under semi-restrictive voting rules. The Council of Ministers operates according to QMV rules that are more restrictive than unanimity but less restrictive than simple majority rule, which the European Parliament follows. In trialogues, the Council and Parliament must find agreement after the Commission has issued its proposal. In terms of the two-step theory, the pivotal voter is the one closest to the status quo. The pivotal voter for the passage of a financial services directive can be either in Parliament (the median voter under simple majority) or in Council (the "255th" voter under QMV rules). If the median voter in Parliament prefers a substantively deeper standard (that is, a greater distance from the status quo) than a standard preferred by the "255th" voter in Council, then the pivotal voter is found in the Council.[405] This pivotal voter must be satisfied in order for the standard to pass.[406]

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402 Majone (1996).

403 Interview, Oxford (8 October 2010).

404 Interview, London (24 November 2010).

405 This concurs with the proposition and evidence in Crombez and Hix (2012, 10-11) that "Proposals need to be preferred to the status quo by the European Parliament and a qualified majority in the Council for adoption. If no policy is preferred to the status quo by the European Parliament and a qualified majority, that is, if the status quo is between the ideal policies of the European Parliament and the two pivotal member states, gridlock results." See also Crombez and Swinnen (2011, 13-15), which is consistent with Crombez and Hix (2012), and also demonstrates that the Commission formally "has no impact on policy under co-

The preceding sections have explained why France pursued legally binding standards for alternative investment fund managers: they had a comprehensive and legalized domestic regulatory consensus that reflected higher standards than any other major jurisdiction. Exporting French alternative investment standards would raise adjustment costs for others, most notably Britain and—through the equivalence process for third-countries—the United States. The EU is less a unitary state-like actor than a body with powerful regulatory capacity whose resources France utilized: expertise; coherence in projecting, monitoring, and enforcing rules; and ability to impose costs for non-compliance.[407]

France's first move at the EU

In this section, I describe the build-up to the European Commission's proposal for the AIFM Directive. French officials sought a legally binding standard, which would be difficult—if not impossible—to negotiate at the International Organization of Securities Commissions (IOSCO). French individuals—from the French President to securities regulators to fund managers—spoke with a single voice across international fora, including IOSCO and the Financial Stability Forum (FSF), on the necessity of alternative investment regulation. But it was at the EU where French officials pounced amidst a backdrop of global financial instability in September 2008.

French officials have a long history of vigorously debating with their US and UK counterparts at IOSCO, a global "soft law" standard-setter for securities firms. Unlike the Basel Committee's risk-based capital adequacy rules for banks, IOSCO has not produced similar standards for securities firms largely because of opposition from the US Securities & Exchange Commission (SEC), which instead preferred to cooperate internationally through non-legally binding Memoranda of Understanding (MoU) with foreign regulators.

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decision" because it "can do no better than propose the joint text" agreed by the Parliament under simple majority and Council under QMV.

[406] The pivotal voter would be the median voter in the Parliament if the Parliament's preference was closer to the status quo than the Council's preference.

[407] Bach and Newman (2007): 831-2.

Indeed, when IOSCO once considered proposals for capital requirements for securities firms, then SEC chairman Richard Breeden retorted, "I'm interested in knowing the capital rules in other countries to know how big their buffers are. I'm not at all interested in what the French think US capital standards ought to be."[408]

IOSCO did occasionally publish reports on various aspects of hedge fund regulation, including a 2003 report on "Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds"[409] and a 2006 report on "The Regulatory Environment for Hedge Funds: A Survey and Comparison."[410]

In 2006 and 2007, the SEC was interested in defining the operational characteristics of hedge funds, an exercise which would help them in their domestic initiative to require fund managers to register, but was uninterested in an international *prudential* standard. The AMF, however, presented prudential concerns at IOSCO to the SEC and UK Financial Services Authority that mirrored its domestic priorities: limit the systemic risk posed by hedge funds by possibly issuing credit ratings for the fund or manager and mandating that their prime brokers follow capital requirements; limit market abuse caused by speculation; increase transparency of fund activities; improve fund administration and asset valuation; and prevent mis-selling of funds-of-funds to retail investors.[411]

In 2007, financial market turmoil raised some pressure on IOSCO and the equally "soft" Financial Stability Forum (FSF) to produce more than reports—but still, neither body produced anything close to prudential standards. In May 2007, the FSF updated its report on "highly leveraged institutions" and recommended that supervisors strengthen hedge fund counterparties' risk management practices, ward against eroding market liquidity, and

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[408] Quoted in Raustiala (2002): 35.

[409] IOSCO (2003).

[410] IOSCO (2006).

[411] Prada (2006).

develop comprehensive data sets on hedge fund exposures.[412] In November 2007, IOSCO set out nine principles for valuing hedge funds' investment portfolios.[413]

US and British regulators practiced minimal and indirect oversight of alternative investment funds and their managers; moreover, they did not believe that hedge funds could directly cause systemic financial instability. The US President's Working Group on Financial Markets, which had been formed in the aftermath of the 1987 stock market crash, concluded that market discipline served as effective indirect regulation of hedge funds and no further reform was required. Thus, even though the SEC supported IOSCO guidelines that endorsed hedge fund manager registration, no agreement on prudential standards for alternative investment fund managers—and certainly not a legally binding agreement—was forthcoming at IOSCO or the FSF.[414]

French officials found a far more encouraging environment among continental European states. Their domestic regulatory consensus neatly coincided with German anxiety about the activist influence of hedge funds and private equity groups on their blockholder model of corporate governance. German regulators, industry and politicians had been extremely frustrated when The Children's Investment Fund (TCI), a London-based hedge fund shareholder in the Deutsche Börse, forced the Börse in 2005 to drop its bid for the London Stock Exchange.[415] This frustration was famously demonstrated in German Social Democratic leader Franz Müntefering's denunciation of hedge funds that "stay anonymous, have no face, fall upon companies like locusts, devour them and move on."[416] When Germany chaired a 2007 G-8 summit in Heiligendamm, Chancellor Angela Merkel lent her support to direct regulation of hedge funds, while the German Presidency of the EU placed increased rules for transparency and a code of conduct on its agenda.[417]

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[412] FSF (2007).

[413] IOSCO (2007).

[414] Interview with Michel Prada, Paris (20 November 2012).

[415] O'Connor (2005).

[416] Landler (2005).

[417] Jones (2007).

However, the European Commission resisted French and German calls to propose standards for hedge funds and private equity groups. At the Commission, Internal Market and Services Commissioner Charlie McCreevy, an Irish politician, had long despised efforts to increase regulatory scrutiny of hedge funds. Indeed, members of Commission Services, the group of staffers responsible for drafting proposals, were told that anyone working on drafting such regulation would be fired. McCreevy was perceived to be protecting Dublin's hedge fund industry, which provided back-office support to managers in London and New York.[418]

However, the perfect political storm was raging, and French and German support for alternative investment regulation echoed efforts by prominent members of the European Parliament. The financial crisis in September 2008—justifiably or not—gave a spotlight to the long-standing ire of some European politicians towards hedge funds.

Reports by members of the European Parliament forced the Commission to act. German politician and MEP Klaus Heiner-Lehne, along with Danish ex-Prime Minister and MEP Poul Nyrup Rasmussen, issued reports on the impact of hedge funds and private equity on corporate governance and broader issues of financial stability. The Rasmussen report passed by an overwhelming majority in the powerful Committee on Economic and Monetary Affairs in Parliament, and called on the Commission to issue a legislative proposal with capital requirements for hedge funds and private equity groups, along with disclosure of their leverage and investment strategies.[419] Similarly, the Lehne Report, which focused on transparency rather than strict prudential standards, passed the Committee on Legal Affairs and the European Parliament by substantial margins. As the leader of the Party of European Socialists, Rasmussen had previously made his intentions obvious: "Sooner or later he [McCreevy] will be instructed by EU governments and the European Parliament to draw up legislation."[420]

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[418] Not-for-attribution interview (8 October 2010).

[419] On 10 September 2008, the vote in Committee was 39 in favor, 1 against, and 1 in abstention. On 23 September 2008, the European Parliament voted 562 in favor, 86 against, and 25 in abstention of the report.

[420] Evans-Pritchard (2007).

The French quickly backed the Parliamentary vote and the Rasmussen report. French MEP and Chair of the Economic and Monetary Affairs Committee Pervenche Bères issued blistering criticism of the Commission and Charlie McCreevy for not moving faster to prepare a legislative proposal for hedge fund and private equity regulation. Jean-Pierre Jouyet, French minister for European affairs and soon-to-be chairman of the AMF, declared, "Saying a *laissez faire* policy must continue, as I have heard, is a mistake. The European Union must have a regulation on hedge funds."[421]

In September and October 2008, McCreevy still refused to budge, maintaining that hedge fund and private equity managers were not causes of the crisis and were subject to other EU financial regulation, such as the Capital Requirements Directive: "I don't believe it is necessary at this stage to tar hedge funds and private equity with the same brush as we use for the regulated sector."[422]

European Commission President José Manuel Barroso came to disagree with McCreevy. Barroso was already upset with McCreevy's ambiguous and underwhelming comments regarding the Lisbon Treaty that he had made ahead of the Irish referendum in June 2008. By autumn 2008, in the face of re-election the next year and under fire from the largest national contingents of MEPs—the Germans and French—and leftist parties in the Parliament, Barroso pressured McCreevy to direct his staff to produce a proposal to regulate hedge funds and private equity.[423] McCreevy attempted to forestall, but by November 2008, it became known "by trickling down from the higher political levels" that a widely encompassing legislative proposal for alternative investment standards would be forthcoming.[424]

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[421] *Europolitics* (2008).

[422] McCreevy (2008).

[423] Not-for-attribution interview (8 October 2010).

[424] Interview with Didier Millerot, Brussels (23 November 2010).

At the Commission, staffers cut corners in developing the proposal. EC officials and civil servants purposefully did not conduct a full consultation process, through which the views of industry, investors, and consumers could be heard. A hastily arranged qualitative impact assessment of the proposal was conducted, instead of a quantitative assessment of the draft Directive's provisions. A relatively junior official, a German staffer seconded from BaFin, was one of the primary drafters, and an industry official later complained, "He was working off of a theoretical model of the industry. The draft just didn't fit reality. There was no oversight of the drafting because McCreevy was hoping it would be so bad, there's no way it would be passed."[425]

While Commission staffers worked to draft a legislative proposal to regulate alternative investment fund managers, French President Nicolas Sarkozy and German Chancellor Angela Merkel pushed at the G-20 to ensure that the forthcoming directive would be consistent with international commitments in the wake of the global financial crisis. Facing Sarkozy and Merkel's demands, UK Prime Minister Gordon Brown dropped his opposition to a high-level, general statement calling for appropriate regulation of hedge funds in exchange for support on other parts of the G-20 agenda.[426]

In April 2009, the G-20 finance ministers and central bank governors met in London, and agreed to "ensure all systemically important financial institutions, markets and instruments are subject to an appropriate degree of regulation and oversight, and that hedge funds or their managers are registered and disclose appropriate information to assess risks they pose."[427] With this minimal endorsement from the G-20, Sarkozy continued pushing for hedge fund regulation as a major part of post-crisis financial reform and his view of a new global financial governance: "I'm not going to repeat what the [German] Chancellor [Angela Merkel] has said better than I can, we want hedge funds to be registered and supervised. … But the principle [remains]: no financial institution unsupervised."[428]

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[425] Interview with Andrew Baker, London (22 November 2010).

[426] Evans-Pritchard (2009).

[427] G-20 Leaders (2009).

[428] French Embassy (2009).

Senior Commission officials admit that their original legislative proposal for the AIFM Directive was poorly written—and even harmful. One called it "the most politicized proposal [by the Commission] in the past ten years," a "bad proposal" motivated by "pure politics."[429] Commission officials and staffers recounted that some aspects of drafting went beyond their control, as several prudential standards in the Directive were made more stringent between DG MARKT and ECOFIN.[430] For example, Commission staffers did not include hard limits on the amount of leverage alternative investment fund managers could hold, yet such limits appeared in later versions. French officials were involved "early" in the drafting of the prudential standards, as well as the provisions on equivalence affecting third-countries, such as the US.[431]

Some EC officials claimed that the sources of ideas for the proposal included codes of conduct developed by hedge fund industry groups, existing national regulatory regimes, IOSCO principles, and existing EU legislation. While basic principles in the proposal calling for sound fund management were uncontroversially echoed by industry codes, provisions such as leverage limits, depositary restrictions, and independent valuation were drawn from existing EU regulations. The influence of the last source—earlier EU Directives known as UCITS and Markets in Financial Instruments Directive (MiFid), which the French helped craft—was especially pronounced, so much so that one official argued that in the proposed directive, "eighty percent was cut and pasted from UCITS and MiFid."[432] Although Commission officials professed not to do so intentionally ("we can't favor one system over another"), it inevitably became the case that "it [the Directive] would look more like one national model than another."[433]

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[429] Interview with David Wright, Oxford (8 October 2010).

[430] DG MARKT is the office of the Directorate General for the Internal Market and Services within the EC, which then submits its proposal to ECOFIN.

[431] Not-for-attribution interviews (8 October 2010); (23 November 2010).

[432] Interview with Michael Booth, London (24 November 2010).

[433] Interview with Chris Becher, Brussels (23 November 2010).

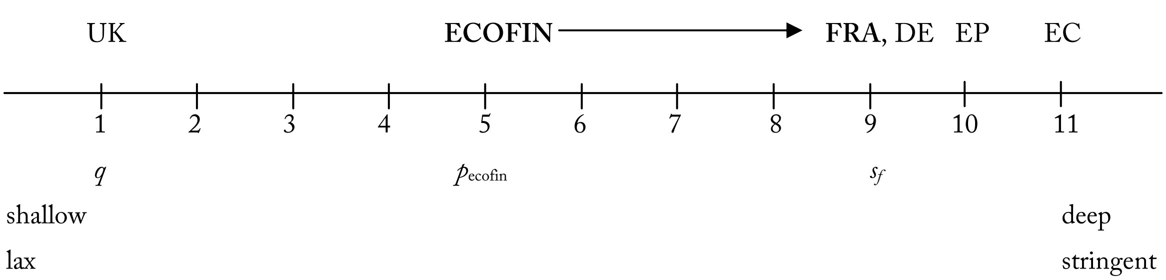
IV. Bargaining

French officials, assisted by their German allies, pressured the European Commission to propose the AIFM Directive. But, this French-German coalition still had to navigate through the complex decision-making process of EU financial standard-setting. For French regulators and industry to successfully achieve their preference for a substantively stringent AIFM standard, the European Commission, Parliament, and Council of Ministers/ECOFIN would have to come to an agreement. For the sake of simplicity, I summarize the key moments in bargaining over the prudential standards in the AIFM Directive (Table 4.1 below). Each of the actor's preferences in Table 4.1 is explained in detail later in this section. These preferences map on to a policy space measured on a single dimension (Figure 4.1 below), running from laxity (the status quo) to stringency.

Table 4.1: Decision-making on prudential substance of AIFM Directive

Time period	**Preference**
Spring 2009	Under French and German pressure, European Commission (EC) proposes very stringent AIFM Directive (11 in Figure 4.1)
Winter 2009-2010	European Parliament (EP) adopts stringent position (10)
Spring 2010	French officials (s_f, 9) successfully appeal to pivotal voter in ECOFIN (p_{ecofin}, 5) and resist UK demands (q, 1) for shallow standard under Qualified Majority Voting rules
Late spring 2010 (officially finalized in autumn 2010)	Passage of Directive requires agreement among EC, EP, and ECOFIN; Trialogue results in stringent AIFM Directive because the pivotal voter in ECOFIN (p_{ecofin}, 5) is indifferent between the French-led coalition's proposal (9) and the status quo (q, 1) and thus supports French proposal

Figure 4.1: Overall bargaining outcome on prudential substance of AIFM Directive



In the following discussion, I first define the international status quo and then describe the preference of Britain, an especially powerful fragmented state that vigorously defended the status quo. I then describe and map actors' policy preferences: the European Commission's proposal for the Directive represented the stringent extreme, whereas the positions of the European Parliament, as well as those of the French and German delegations, favored stringency, but not as radically as the Commission. French representatives led a coalition of Member States that exceeded the minimum number of votes required under QMV rules at the Council of Ministers in its ECOFIN form. Taking advantage of semi-restrictive decision-making rules, the French-led coalition satisfied the pivotal voter at ECOFIN and completely isolated the British, resulting in a far more stringent and deeper prudential standard than the latter preferred—consistent with the propositions of my two-step theory.

While the stringency of the policy substance settled quickly in late spring 2010 (given the location of actors' preferences under QMV rules; Figure 4.1), bargaining took much longer on the question of whether non-EU funds and fund managers would be able to operate in the EU under the AIFM Directive (the so-called "third country passport" issue). Thus, later in this section, I also illustrate a second unidimensional policy space over open versus closed access for third-country fund managers seeking to operate in the EU alternative investment market.

Although they supported French representatives in creating a stringent alternative investment prudential standard, many Member States were very reluctant to support the French call to shut out non-EU fund managers (namely, US fund managers) and non-EU funds (such as those domiciled in the off-shore centers) from operating freely across the EU. The directive thus features a compromise that left this issue of third country passports somewhat unresolved: the newly established European Securities and Markets Authority (ESMA) will decide in 2015 whether the passport should be granted to third countries.

The main alternative explanation of international financial standard-setting—states with the largest markets prevail—falls short in an institutional decision-making environment that allows financially weaker states to drive regulatory change by overcoming more powerful states satisfied with the status quo. This influence of decision-making rules explains the night-and-day difference between the substantively inconsequential draft IOSCO Principles for Hedge Fund Regulation (negotiated under open, consensus-based rules) that were proposed just a few weeks before the eventually deep and distributionally impactful AIFM Directive (see pp. 165-166).

International status quo

As defined in Chapter 2, the international status quo is the exogenous international policy outcome that would occur if bargaining did not produce a standard. The British interests in the status quo are described at length below, but I provide a short survey here of the status quo on alternative investment standards.

In 2008, there was no international prudential standard for alternative investment fund managers or funds. In most EU Member States, national standards on hedge funds and other alternative investment funds operated on the basis of "private placement regimes." Such regimes set certain restrictions on how fund managers can market their funds and who can invest in alternative investment funds. Some countries set rules based on minimum investment amounts (e.g. €250,000 in Belgium) or types of investors (e.g. institutional, corporate or "sophisticated" investors in Switzerland and the UK). By following such restrictions, fund managers could forego most, if not all, prudential regulatory requirements.[434]

Whereas the UK FSA focused on only indirect regulation of fund managers and France directly regulated both fund managers and funds, Germany solely regulated funds. Germany developed its framework in 2004 and defined a hedge fund as a fund which "uses either leverage or short selling strategies or both and is not restricted in its choice of assets."[435] The German financial supervisor, BaFin, issued written licenses to funds and approved their terms of contracts. German hedge funds had to follow minimum capital

[434] Cornish and Perlow (2012).

[435] Rivière (2010): 28.

and risk diversification requirements, but were not limited in their risk concentrations (as is the case in France). While there were few limits on leverage and investment strategies, the German Ministry of Finance could restrict funds' leverage and short-selling to prevent market abuse. Further, German hedge funds could not invest in raw materials or real estate, and could not own more than 30 percent of a non-publicly listed company.[436]

In 2009, US and UK hedge fund regulations were minimal, but the former were rule-based, whereas the latter fell under the FSA's principle of risk-based supervision (described below). At the time of the AIFM proposal, the US Congress held hearings on future legislation that would comprise the Dodd-Frank Act, which stipulates minimal registration requirements for hedge fund managers (called "hedge fund advisers" in the US) with at least $150 million in assets under management, but does not prescribe restrictions on investment strategies, leverage, or risk concentrations; hedge fund managers comply with record-keeping requirements on these and other measures, however.[437]

Market access was largely determined by national boundaries. If a US fund manager wanted to gain investors across the EU Member States, she would have to apply for authorization to 27 different Member State supervisors under each of their private placement regimes. Non-US fund managers seeking US investors went through private placements to raise capital from institutional investors such as universities, insurance companies, and pension funds, instead of public offerings and registration with the SEC.

In the absence of the AIFM Directive, the status quo of minimal international coordination would have prevailed, and mostly lax national regimes would have remained dominant. Without an international or EU standard, private placement regimes would have continued in the EU, while US fund managers faced nearly no new prudential standards, only disclosure requirements. Under the status quo, as the legal home for most global hedge funds, Bermuda, Jersey, the Cayman Islands, and other off-shore centers

[436] Ibid.: 29.

[437] Champ (2012).

operated with minimal tax, accounting, or information-sharing requirements to coordinate with the main "on-shore" supervisor of the fund managers (e.g. US SEC, French AMF).

UK: satisfied with the status quo

Given British regulators' history of overseeing the largest alternative investment industry in Europe, one might reasonably expect the UK model of alternative investment regulation to shape corresponding EU standards. At the time of the European Commission's proposal in April 2009, the London hedge fund industry was, by any statistical measure, hegemonic within the EU. London managers accounted for 76 percent of European hedge fund assets, totaling nearly $382 billion. Although US fund managers held 68 percent of assets under management in the global industry, European managers accounted for 23 percent at end-2009; New York fund managers alone managed 41 percent of global assets, compared with 20 percent in London.[438]

The UK Financial Services Authority evaluated London fund managers within the same Advanced, Risk-Responsive Operating FrameWork ("ARROW") process applied to all asset managers with the purpose of embodying "our principles-based approach, delivering a lighter regulatory touch for those firms that pose less risk to our statutory objectives."[439] The FSA focused on overseeing London managers, not the funds themselves, which are often legally domiciled in the Caymans, Delaware, or elsewhere. The FSA judged that hedge fund managers did not pose substantial risks, and so only developed risk mitigation plans with the forty largest managers in response to the growing size of the industry.[440]

Over the course of the 2000s, the FSA focused on issues of market abuse, inadequate risk management, liquidity disruption, and investor confidence, a scope of interest that was actually far wider than that of the US SEC. Yet, the FSA viewed disclosure and transparency requirements as sufficient regulatory responses. They also welcomed industry

[438] IFSL (2010).

[439] FSA (August 2006).

[440] FSA(March 2006).

standards developed by the Hedge Fund Standards Board in 2008; composed of the fourteen leading hedge fund managers, the Board sought to ward off statutory regulation at the UK or EU level.

Although the financial crisis discredited the FSA's "light touch" model, it felt little need to pursue international regulation of hedge funds. Indeed, pursuing such regulation when few in Britain saw hedge funds as a cause of the crisis would have further undermined the FSA. In his authoritative report, Lord Adair Turner called for more disclosure by hedge funds, as well as supervisory authority to apply prudential rules if a fund became systemically important. In a meeting with US members of Congress in September 2009, Turner said that "if there were concerns, regulators could impose greater capital requirements [on hedge funds], but he did not believe that a regulation of the industry itself was necessary."[441]

If Britain had a preference on the form of hedge fund regulation at all—for the sake of post-crisis response—it was a non-legally binding set of IOSCO principles. IOSCO established a Task Force on Unregulated Financial Entities in late November 2008 that was co-chaired by the FSA. One month before the European Commission proposed the AIFM Directive, IOSCO released a consultation paper with non-binding recommendations on risk management for prime brokers; disclosure; some level of registration and authorization; and principles for monitoring and supervision. It devoted the bulk of its paper to an overview of current regulatory approaches across states and the efforts of the hedge fund industry to develop a code of conduct.[442]

The proposed IOSCO principles were toothless because they did not commit states to change the status quo of minimalist, arm's-length regulation of hedge funds in major jurisdictions. Because the IOSCO decision-making process relies on consensus-based rules, the US and UK easily prevented France and Germany from tabling a more stringent IOSCO standard. The *Financial Times* regarded the consultation paper as evidence that "IOSCO is placing too much faith in the cult of supervision," and expressed relief that

[441] US Embassy (2009).

[442] IOSCO (2009).

"despite the brief to IOSCO, the G20's priorities—quite rightly—lie elsewhere."[443] With IOSCO soliciting views from industry groups and slowly moving towards a set of non-legally binding principles, British regulators and industry were content. They had little idea of what would be proposed in the AIFM Directive a few weeks later.

UK: fragmented state caught by surprise

The UK FSA developed its light-touch standards for the alternative investment industry in the context of a fragmented state.[444] The London hedge fund industry features a low level of integration, a high degree of competition for members, and no standard-setting authority. The industry is represented by groups such as the Alternative Investment Management Association (AIMA), Association of Investment Companies (AIC), and the Investment Management Association (IMA). Unlike under French law, no firm is required to join an association. Although it is a global industry association, AIMA is still seen as representing London's interests; its members manage over 75 percent of global hedge fund assets and 70 percent of global fund of hedge fund assets.[445] None of these industry associations has public authority to set standards with regulators. The Hedge Fund Standards Board provided a voluntary code of conduct in 2008. However, a post-crisis parliamentary inquiry revealed that only thirty-four firms—out of 400 to 450—signed up to follow the standards.[446]

The complexity of London securities markets drives fragmentation between regulators and industry associations, as well as fragmentation among such associations. Buy and sell-side firms often hold interests antagonistic to each other. Sell-side firms, which include investment banks such as Barclays Capital, are concentrated with large balance sheets and resources. The buy side, which purchases securities sold by the investment banks, is much more fragmented. Representing many buy-side firms, IMA head Richard Saunders

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443 *Financial Times* (2009).

444 The history of the UK banking regulatory structure is found in the next chapter.

445 AIMA (December 2010).

446 House of Commons (2009): 128.

argued: "The buy side needs to be better represented. That's talking against our own book, by the way. We have different competing interests sometimes from the sell side. Our view would be that the default position should be given to the buy side, as they are the agent of the end investor."[447]

Practically speaking, fragmentation among the alternative investment industry and its arm's-length interaction with the FSA hampered information-sharing about the possibility of the European Commission proposing a stringent prudential standard. The IMA's Saunders remembered, "We knew there was a completely different version of the directive that was floating around. This was the [laxer] McCreevy version, and then this other version appeared, driven by Barroso."[448] Unused to direct regulation, UK hedge fund managers appeared to pay little heed to rumors that the Commission staffers were readying a stringent proposal.

Similarly, the UK FSA was caught off-guard by the Commission's proposed AIFM Directive in late April 2009. At the highest levels, the contrast between the FSA's lack of awareness versus French and German regulators' involvement and knowledge of the Commission's drafts is striking. Whereas French AMF Secretary-General Thierry Francq was well aware of the forthcoming prudential requirements and third-country restrictions,[449] then-FSA CEO Hector Sants recounted, "I don't know what we were expecting. I wasn't at the working level of this. I know we were *hoping* for something different. It was more extreme than we had hoped." He added, "Global issues require global solutions. We would have preferred an approach through IOSCO for the sake of a level playing field."[450]

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[447] Interview, phone (14 December 2010).

[448] Ibid.

[449] Interview, Paris (12 January 2011).

[450] Interview, Oxford (3 March 2011).

The Commission's proposal (spring 2009)

On 29 April 2009, the European Commission proposed the Alternative Investment Fund Managers (AIFM) Directive, which landed like a French-kissed bombshell in London. "I was told that Sarkozy had some friends who lost big in the crisis, so that's why he pushed so hard," one City of London official said.[451] A former UK official at the Commission familiar with his French counterparts, added, "Usually, the French are so rational, normal. I think a few people surrounding Sarkozy were whispering in his ear, telling him he had to do this."[452] A UK industry official recalled, "I was told directly that there were calls from the offices of the French President and the German Chancellor to the Commission, urging that this directive be proposed."[453]

At the European Commission, staffers viewed their proposed AIFM Directive as "delivering on the G20 mandate. Not the same as in the US. This is much more prescriptive."[454] The IOSCO Principles on Hedge Fund Regulation, which would not alter the international status quo, were viewed as "just that, principles, at the lowest common denominator." The official did not have to add that, as a legally binding agreement, the AIFM Directive would be required to be implemented in Member States and have its compliance monitored.

Almost as soon as it appeared, the Commission's proposed AIFM Directive came under attack. According to one official, "The directive was extremely detailed for being developed at Level 1. The detail it had is usually reserved for the Level 2 process."[455] The scope of the Commission's proposal covered all non-UCITS investment fund managers (hedge funds, private equity, venture capital, and real estate) with some exemptions: leveraged AIFMs below €100 million; non-leveraged AIFMs below €500 million; and EU AIFMs

[451] Interview with Paul Sizeland, London (29 October 2010).

[452] Interview with David Wright, Oxford (8 October 2010).

[453] Interview with Richard Saunders, phone (14 December 2010).

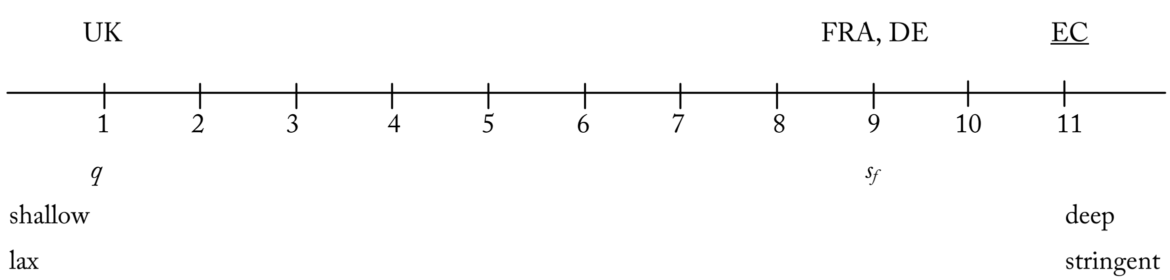
[454] Interview with Chris Becher, Brussels (23 November 2010).

[455] Interview with Michael Booth, London (24 November 2010).

that only manage non-EU AIFs.[456] AIFMs would have to follow caps on leverage set by the Commission and faced the possibility of additional leverage limits in crisis situations. New capital requirements would hit private equity and venture capital fund managers especially hard.[457]

The proposed reporting requirements on investment strategies, asset holdings, trading practices, and risk exposures were extensive. The requirement to use a depositary meant considerable compliance costs for private equity, venture capital, and real estate fund managers (which rarely use depositaries' custodial services), and for UK hedge fund managers that rely instead on prime brokers to safeguard their assets.[458] Similarly, the Commission's proposal sought to radically restructure the delegation of UK fund managers' administrative services, such as asset valuation, portfolio management, and risk management, which are spread across the world; large fund managers use portfolio managers, trade dealers, back-office performance support, and custodians across numerous third-country jurisdictions.[459] On corporate governance, fund managers would be required to institute internal risk and management controls, as well as adjust their voting rights as their share of certain companies increased. The Commission thus proposed a very substantively deep and stringent standard (Figure 4.2 below).

Figure 4.2: European Commission and key Member State preferences on AIFM prudential standard (spring 2009)



[456] European Commission (April 2009).

[457] Charles Rivers Associates (2009): 100.

[458] Article 17 in European Commission (April 2009).

[459] Charles Rivers Associates (2009): 106.

The Commission further sought to shape the *global* alternative investment industry through a number of conditions requiring: third-country AIFMs to operate under equivalent national regulation; reciprocal market access and cooperation agreements between the third country and the EU; and third country compliance with the OECD Model Tax Convention (also applicable to third-country AIFs, such as those legally domiciled in the Caymans).[460] This represents a policy preference moderately more favorable towards third-country market access than the status quo of country-by-country authorization.

British representatives and industry officials decried the proposed directive's undue focus on the entire alternative investment industry, as well as the extensive adjustment costs to prevailing business models. With changes in Commission staff and management, as well as parliamentary elections, all stakeholders expected the bargaining process between Commission officials, finance ministers at ECOFIN, and representatives in Parliament to take over a year.[461]

The European Parliament's preference (winter 2009-2010)

The European Parliament (EP) favored a stringent AIFM standard—more stringent than ECOFIN's preference (see below) but less stringent than the Commission's proposal (see above). The Rasmussen and Lehne Reports, which forced the Commission to issue a legislative proposal in the form of the AIFM Directive, had passed by overwhelming majorities in Parliament. French MEP Jean-Paul Gauzès was appointed *rapporteur* to manage Parliament's response to the Commission's proposal. Gauzès represented the center-right European People's Party (EPP), most of whose members favored a major shift in the status quo towards stringency. An overwhelming multitude of MEPs, easily exceeding the simple majority requirements, supported a stringent standard.

With 1,669 amendments submitted on his draft proposal, Gauzès sought compromise between the EPP, the Group of the Alliance of Liberals and Democrats, and the Party of

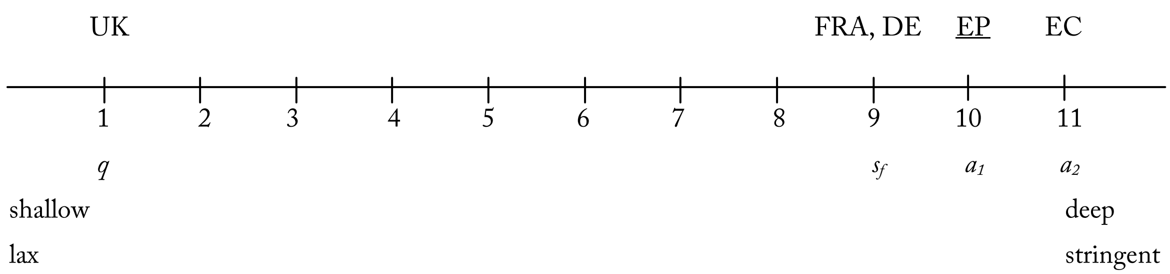
[460] See for example Articles 5 and 6 in European Commission (April 2009).

[461] *Europolitics* (1 July 2009).

European Socialists, who clamored for the most stringent standard.[462] Poul Nyrup Rasmussen, leader of the European Socialists, notably attacked the Commission's proposal for being full of "Swiss cheese," arguing that both fund managers and funds themselves should be regulated without any exemption for smaller funds.

By the end of 2009, Gauzès circulated his draft report recommending that the Directive cover *all* AIFMs, including smaller ones. However, to placate more centrist MEPs, he proposed that each AIFM set its own leverage limits (instead of the Commission setting limits). The new European Securities and Markets Authority (ESMA), a single EU securities regulatory body, would monitor leverage and the Commission would retain emergency authority to impose extra leverage requirements.[463] The EP's preference was for a very stringent standard, but not as stringent as the Commission's preference (Figure 4.3).

Figure 4.3: European Parliament's preference on AIFM prudential standard (winter 2009-2010)



On third country issues, the EP sought to mostly shut out non-EU funds. In an internal members' document, the AIMA industry association argued that the Parliament's position was a "very disappointing signal" given that "rules on depositaries, outsourcing, valuation, leverage, short selling, access to third countries' funds and service providers have no equivalent in any part of EU financial services legislation. The type of 'protections' that the EU Parliament offers to the most sophisticated investors and market participants in the

[462] *Europolitics (*28 August 2009).

[463] AIMA (January 2010).

form of severe business-model restrictions could result in forced restructuring of many existing and well functioning commercial relationships."[464]

In particular, the Parliament's position included restrictions on investment by EU fund managers in non-EU funds.[465] AIMA argued that this would prevent EU investors from using popular products such as long-only mutual funds, Exchange Traded Funds (ETFs), and real estate funds; they cited the example of Dutch pension fund managers, which invest about 22 percent of their €450 managed assets in non-EU and non-UCITS funds.[466]

Council of Ministers/ECOFIN's preference (late spring 2010)

Although formal EU rules call for the Economic and Finance Ministers in the Council of Ministers (ECOFIN) to vote on a text proposed by the European Parliament (which MEPs formulate in response to the Commission's proposal), in reality, the Parliament and ECOFIN work on parallel tracks. By late spring 2010, it was clear that ECOFIN favored a less stringent position, which was closer to the status quo, than the Parliament or Commission did. Thus, the pivotal voter—whom the French would have to satisfy—was in ECOFIN under QMV rules, and not the median voter in Parliament.

In autumn 2009, at ECOFIN, the Swedish Presidency sought agreement with other Member States closer to the status quo and thus more favorable to the UK. The Swedish Presidency attempted to strike leverage and investment limits altogether, delete the Commission's restriction on non-EU investment, and loosen restrictions on delegation of functions across jurisdictions. But, it appeared that the pivotal voter in ECOFIN preferred a relatively stringent standard because the Swedish Presidency was forced to put limits back in the draft.[467] In early 2010, as the Spanish Presidency took over, ECOFIN had still not

[464] AIMA (May 2010).

[465] *Financial News* (June 2010).

[466] AIMA (Summer 2010): 2.

[467] *Europolitics* (9 December 2009).

decided major issues left over from the Swedes: depositary requirements, independent valuation, remuneration, and treatment of non-EU fund managers and funds.[468]

In ECOFIN, French officials sought a stringent standard that would satisfy the pivotal voter. At a public speech in London, AMF Chairman Jean-Pierre Jouyet clearly laid out the French position that reflected its 2003 domestic regulatory consensus, which had sought specific requirements for each type of fund, instead of the one-size-fits-all requirements favored by the Commission. The French position on depositaries was also more flexible than the Commission, and Jouyet called for "profound" amendments to allow for the depositary requirements to correspond with the UCITS Directive; be adapted to each type of fund; allow supervisory discretion; and allow investment banks (such as US or UK prime brokers) to also serve as depositaries.[469] He also supported allowing fund managers to conduct independent asset valuation, instead of requiring another entity to conduct the valuation, as the Commission proposed. Corresponding with Gauzès' position in Parliament, Jouyet supported liability requirements for depositaries that delegate their functions and fund managers' discretion to set their own leverage and investment limits, subject to monitoring by the European Securities and Markets Authority (ESMA).

Nevertheless, on the policy dimension regarding third-country market access, Jouyet and other French officials did not support the Commission's proposal in allowing third-country or UK fund managers to benefit from marketing third-country funds across the EU.

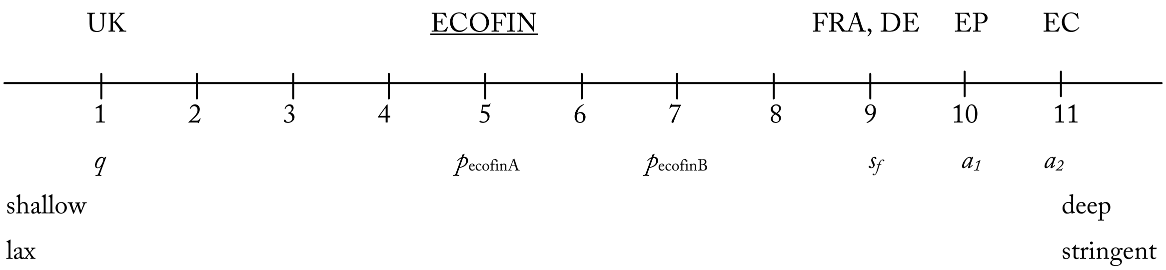
Figure 4.4 below can be considered in two ways. 1) It is an illustration of Member States' and EU institutions' preferences in bargaining. 2) It is an illustration of bargaining among Member States in ECOFIN; the policy positions of the European Parliament (EP) and European Commission (EC) can be taken to correspond to Member State preferences in ECOFIN. Viewed the second way, in this simple model of QMV rules, seven out of eleven votes are needed to approve a proposed Directive text at ECOFIN. Thus, approaching from the most extreme position (11) or from the status quo (q, 1), the pivotal

[468] *Europolitics* (18 December 2009).

[469] Jouyet (2009).

voter is the seventh vote from the right (p_{ecofinA}) or from the left (p_{ecofinB}). Because the French and Germans preferred a position closer to the most extreme position than to the status quo, their targeted pivotal voter in ECOFIN lay at the fifth position (p_{ecofinA}).

Figure 4.4: ECOFIN's preference on the AIFM prudential standard (late spring 2010)



Jouyet and other French officials hit the mark, while the British became increasingly desperate. The French had made a proposal that would make the pivotal voter in ECOFIN indifferent between the status quo (q, 1) and their preferred stringency (s_f, 9). By March 2010, national representatives at the COREPER (the committee which facilitates bargaining at ECOFIN before the national finance ministers consider issues) settled much of the prudential policy substance on leverage and valuation, while a number of Member States disagreed on the third-country issues, especially related to outsourcing of administrative functions.[470] Only the UK and Czech Republic appeared to be hold-outs on the prudential substance. COREPER noted that "a qualified majority is emerging to support the current [Spanish] Presidency compromise proposal subject to the finalisation by one delegation of its scrutiny of the text."[471] That one delegation was Britain, where Prime Minister Gordon Brown was running for re-election and directly appealed to the Spanish Presidency to delay voting on ECOFIN's position until after the UK general election.[472]

By May 2010, both ECOFIN and the European Parliament were ready to proceed, the latter's position more stringent than the former's. Despite the UK's appeals, other national

[470] Council (8 March 2010).

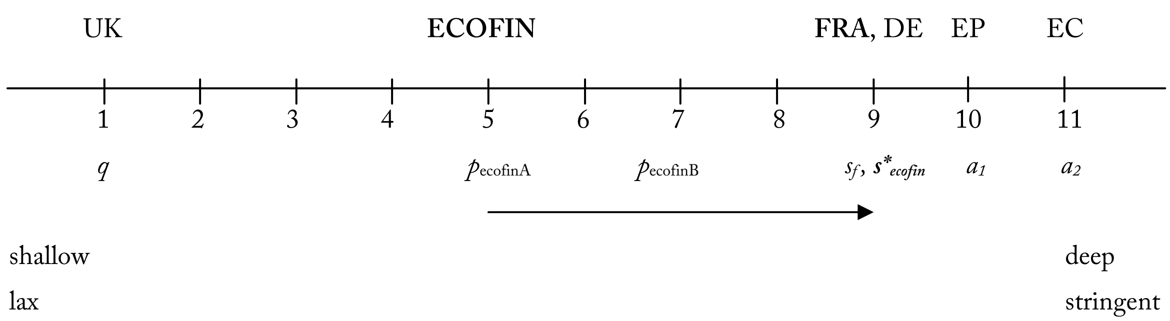
[471] Council (11 March 2010).

[472] *Europolitics* (10 May 2010).

delegations at ECOFIN's Working Party on Financial Services did not budge: "It appeared in that meeting that further reflection had not lead [sic] to any major changes in the positions of delegations."[473]

The Council's QMV rules (requiring more support for the standard than the simple majority rule in Parliament) made ECOFIN's position slightly more favorable to British representatives and industry officials. But the UK was still isolated, as only the Czech Republic joined it in actively resisting the Spanish compromise. The newly minted UK Chancellor of the Exchequer George Osborne admitted that he could do no better than the previous UK Government: "It was something of a hospital pass when it came to the negotiating position. There were close to no allies around the table."[474]

Figure 4.5: Bargaining on the AIFM prudential standard (late spring 2010)



As Figure 4.5 illustrates, the pivotal voter in ECOFIN adopted a substantively deep and stringent position (moving to the French/German position located at 9). By now, the Parliament and ECOFIN had adopted their respective positions on a stringent AIFM prudential standard, and "trialogue" negotiations between themselves and Commission officials began. During trialogues over summer and autumn 2010, the Parliament and

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[473] Council (11 May 2010).

[474] *Europolitics* (19 May 2010). "Hospital pass" is a term used in rugby and American football. In the course of play, when catching such a pass, the recipient is subject to heavy, unavoidable, and immediate contact from an opposing player.

Commission acceded to ECOFIN's position because its pivotal voter was closer to the status quo.

Empirically, the AIMA industry association considered the ECOFIN position more reasonable than that of the Parliament: "On every single issue presented in the detailed table, the Council text seems to be more reasonable and less restrictive. In this sense, it is a text that has gone furthest from the utterly unworkable initial proposal by the Commission." Nevertheless, while ECOFIN prescribed only reporting requirements on short selling, its provisions on depositary liability, outsourcing or delegation of administrative functions, and supervisory discretion on leverage were still "worrying provisions which do not take into account market reality and instead attempt to restructure it with little benefit in terms of reduction of micro as well as macro prudential risks."[475]

Whereas trialogue discussions on leverage, corporate governance, valuation, and depositary liability had led to a nearly finished prudential AIFM standard by the end of summer 2010, the major third-country issue remained: whether non-EU fund managers and funds would be allowed to operate in the EU market. This mostly affected US managers who sought to raise funds from EU investors, as well as London managers that operated funds located in off-shore centers. This debate over open access ("free trade") versus no access ("Fortress Europe") attracted much media attention and consumed the trialogue discussions during summer and autumn 2010.

The Commission supported open market access through a single passport for both EU and non-EU fund managers; indeed, continued integration of the EU single financial market is how the Commission publicly justified its proposal for the Directive. The Parliament's position was strongly influenced by Socialists "calling for stricter rules and fewer exemptions."[476] In the Council, a number of Member States joined the UK and "refuse[d] to sign up to a third-country clause they consider to be protectionist."[477]

[475] AIMA (May 2010).

[476] *Financial News* (June 2010).

[477] Ibid.

As a result, the Council's draft text for the AIFM Directive was "not as extreme as that of the European Parliament, including on the crucial issue of third countries (the Council text contains a possibility of a private placement regime which would allow third country managers to market their funds in individual Member States subject only to some reporting requirements irrespective of the prudential rules governing the third country industry)."[478] The national private placement regimes constituted the status quo; private placement would allow UK fund managers to market non-EU funds. But without a single EU passport, UK fund managers would still need separate authorization across different EU jurisdictions.

Because the Parliament again favored deeper, more stringent restrictions than the Council, the pivotal voter was again in ECOFIN. At ECOFIN, French representatives strongly opposed the idea of a passport for non-EU fund managers and non-EU funds to operate across the internal EU market. They supported retaining national private placement regimes, which would now be subject to the AIFM standards; a passport for third-country fund managers meant that French fund managers' competitive advantage would be reduced if US managers could easily benefit from actively marketing to EU investors.[479] In addition to French officials in Brussels, the AMF regulator and AFG industry group strongly supported preventing third-country fund managers and funds from gaining the single passport.[480] Because of prevailing AMF regulation that shut out offshore funds, third-country restrictions would have no impact on Paris-based managers, who would be able to easily market their EU-domiciled funds across Member States. However, German officials—though they had been allied with the French on the stringency of the prudential policy substance—supported an EU internal market open to non-EU funds.[481]

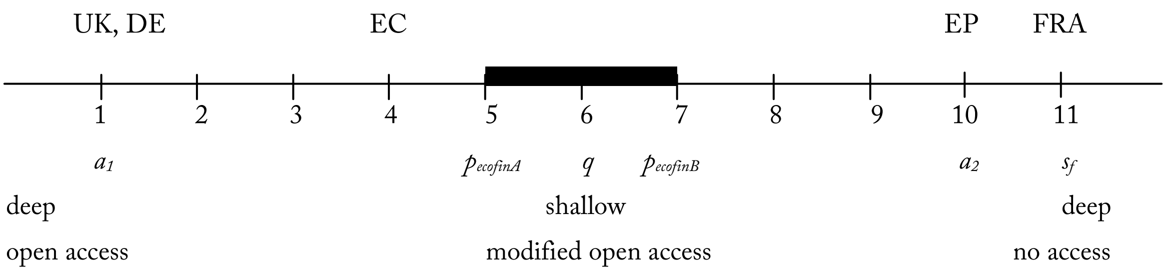
[478] AIMA (May 2010).

[479] *Financial News* (September 2010).

[480] AFG letter in House of Lords (2010): 190.

[481] According to Abdelal (2007), German officials have consistently and strongly supported open capital flows since the end of the Second World War, the *erga omnes* principle.

Figure 4.6: Bargaining on third-country access in the AIFM Directive (autumn 2010)



Third-country fund managers could presently operate in the EU through national private placement regimes, the most developed one being in London. This meant that the status quo (q) fell precisely between the preferences for open access ("free trade") and no access ("Fortress Europe"), meaning there was no proposal that the Belgian Presidency at the Council could make under QMV rules that would satisfy Member States which agreed with the UK and Germany or that would satisfy Member States which agreed with France. Given the location of the status quo at 6 (in the middle of the "gridlock interval"), any proposed standard at, say, 4 or 8 would entail a greater distance from the status quo (q) for a pivotal voter (p_{ecofinB} or p_{ecofinA}) than its present location. Thus, gridlock resulted.

Why were the French so insistent on, as the UK alleged, a "Fortress Europe" to guard against foreign hedge funds? In addition to their commitment to secure private distributional benefits for French asset managers, French officials believed the failure of a non-domiciled EU fund would present a very high risk to retail funds-of-funds investors of losing assets. AMF Secretary-General Thierry Francq argued, "If there is a problem [with a non-EU fund], where is the court? We have a problem with Luxembourg. LuxAlpha was a UCITS [mutual fund] invested only in Madoff funds. France was hit through this UCITS, so French people are going to a Luxembourg court. But, they have not succeeded in establishing that they are part of the fund…. In France, civil liability is full without any cap on damages. In the Caymans, the cap is $3,000. If it's a fund of $1 billion, that's nothing."[482]

[482] Interview, Paris (12 January 2011).

However, British representatives preferred the single passport (as did German officials for the purpose of an open integrated EU market). For London fund managers, who domiciled their funds offshore, a "Fortress Europe" would mean significant change to their business models. Further, the Commission supported the passport if third-country jurisdictions, such as the US SEC, operated with equivalent regulation of alternative investment fund managers.[483] At the end of August 2010, the Belgian Presidency left Articles 34 to 38 blank in its compromise text.

At the beginning of October 2010, despite Germany's preferring a more integrationist stance, France appeared to line up simple majority support for its position in ECOFIN. Nevertheless, a "blocking minority" existed,[484] as Sweden, the Netherlands, and the Czech Republic joined the UK in pushing for market access for third-country fund managers and funds.[485] As it appeared that a qualified majority was not in the offing to eliminate the possibility of a third-country passport, French representatives were forced to back down.

In the last days of bargaining, "it was very clear that France had been deserted by its natural allies."[486] Without a qualified majority, France nevertheless gained a provision allowing the Paris-based European Securities and Markets Authority (ESMA) to decide whether the passport would be available to non-EU fund managers and funds.

The final compromise on third-country rules reflected gridlock. National private placement regimes will continue until 2018, although the passport will be immediately available for EU AIFMs and AIFs. Thus, US fund managers can still market freely in the UK, although they will still have to individually register across EU jurisdictions. In 2015, if ESMA decides that non-EU fund managers and funds can access the single market through a passport, then it will also decide on terminating the national private placement

[483] *Europolitics* (September 2010).

[484] Fairless and Bollen (2010).

[485] *Europolitics* (October 2010).

[486] EU diplomat anonymously quoted in Dalton (2010).

regimes.[487] ESMA will decide on the basis of equivalence, that is, whether third-country fund managers and funds are subject to "an equivalent rule having the same regulatory purpose and offering the same level of protection to the relevant investors."[488]

Post-bargaining outcomes for the French

In this section, I detail how the legally binding AIFM Directive reflects the French regulatory consensus. As a result, France faces virtually no compliance costs when implementing the AIFM Directive. Although French officials were unable to definitively shut out non-EU fund managers and funds, they are keen to influence the stringency of prudential standards for fund managers and funds in third countries; through the equivalence process, the Commission and ESMA will determine whether third-countries, such as the US, meet a level of prudential stringency necessary to access the EU market.

The AIFM Directive is all-encompassing for non-UCITS funds, including not just hedge fund managers, but private equity, real estate, and venture capital fund managers—a wide-ranging, UCITS-like framework that already exists in France. Provisions on soundness, systemic risk, and investor protection are well-aligned with the French regulatory consensus and the country's previous experience in the UCITS market. With its legally binding rules on market abuse, corporate governance, mis-selling, leverage, and depositary liability, the AIFM Directive is a major loss for the British.

The depositary liability rules, which pose high compliance costs for London, are similar to the French consensus. Francq explained, "There is a cross-check between manager and depositary. Something like Madoff cannot happen in France. We have an element of confidence. The AFG was earlier to develop this model [than industry groups in other countries]. When we put in the legal *enveloppe* for alternative investment funds, we will use UCITS. It is a natural movement for industry."[489]

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[487] AIMA (November 2010).

[488] AIMA (November 2010); Article 37 in European Parliament (November 2010).

[489] Interview, Paris (12 January 2011).

Every fund manager must appoint a depositary, which will be liable for safeguarding fund assets and monitoring purchases and sales, in addition to guaranteeing the valuation of fund shares and the fund manager's actions in the best interest of investors. A depositary will still be responsible for the actions of third parties to whom it has delegated that result in losses, unless it can prove the loss was the result of external circumstances.

The rules on liability for depositaries were especially irksome to London, which followed a different, prime-broker model. The liability standard was adjusted, but still reflected the fact that "the French took the liability standard from their own regime and put it in [the directive]."[490] As an EC staffer noted, "The depositary model is much more popular on the [European] Continent, whereas prime brokerage is more popular in the UK and US. They perform many of the same functions of the depositary, but there are potential conflicts because prime brokers are also counterparties, whereas depositaries are supposed to be independent. This sort of incremental cost for hedge funds was far greater for the UK industry than for France."[491]

Further, the AMF and AFG agreed with the Directive's final treatment of leverage limits.[492] Fund managers will have to set *ex ante* leverage limits for each fund and will be required to file detailed leverage reports; ESMA can recommend to national supervisors that they increase leverage requirements.

French representatives also succeeded in achieving their preference on asset valuation. Independent valuation by an external entity of assets is not required in France (but was proposed by the Commission), and the AFG noted that "the notion of 'independent valuator' is contrary both to the existing regime of the UCITS Directive and to many

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[490] Interview with Michael Booth, London (24 November 2010).

[491] Interview with Chris Becher, Brussels (24 November 2010).

[492] AFG in House of Lords (2009); Jouyet (2009).

national regimes regarding non-UCITS funds;"[493] the AMF concurred that the fund manager should carry out internally independent valuation.[494]

The AIFM Directive increases the competitiveness of the French asset management industry, much to the satisfaction of not only the AFG, but also the AMF:

> For us, it will be easy to implement the AIFM [Directive]. Even contractual funds are managed by asset management companies that follow UCITS rules. You need to have this status. Rules on companies that sell alternative investment funds according to the EU directive are similar to what we have already. It will not be difficult to be transposed. In fact, it will be used to simplify our system…. We had too much complexity, which does not protect investors.[495]

For the AFG, French asset managers, and bank-owned firms like Amundi which offer alternative investments, the AIFM Directive is a competitive opportunity to develop a European brand for hedge funds and funds-of hedge funds. As the AFG stated in a letter to the UK House of Lords: "But the ultimate aim of the Directive must be to set up a framework for EU AIFs which is able to compete in the best way with non-EU ones—as it was successfully found with the UCITS Directive, which facilitated the worldwide selling of European mutual funds."[496]

By setting legally binding standards for alternative investment fund managers, French regulators and industry have clawed into this lucrative market. The AMF established an AIFM Directive Stakeholders Committee, composed of both regulators and industry officials, to guide implementation of the directive in France. The report stated, "In 2003, French regulators created new types of investment vehicles, registered funds ("fonds contractuels") and authorised funds with streamlined investment rules ("ARIA" funds) that could be used for 'alternative investment fund management' strategies…. The introduction

[493] AFG in House of Lords (2010): 193.

[494] Jouyet (2009).

[495] Interview with Thierry Francq, Paris (12 January 2011).

[496] AFG in House of Lords (2009): 195.

of these new funds in France marked a first phase of innovation in alternative investment fund management that helped promote the French industry and make it more attractive to investors."[497] The Committee added that in addition to "considerable untapped demand from retail investors," the Directive should "improve the prospects for the growth of French alternative investment fund management with institutional investors and private wealth management customers."[498]

Disclosure requirements would have been forthcoming in any new hedge fund regulation, but the UK FSA was frustrated with investor protections in the Directive. "The standards included were the same as those in UCITS. But, UCITS are marketed to retail investors. Investors in these funds are not people on the street, they're not stupid people."[499] Yet, for French banks such as Société Générale, hedge funds are themselves the *products* when they are selected, along with other funds, to form funds-of-hedge funds, which are popularly marketed to *retail* investors.

Despite bargaining that stretched out over nineteen months, the stringency of the AIFM standard did not change much. As one FSA staffer admitted, "Not that much has changed, although some things have swung…. This was not a reasoned, rational technical debate."[500] A Cabinet member of the European Commission added, there was little doubt that a stringent directive would be passed because "heads of state were involved. There would be real regulation."[501]

In the end, British representatives were able to battle back on the issue of a third-country passport, but were not very successful in diluting the stringency of the proposed prudential standards. The legally binding AIFM standard is a low fit with British preferences. And a costly one at that: while a survey commissioned by the FSA cited the one-off cost to hedge

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[497] AMF (2012): 6.

[498] AMF (2012): 7.

[499] Interview with Michael Booth, London (24 November 2010).

[500] Ibid.

[501] Interview with Didier Millerot, Brussels (23 November 2010).

fund managers at €1.4 billion,[502] the impact assessment by the European Parliament suggested that the one-off cost could be as high as €2.2 billion, and ongoing transaction costs for funds could increase by 10 to 15 percent.[503]

Equivalence and global regulation

The AIFM Directive provides ample opportunity for the Commission to ensure that EU AIFM standards become the *de facto* global standards for US and Asian fund managers, as well as offshore centers for funds, such as the Cayman Islands and Bermuda.

The Commission has directed ESMA to detail the provisions of cooperation agreements and information-sharing agreements with third-country supervisors, such as the US SEC, that the Commission will then enter into; these agreements are to be in place before the passport can be granted to non-EU managers or funds. Requirements that the third country is not listed as a non-cooperative country by the Financial Action Task Force on anti-money laundering and terrorist financing are directed towards offshore centers.

Equivalence means that the US, as well as London managers controlling offshore funds, will have to meet the AIFM Directive's standards in order to market their funds in the EU. A Commission official explained, "We had the idea of using equivalence to create incentives for other countries to have similar regulatory outcomes."[504]

Equivalence is essential for the French to export their regulatory model globally. An FSA official noted, "The first time non-EU managers get access to a passport, it will be a big issue for the French, who thought it was right to ramp up equivalence principles."[505] In their November 2010 newsletter, the AMF took issue with potentially extraterritorial elements of the US Dodd-Frank Act, which has minimal registration requirements that

[502] Charles River Associates (2009): 112.

[503] European Parliament (2009): 24.

[504] Interview with Didier Millerot, Brussels (23 November 2010).

[505] Interview with Michael Booth, London (24 November 2010).

will be easily met for French firms, in anticipation of the coming debate: "It will be up to the AMF, European regulators and Community institutions in general, as well as Europe's financial services industry, to seize the opportunity for consultation with the US authorities and give their opinions on how the provisions of the Dodd-Frank Act can be adapted."[506] AMF Secretary-General Francq was forthcoming:

> Are the United States equivalent? Probably, but there is one big difference. There is no obligation to separate manager and depositary. That is our cornerstone. But, are we really going to say the US are not equivalent? We probably will say they are not. Someone has to stand up to the US. If not us, then who?[507]

Conclusion

When Lehman Brothers failed and the international financial system lurched in September 2008, there were a number of dimensions to the panic that could have received the focus of an initial prudential regulatory response: capital adequacy, liquidity standards, cross-border insolvency, or credit rating reform. In the European Union, French and German officials charged hedge funds with precipitating the crisis. Yet hedge fund managers, who withdrew their funds from failing investment banks, acted more like retail depositors carrying out a classic bank run than nefarious profiteers (a label perhaps more appropriate for credit ratings agencies, mortgage lenders, or sell-side issuers of credit default swaps).[508]

This chapter has shown that the European Commission proposed the Alternative Investment Fund Managers Directive under French pressure, assisted by German officials. Direct appeals to the Commission came from the French securities regulator (*Autorité des Marchés Financiers*), *Trésor*, and investment fund industry group (*Association Française de Gestion Financière*), as well as from French MEPs and representatives in Brussels. President Nicolas Sarkozy considered hedge fund regulation a top priority. It was a full court press, and Paris was determined to win.

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[506] AMF (Third Quarter 2010): 10.

[507] Interview, Paris (12 January 2011).

[508] Gorton and Metrick (2010); Dixon et al. (2012).

Winning meant legally binding the City of London and its fund managers, as well as the US and off-shore financial centers, to stringent prudential regulation—and France managed to quickly project its preferences for hard law because of its domestic institutional coordination. Taking advantage as a first-mover at Level 1 of the EU financial standard-setting process, France used semi-restrictive Qualified Majority Voting rules in the Council of Ministers to isolate Britain and enact a deep AIFM prudential standard. It negotiated to a stalemate on third-country access rules, which will be decided by the Paris-based European Securities and Markets Authority (ESMA) in 2015, as it was only able to garner a simple majority (not qualified majority) at the Council of Ministers.

As ESMA and other EU committees have developed the implementing measures for the AIFM Directive, it appears that the French initiative has successfully set the pace of global alternative investment fund regulation. Indeed, the US-based Patton Boggs law firm has advised its clients that the AIFM Directive's third-country provisions on disclosure, transparency, anti-money laundering, and prudential compliance, as well as cross-border cooperation agreements with the SEC and other regulators, comprise an equivalence process that "may be costly and burdensome for U.S. fund managers—prohibitively so in some cases."[509]

This was a "most-likely" case of the two-step theory: the French regulatory structure in securities markets is nearly as coordinated as the United States banking regulatory structure is fragmented. Correspondingly, this French public-private regulatory collaboration transforms strong, credible domestic commitments into the pursuit of strong, credible international commitments. The decision-making rules at the EU are more restrictive than rules at other international standard-setters, conferring a bargaining advantage on effective first-movers. If the form and substance of new international alternative investment standards had turned out to be soft and shallow, then the two-step theory would be in trouble.

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[509] Patton Boggs (2012).

What the two-step theory *does not* account for is organizational choice, that is, conditions under which a state selects a specific organization to begin bargaining, although I note below that institutional complementarity is a condition for a successful first move. French officials' choice to set a standard at the EU—as opposed to a UN body or the IMF—is partially rooted in history, as the first half of this chapter has demonstrated. The EU is itself a focal point standard-setting institution, whose capacity to form hard law and ability to bind third countries aligned with French preferences and historical engagement in building the EU single financial market. Even if the French had been successful at IOSCO or the G-20 in setting a soft standard, they would not have accomplished their objective of legally binding other states. Across all international institutions, the French projected a coordinated, single voice—as opposed to a fragmented cacophony.

Alternative explanations

I consider here competing explanations for the form and substance of the EU Alternative Investment Fund Managers (AIFM) Directive. The rationalist/legalization perspective would most likely predict that the prevailing international standard for hedge fund and other alternative investment fund managers should be soft. Instead, the AIFM is deeply stringent and binding not only on EU Member States, but also through its extraterritorial effect on US fund managers and offshore jurisdictions. I do consider a complementary explanation based on the Varieties of Capitalism (VoC) approach applied to regulatory preferences. In doing so, I highlight the many similarities, but also the crucial differences between my framework and that of the VoC approach.

Moreover, I consider competing explanations for the deep substance of the prudential aspects of the AIFM Directive. Given the hegemonic financial market position of the UK within the EU, a counter-argument based on market size clearly falls short. I also explore the conditions for first-mover advantage and briefly consider counter-arguments about the influence of domestic constraints and the role of supranational actors.

Form

The rationalist/legalization perspective would predict a soft standard for the regulation of alternative investment fund managers for several compelling reasons: the uncertainty of regulating a previously unregulated global industry;[510] the "sensitive" nature of regulating firms that seamlessly transfer cross-border investment funds;[511] and the diversity of preferences resulting from the concentration of alternative investment fund managers in "Anglo-Saxon" economies. Some scholars argue that the difficulties posed by regulating cross-border investment flows through legally binding standards are critical explanations for the reversal of the international monetary regime from hard to soft form.[512]

Yet, the rationalist/legalization perspective fails to incorporate the implications of capitalist and institutional diversity for preferences on form. The influential Varieties of Capitalism approach focuses on the institutional underpinnings of liberal and coordinated market economies to answer questions about firm and industrial organization, rates of economic growth, inflation and unemployment, and the pace of innovation.[513] Applied to preference formation, the VoC approach "underscores that institutional interests are often analytically prior to material interests since economic groups employ institutions to sustain their competitive advantages."[514] The VoC approach informs and coincides with several theories in international political economy,[515] in addition to the two-step theory in Chapter 2: coordinated states feature hierarchical, non-market based relations among public and private actors, whereas fragmented states feature competitive public and private actors unlikely to regularly collaborate in domestic standard-setting.

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[510] Abbott and Snidal (2000): 441.

[511] Ibid.

[512] Simmons (2000): 54; Raustiala (2005): 595.

[513] Hall and Soskice (2001).

[514] Fioretos (2010): 699.

[515] Drezner (2007) uses VoC generally to characterize the market economies of the unitary states in his model. The analytical priority of institutions is also found in the Institutional Complementarity Theory proposed by Büthe and Mattli (2011).

Adopting a VoC perspective, Orfeo Fioretos argues that differences in how economic groups are "embedded" in policymaking processes will influence their institutional preferences. France's mostly bank-based, coordinated market economy conditions the domestic setting in which public and private actors interact. This chapter concurs with Fioretos' criticism of Drezner's unitary model and the recognition that states such as France can harness the market power of the EU to extraterritorially bind third countries such as the US.[516]

Yet, in Fioretos' explanation of the soft and shallow G-20 endorsement of hedge fund regulation,[517] legally or non-legally binding form is not explicitly considered as a type of institutional preference. Instead, "institutional preference" refers to regulatory stringency versus laxity, that is, direct or indirect regulation of fund managers. Thus, Fioretos argues that German associational governance and traditional French governmental regulation led to a preference for stringent and direct regulation of hedge fund managers—not a preference for hard or soft form.[518]

My approach instead links the structural coordination within a state to a preference for form. It does not link coordination to stringency or laxity, which can be—but is not always—a function of the type of market economy. For example, as I note in Chapter 6, French and German officials supported UK Financial Services Authority officials in pursuing an international standard on risk-based insurance capital intended to *reduce* required amounts of regulatory capital through internal modeling. Similarly, French officials joined Bank of England officials in supporting a bail-in standard at the Financial Stability Board, even though such an open bank resolution tool arguably increases moral hazard and thus the implicit funding subsidy received by large banks (Chapter 5). In Basel

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[516] Fioretos (2010): 712. See also Helleiner and Pagliari (2012) and Zimmerman (2012).

[517] G-20 Leaders (2009).

[518] Fioretos (2010): 704-6. Do common law or civil law countries have varying preferences for the form of international standards? As Casper (2001) argues, the classical US legal system complements market-based inter-firm relations, whereas non-market based firm relations in Germany are complemented by highly regulatory contract law. Whether consideration of the type of legal system would add a great deal to the explanatory force of the two-step theory proposed in Chapter 2 remains to be determined.

III negotiations, French and German officials preferred laxer quantitative liquidity standards than did the US Fed or UK officials (Chapter 3).

However, Fioretos' article does neatly demonstrate why the US Securities & Exchange Commission, a fragmented state actor, preferred the soft G-20 agreement on hedge fund regulation. In December 2004, the SEC sought to change the domestic status quo, and announced plans for all hedge fund managers, controlling more than $30 million in assets, to register.[519] Unsurprisingly, the Managed Funds Association and other US hedge fund industry associations vigorously opposed the SEC's initiative. Less than two years later, the DC Circuit Court in *Goldstein v. SEC* decided to overturn the rule, agreeing with the plaintiff, Bulldog Investors, that the SEC did not have the authority to force such registration through the 1940 Investment Advisers Act.[520]

In the aftermath of the 2008 crisis, US Treasury officials did not support the development of legally binding international financial standards, but they did assist the SEC. US Treasury and SEC officials incorporated the SEC's proposal for hedge fund registration through the G-20 London summit communiqué to provide domestic leverage during drafting of post-crisis financial reform legislation.[521] Subsequently, the Dodd-Frank Act incorporated the SEC's policy preferences to require hedge fund managers with over $150 million in assets under management to register, entailing disclosure requirements on their firm, funds, and investors.[522]

Substance

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[519] Registration does not entail prudential regulation, which the SEC resisted at IOSCO, as noted previously on pp. 153-155.

[520] *Goldstein v. Securities and Exchange Commission,* No. 14-1434 (D.C. Cir. June 23, 2006).

[521] Fioretos (2010): 715.

[522] Ahmed (2010).

Market power matters, but it does not determine the substance of international financial standards. Daniel Drezner proposes a compelling game-theoretic model of regulatory coordination between a "great power" and a smaller state:

> The logical extension of the effect of market size is that, *ceteris paribus*, once an economy amasses enough relative size, the *only* equilibrium outcome is coordination at that country's standards. Assume that country A is the great power. After a certain point, increasing A's market size vis-à-vis country B reduces A's benefit of coordinating at B's standards to the point that it prefers the status quo to coordination at B's regulatory standards.[523]

In the case of the AIFM Directive, the UK vigorously fought to maintain the status quo, and may very well have succeeded in forcing the EU to coordinate at the City of London's preferred standard—except for the use of Qualified Majority Voting rules, an institutional feature of prior delegation from the UK to Brussels through the Single European Act.

Couldn't the UK have achieved a somewhat shallower standard than what finally passed? After all, Charlie McCreevy, European Commissioner for Internal Market and Services, attempted to scuttle efforts at drafting a stringent AIFM proposal. But, according to my interviews and review of publicly available documents and periodicals, senior officials at the UK Financial Services Authority and Her Majesty's Treasury did not at all anticipate the stringency of what EC President Barroso—pressured by French and German regulators and finance ministry officials—would force McCreevy to propose in the substance of the AIFM Directive. Conceivably, if the UK had proposed and led bargaining in ECOFIN on a proposed AIFM standard that entailed moderate, but not deep, change from the status quo, then it could have garnered enough support from other Member States.

In other words, French and German officials successfully made a first move in launching negotiations on a deep AIFM standard, gaining an important bargaining advantage under

[523] Drezner (2007): 56.

restrictive decision-making rules. Under what conditions do certain states such as France become first-movers? There are at least three possible conditions:

1. *Demand*. High domestic demand for an international standard (from a regulator, the public, or industry) often exists in the aftermath of a crisis, as information about firm failures and market volatility spreads, spurring calls for international regulatory change.[524]

2. *Expertise*. Better-resourced regulators from wealthier states can afford the technical expertise and research needed to propose substantively detailed financial standards.[525]

3. *Complementarity*. Domestic fragmentation or coordination that complements the structure of the relevant international standard-setting institution increases the likelihood of a successful first move.[526] In other words, actors from fragmented states succeed as first-movers in standard-setting institutions with open membership rules (e.g. the US Federal Reserve at the Basel Committee), whereas actors from coordinated states succeed as first-movers in standard-setting institutions with consolidated membership rules that require the projection of a single national position (e.g. French finance minister at the Council of Ministers).

All of these conditions existed in France. In the UK, by contrast, there was no demand among regulators, industry associations, or the public for new, post-crisis hedge fund regulation. Furthermore, the fragmented structure in the City of London, wherein the UK Financial Services Authority interacts with various, non-encompassing industry associations, hinders information-sharing and representation of London's interests in Brussels.

After the AIFM Directive survived trialogue negotiations between the European Commission, Council of Ministers, and Parliament, the head of the Investment Management Association declared, "As so often, the British in Brussels seemed to be

[524] Mattli and Woods (2009).

[525] Brummer (2012).

[526] Büthe and Mattli (2011).

playing by the rules of cricket, while everybody else was playing by the rule of ice hockey." What did he learn from this experience? "The importance of consultation. I sometimes think that regulators and legislators are suspicious of consultation with the industry."[527] If, as it appears, two-level institutional complementarity influences first-mover success and bargaining advantage, then the membership rule of consolidated representation at ECOFIN and through the Lamfalussy Process is not a good fit with the fragmented UK structure.

Do domestic constraints also provide a bargaining advantage in this case? Schelling's conjecture and Putnam's hypothesis assume that one actor in a two-actor model is domestically constrained.[528] Thus, in the case of the substance of the AIFM Directive, an alternative explanation based on actors' domestic constraints generates the same conclusion as the simple bargaining model I use: the more domestically constrained state (France) succeeds in bargaining for a deeper standard than the less domestically constrained state (UK).

Any actor from a coordinated state is domestically constrained. What I have termed a "domestic regulatory consensus" reflects a durable credible commitment among regulators and industry associations unlikely to budge when a coordinated first-mover pursues a hard standard. The costs of renegotiating that domestic consensus credibly signal a constraint to foreign counterparts during bargaining.

A fragmented state actor can be *equally* domestically constrained: the fragmented state actor is unsure whether it can implement the internationally negotiated standard—and its bargaining counterparts are thus also unsure whether the fragmented state actor can deliver (i.e. uncertain size of a probably small win-set). This is a bargaining advantage allowing the fragmented state actor to request substantive concessions and side payments. An even

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[527] Saunders (2010).

[528] See above p. 118.

greater advantage emerges if the fragmented state actor knows the size of the domestic win-set, but its negotiating counterparts do not.[529]

However, the UK did not face constraints in implementing the AIFM Directive other than its reluctance to regulate a lucrative industry. While it was under criticism for its "light touch" approach before the financial crisis, neither the Bank of England nor HM Treasury had criticized the UK FSA for its oversight of alternative investment fund managers. Hedge fund regulation (as opposed to areas of banking regulation) was firmly within the FSA's remit. As a result, UK officials negotiating in Brussels could not credibly signal to their negotiating counterparts that the FSA faced any domestic institutional constraint in adopting a stringent AIFM standard.

One final alternative explanation I consider is the role of supranational actors in influencing the substance of directives, especially the role of the European Parliament.[530] Eilís Ferran emphatically concludes that the "European Parliament played a significant and shrewd role" during bargaining on the AIFM Directive.[531] Ferran asserts that the Parliament "deftly distanced itself from its pre-crisis reputation as an indiscriminate scourge of hedge funds and private equity by aligning itself with industry in supporting certain issues, such as a proportionate, differentiated, 'one size doesn't fit all' approach and maintaining third-country access to EU markets."[532]

I argue however that both my and Ferran's empirical discussion demonstrate that the median voter in Parliament held a position more stringent than that found among the pivotal voter in the Council of Ministers.[533] The Parliament's "conciliatory" movement towards a slightly less stringent position during trialogue negotiations reflected the power

[529] Tarar (2001). See also Mo (1995) and Iida (1993).

[530] For example, see Hix (2002).

[531] Ferran (2011): 398.

[532] Ferran (2011): 413.

[533] Ferran (2011): 398-408.

of QMV rules and Member State preferences at ECOFIN—not a new, industry-friendly posture among MEPs.

The experience of the AIFM Directive was only the beginning of post-crisis headaches for British officials. Further disputes with France and Germany over Basel III implementation and derivatives markets reform led UK Prime Minister David Cameron to withhold support in December 2011 for an EU-wide treaty on fiscal policy and financial stability. Cameron's pronouncement, supportive of the City of London, served as a threat to exit the process of European integration: such a threat is the final source of leverage for recalcitrant actors disadvantaged by restrictive rules.[534]

Cameron sought to veto financial services regulation detrimental to the City by demanding a unanimity voting requirement on the "transfer of powers from national level to EU agencies" and on "maximum harmonization provisions" (as in Basel III) that limit national regulators' discretion.[535] Those demands fell short, but Cameron has successfully adjusted decision-making rules that would increase the influence of non-euro Member States at the European Banking Authority.[536]

British initiatives at the December 2011 EU summit and afterward demonstrate just how important it is to shape the rules of the (bargaining) game for the long run. In the aftermath of a crisis, demands to change the status quo emerge swiftly, and previously agreed restrictive rules will straitjacket some—no matter how financially powerful they are.

[534] BBC (2011).

[535] "Annex" (2011).

[536] These developments were still ongoing at time of thesis submission. Barker (2012).

Table 4.2: The two-step theory and the EU AIFM Directive

Proposition	**Evidence**
Coordinated state features high level of integration, low degree of competition, and shared public authority	French regulatory structure features two main actors in asset management: AMF regulator (*Autorité des Marchés Financiers*) and AFG industry association (*Association Française de Gestion Financière* under peak-level AFECEI)
Domestic regulatory consensus	2003 Financial Security Law defined framework for alternative investments; collaborative reports by regulator-industry committees (Adhémar and Delmas-Marsalet reports) refined consensus
Incentives to pursue legally binding international standard	Soundness of funds, investor protection, competitiveness of French asset-management firms and big banks' "funds of funds" products
Coordinated state regulator makes first move at hard law international institution	French officials, allied with German representatives, force European Commission to draft stringent AIFM proposal; EU directives are legally binding with strong compliance mechanism; third-country equivalence process shapes global regulation
Recalcitrant actor prefers status quo on substance	UK FSA does not see hedge funds as cause of crisis; prefers status quo of laxity on prudential regulation
Restrictive decision-making rules advantage first-mover during bargaining; leads to deep standard	France builds coalition in Council of Ministers under Qualified Majority Voting rules, which allows it to resist UK demands for laxer standard France has less support on issue of third-country access (cannot achieve qualified majority); Germany and Commission prefer more open access, a position shared by UK; question of third-country passport to be decided in 2015

CHAPTER FIVE

The Bank of England: Bailing In, Not Out

On 13 September 2007, the BBC reported that the Bank of England had agreed to extend emergency lending for a troubled mortgage bank in northeast England: Northern Rock. The next day, scores of customers lined up outside the bank's branches, ready to withdraw their deposits. The Bank of England's support was intended to assure Northern Rock customers that their money was safe. The customers were not being irrational. Britain, at the time, did not have a regulatory and legal framework able to handle the failure of a bank and prevent a disorderly collapse of the financial system. Indeed, deposits were fully insured only to £2,000, and 90 percent insured up to £35,000.[537] If the Bank of England had *not* intervened, if the British government had not eventually nationalized the bank, and if Northern Rock had been put into bankruptcy, depositors would have been treated like any other creditor of the bank, with their potential losses between £2 and £10 billion.[538] The emergency bailout of Northern Rock was the start of two years of general confusion, nationalization, and recapitalization in the British financial system.

The first stage of the two-step theory suggests that a fragmented state actor prefers a soft international standard when it faces threats to its policy preference or autonomy. However, despite criticism of the Bank of England that it acted too little and too late, the Bank deftly *gained* power at the expense of the UK Financial Services Authority (FSA) in the British regulatory structure. It also gained control of new "special resolution" tools in a revamped resolution regime, which would allow the Bank of England to close failing small and medium-sized banks without causing disruptions and losses to the public.

Given its new authority, why would the Bank of England pursue an international standard? The UK Special Resolution Regime is *not* equipped to handle the failure of a global and

[537] See Shin (2009) for a discussion of UK depositors' incentives during the run.

[538] National Audit Office (2009).

complex British bank, such as Barclays or HSBC. If such a bank were to fail, the Bank of England would lose control of the resolution process to Her Majesty's Treasury if the Treasury had to grant a bailout or exercise "temporary public ownership" of the bank. In other words, despite the run on Northern Rock, the Bank of England had not eliminated "Too Big to Fail." And if a larger British bank needed a bailout, the Bank of England would have its autonomy severely reduced.

As a result, the Bank of England drafted proposals for *bail-in*, which is a prudential tool to force some of a failing global bank's creditors to bear losses, thereby avoiding public losses. It is where prudential financial regulation, which is meant to prevent firm failure, meets resolution, which is meant to close a financial firm. By avoiding a government bailout, bail-in would ideally allow the Bank of England to apportion losses to the failing bank's creditors, supply emergency funding, and prevent HM Treasury from gaining control of the resolution process. Bail-in could also become an important plank in the EU's proposals for a crisis management framework and post-crisis UK banking reform plans.

Operating in a fragmented state, the Bank of England faced skepticism among major UK banks and lacked a domestic consensus with the FSA and HM Treasury on the feasibility of bail-in. Without such consensus, the Bank of England could not pursue hard law. Thus, the Bank pursued a non-legally binding standard on bail-in at the Financial Stability Board (FSB) to improve its domestic political position, instead of seeking a legally binding standard through the IMF, EU or other standard-setting institution. Set up by G-20 Leaders in response to the global financial crisis, the FSB is a soft law institution that produces standards through open decision-making rules that conform closely to the ideal-type open rules described in Chapter 2. The Bank could bargain for a soft standard at the FSB without prior domestic coordination. Hard law institutional options, such as the IMF or the EU standard-setting process, were simply too costly for the Bank.[539]

[539] George and Bennett (2005): 120-3. This case serves as a useful test of the sequence posited in my two-step theory of standard-setting. The bail-in case can be considered a "less-likely" case because the UK is a less fragmented state than the US and has access to both hard and soft law focal point international institutions

Bargaining at the FSB was not costless, either, for the Bank of England. As the simple bargaining model of the two-step theory predicts, a recalcitrant actor who prefers the status quo determines the substance of the standard under open decision-making rules. In this case, the US Federal Deposit Insurance Corporation (FDIC), which preferred traditional closed-bank resolution tools, forced the policy substance of the bail-in standard to be much shallower than the Bank preferred. This occurred despite support for a deeper bail-in standard from the French *Trésor* and other European members; the New York Federal Reserve also favored a deeper standard than the FDIC did. But, the FDIC had long operated a bank resolution regime at home, and the scope of its resolution authority had been widened under the Dodd-Frank Act. It had little appetite for what it regarded as an untested, overly clever idea.

Nevertheless, the Bank of England was able to use a soft, shallow bail-in standard to set the regulatory reform agenda within the European Union and the UK. Bail-in is now a tool included in the proposed EU Bank Recovery and Resolution Directive, as well as part of pending domestic bank reforms. Meanwhile, given its undisputed status as the US resolution authority, the FDIC is under no pressure in the US to adopt the Bank's version of bail-in. As part of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, the bail-in tool is a soft and shallow standard that suits the needs of both the Bank of England and the FDIC.

I conclude the chapter by assessing this case in light of the two-step theory and considering alternative explanations for the form and substance of the FSB bail-in standard. The rationalist/legalization perspective would predict a legally binding standard on bail-in; moreover, global banks, academics, and the IMF have all considered hard law as the ideal form for a bail-in standard in cross-border financial resolution. On substance, "great

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that could have set the bail-in standard. This case is a stronger test of my proposition that fragmented states choose soft law institutions than the US/Basel case because the US is not a Member State of the EU.

power" regulatory coordination, the unity of the bargaining team, and first-mover advantage[540] cannot account for the shallow bail-in standard.

I. The City of London and its regulation: market-driven fragmentation

The British financial system has been characterized by the depth and international bent of its capital markets. Scholars have long observed how the Empire oriented the City of London—the epicenter of British financial power—towards overseas lending. Traditional producer groups did not depend on public institutions for industrial expansion, as occurred in continental Europe. Instead, financing for industrialization depended on successfully issuing bonds and equity shares. This arm's-length relationship hampered coordinated state intervention in the years after World War II, and despite often tepid economic growth at home, the City resiliently grew in importance as a major global financial center.[541] When the present era of financial globalization arrived in the 1960s and accelerated in the 1970s and 1980s, the personally intimate governance of the City—forever unused to any statutory regulation—was transformed into a fragmented structure.

With a few dominant banks once protectively overseen by the Bank of England, there is little doubt that a more coordinated structure previously existed in the City of London. At the City's pinnacle were the major clearing banks, such as Barclays and National Westminster, which carried out the operations necessary for government credit and monetary policies, and which benefited from entry barriers that blocked out competitors.[542] Nationalized in 1946, the Bank of England relied on "moral suasion" to deter excessive risk-taking and shoddy management. As the Governor of the Bank said in 1957, "If I want to talk to the representatives of the British Banks, or indeed of the whole financial community, we can usually get together in one room in about half-an-hour."[543]

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[540] This is first-mover advantage defined according to the three conditions posited in the previous chapter (pp. 191-193): high demand for regulatory change; technical expertise and resources; and institutional complementarity.

[541] Shonfield (1965); Gerschenkron (1962); Zysman (1983); Hall (1986).

[542] Grady and Weale (1986): 71.

[543] Moran (1986): 15.

However, the cartel of clearing banks gradually weakened as globalization intensified. Their share of domestic deposits fell from over two-thirds in the 1920s to under one-third by the late 1960s.[544] In the early 1960s, the Bank consciously permitted financial integration and specialization to proceed through the Eurodollar markets, which allowed foreigners, especially American corporations, to pursue higher rates of return than what was available in their domestic markets: "however much we dislike hot money we cannot be international bankers and refuse to accept money."[545]

In the 1970s, impelled by crisis, the Bank of England began to move towards a statutory framework for financial regulation.[546] It established the Bank Supervision Division, its first staff fully dedicated to supervisory issues. The 1979 Banking Act provided the UK's first legal framework for regulation of banks, but actually entrenched resentment by providing for two tiers of institutions: the more prestigious institutions were designated "recognised banks" and were subject to lower reporting requirements than the mere "licensed deposit-takers."[547]

In the securities markets, Her Majesty's Treasury and the Bank of England oversaw the "Big Bang" 1986 Financial Services Act, the radical fragmentation of the London securities market.[548] In the late 1980s, the Department of Trade and Industry (DTI) was formally at the head of the securities market regulatory structure, but it delegated to a private, self-regulatory institution: the Securities and Investments Board (SIB). The SIB, in turn, delegated to a number of self-regulatory organizations (SROs) that oversaw specific sectors. This fragmentation meant that regulators and industry were ripe for fierce debates over authority in rule-making and policy preferences.[549] The proliferation of SROs occurred

[544] Story and Walter (1997): 225.

[545] Quoted in Schenk (1998): 235; Friedman (1971).

[546] Grady and Weale (1986): 71.

[547] Ibid.: 170.

[548] Thomas (1989); Hall (1987).

[549] Story and Walter (1997): 241-2.

even as the government encouraged the formation of conglomerates, which combined retail and investment banking.

Within the fragmented regulatory structure, the SIB had little legitimacy and even less power, which it shared with the Bank of England.[550] It was a nominally corporatist structure, in the sense that it invested private institutions with public authority. But, it was so muddled by the complexity and confusing hierarchies of responsibilities—and by the sheer *number* of organizations now statutorily invested—that a national, peak-level association of the kind that distinguishes the French and German institutional structures never emerged.

Since the late 1990s, the City features much less regulatory fragmentation, but even higher levels of specialization and internationalization. The Bank of England, which had always directed banking supervision and which heavily influenced rules for securities firms, was stripped of its regulatory portfolio in 1997 after a series of scandals—from the spectacular fraud of Bank Credit and Commerce International (BCCI) to massive mis-selling of pensions—undermined confidence in the august institution.[551]

As part of the fallout, Chancellor of the Exchequer Gordon Brown directed the creation of a new "super" regulator, which assumed the supervisory duties of the Bank of England, as well as a merger of the SIB with the City SROs.[552] The new Financial Services Authority (FSA) received its statutory framework in 2000 and concentrated all regulatory authority in itself, depriving the City of its historical role in self-regulation. The FSA was an attempted solution at answering the question that has bedeviled City figures, Bank officials, and successive British governments: how to effectively police the risks arising from complex financial markets and firms, which are ever more specialized, conglomerated, and internationalized?[553]

[550] Moran (1991): 73.

[551] Prabhakar (2011).

[552] Brown (1997); Taylor (2010).

[553] Reforms of the regulatory structure in the aftermath of the 2007-'08 crisis are discussed in this case study.

The private side of the British structure is completely fragmented. Given poorly integrated industry associations, there is a high degree of competition for new members and resources. Few industry associations can claim to comprehensively represent the major players in both banking and securities markets. For example, the British Bankers Association (BBA) heavily recruited Goldman Sachs and Morgan Stanley, but they chose to join instead the Association of Financial Markets in Europe (AFME).[554] Small British financial firms are often marginalized ("they drift in and out of the BBA")[555] and sometimes join the Building Societies Association and other groups, which exist to represent mortgage lenders and small institutions.

The City of London organization attempts to bridge the fragmentation in the industry through the International Regulatory Strategy Group (IRSG), which convenes to discuss the interests of different sectors in pending global, EU, and US legislation. But, finding consensus within the industry is difficult. As one City of London official stated, "Everyone is trying to stretch their boundaries. Look at the BBA, their tag line changed from 'voice of banking' to 'voice of financial services.' Their subscriptions and revenue are under threat. We aim not to get into turf battles, but it's sometimes amusing to see the assertion of member motives."[556]

Industry associations stand at arm's-length from regulators. In the fragmented structure that prevails in the City today, there is "no legal requirement to bring in trade associations."[557] The FSA has a process of consultation that (usually) engages early with the industry associations, but fragmentation means that not all relevant private stakeholders are heeded. A senior official at Her Majesty's Treasury characterized the relationship between UK regulators and industry as "complex, kaleidoscopic." As a former head of an

[554] AFME was formerly the London Investment Banking Association (LIBA), and merged with the Securities Industry and Financial Markets Association (SIFMA).

[555] Interview with Sally Scutt, London (7 June 2010).

[556] Interview with Paul Sizeland, London (26 October 2010).

[557] Interview with Jonathan Taylor, London (12 November 2010).

industry association, he added, "A merger of industry associations would never work, especially of AFME and BBA. It wouldn't really represent industry. In Europe, they are much more about social partnerships…. At the end of the day, business is for business. Government is for government. They don't mix."[558]

Over the past fifty years, regulation of the City—and now, Canary Wharf and Mayfair[559]—has proceeded from "moral suasion" to informal guidelines to self-regulation by industry to direct regulation by a consolidated authority, which, after the latest crisis, has now been split and concentrated in the Bank of England. The ultimate consequence of this kaleidoscope has been that actors are incentivized to operate at arm's-length. Scarcely has a decade gone by without another major shift in the British regulatory structure.[560] Consulting but not incorporating industry groups, the FSA issues rules that have limited legitimacy for industry, which constantly complains about the "level playing field" being skewed against them. Industry associations continue to compete with each other to expand their expertise, resources, and membership lists. As the FSA will be split and subsumed into the Bank of England in the aftermath of the most recent crisis, and as London's financial markets show little sign of simplifying, the market-driven fragmentation of the British regulatory structure will likely continue.

A brief note on bail-in

This technical note briefly discusses the concept of resolution and bail-in, which is the policy substance that the Bank of England and other actors bargained over at the Financial Stability Board. Resolution refers to measures taken to restructure and restore distressed or insolvent firms to soundness and profitability.[561] These measures include: removing senior

[558] Ibid.

[559] Canary Wharf now hosts many of the City's major institutions. Mayfair is home to the hedge fund industry.

[560] In the aftermath of the 2008-2009 crisis, the FSA is to be split, partly absorbed into the Bank of England, and another part to form the new Financial Conduct Authority.

[561] Corporate insolvency usually occurs when the firm is cash flow or balance sheet insolvent; in the former, the firm is unable to pay obligations as they come due and in the latter, assets are worth less than liabilities.

management; appointing an administrator to manage the firm; using powers to terminate or assign contracts or purchase and sell assets; and overriding shareholders' rights to permit mergers, acquisitions, sales of operations, recapitalization, and so on. If such a firm cannot be resolved, it may be liquidated.[562]

Non-financial firms go through a protracted, court-based legal process which attempts to add as much value as possible to the firm by selling physical assets while the firm is still viable; because these firms have physical assets that will not disappear, there is little incentive to expedite the resolution process.[563]

In the case of banks, waiting to determine insolvency is counterproductive; regulators are prevented from intervening early and the bank has already lost much of its value. For example, Lehman Brothers was forced to sell its investment banking and trading businesses for less than $500 million, compared to the $4 billion in annual profit they garnered before bankruptcy.[564] Destruction of value leaves less money available to pay out to creditors. The lack of early intervention means regulators cannot change the bank's management, and thus shareholders can still resist reorganization.[565] Many have thus supported a special resolution regime for banks, in order to serve three major purposes: continued operation of payments and settlements; protection of individual depositors; and, prevention of a loss of confidence among counterparties to the failed bank and the general public, which may cause a run on otherwise healthy banks.[566] As this chapter demonstrates, the lack of such a regime became the Bank of England's defense for not acting sooner to bolster Northern Rock.

"Bail-in" refers to a specific resolution tool that can apply to *open* banks, that is, banks that have not yet been declared insolvent. Under bail-in, a resolution authority, such as a

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[562] IMF and the World Bank (2009): 10.

[563] Campbell and Lastra (2011): 34.

[564] McCracken (2008).

[565] House of Commons (vol. I, 24 January 2008): 81-82.

[566] IMF and the World Bank (2009): 16.

central bank or financial regulator, takes control of the faltering bank and restructures its liabilities by converting the claims of unsecured debtholders into equity. Writing down unsecured debt allows regulators to account for extensive losses on the bank's assets. Because equityholders usually lose the value of most if not all of their stakes in a resolved bank, this effectively means losses for unsecured creditors.

Opponents of bail-in argue that the tool merely exacerbates the funding pressures facing a faltering bank by sending a panic signal to the rest of the market. As a result, bail-in could trigger a run by short-term lenders, instead of providing reassurance. Banks do not have identical views on the merits of bail-in, but their preferences are a function of adjustment costs: sound banks with low cost of unsecured funding generally oppose bail-in because they believe the tool will lead to higher unsecured funding costs for *all* banks, regardless of their soundness. Banks that required government support during the 2008 financial crisis generally support bail-in because they believe the tool will provide greater reassurance to investors and allow them to re-attract cheaper, unsecured funding.

Not enough for the Bank: the Special Resolution Regime and regulatory authority

In summer 2007, a financial crisis began in Britain with worries about the soundness of Northern Rock, a major mortgage lender reliant on short-term funding. The UK Financial Services Authority was responsible for micro-prudential supervision of individual financial firms, whereas the Bank of England had responsibility for financial market stability. However, unlike the US Federal Reserve and the European Central Bank, the Bank of England did not publicly move to assist frozen interbank lending markets in August 2007.[567]

Into September, the Bank of England and its Governor, Mervyn King, remained silent as opposition grew to its apparent lack of action.[568] King was reluctant to provide "ex post insurance" to British banks, which sought to gain more central bank reserves in exchange

[567] For an accessible technical explanation of these operations, see Cecchetti (2007).

[568] Dey (2007).

for illiquid collateral, namely their mortgage-backed securities. He wrote to the Treasury Select Committee on Wednesday, September 12 that "the provision of large liquidity facilities penalizes those financial institutions that sat out the dance, encourages herd behaviour and increases the intensity of future crises."[569]

However, days later, Northern Rock could barely fund itself, and the Bank soon reversed its hard-line stance. The growing possibility that depositors would lose a substantial amount of their savings forced the Bank to establish a backstop support facility for Northern Rock. When the BBC leaked news of the liquidity facility, the retail depositor run began. Three days after the run began, a government guarantee of retail and wholesale deposits in Northern Rock (a bailout eventually worth £51 billion) was announced in an attempt to stabilize the situation.[570] The troubled lender was nationalized soon thereafter.

It appeared that the Bank of England had made an abrupt U-turn by publicly refusing emergency liquidity support and then proceeding to secretly backstop Northern Rock. Under parliamentary scrutiny for his apparent inconsistency, King blamed legal hurdles for not being able to take more decisive action.[571] With his institution and leadership in question, King pushed first and foremost for a special resolution regime for banks:[572] "Our system for dealing with insolvency of banks and deposit insurance is markedly inferior to other countries."[573]

The Bank argued that the lack of a special resolution regime meant that "we could not do anything while Northern Rock was meeting regulatory capital and other guidelines. We

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[569] House of Commons (vol. II, 24 January 2008): Ev 217.

[570] House of Commons (vol. I, 24 January 2008): 69-71.

[571] House of Commons (vol. II, 24 January 2008): Ev 2.

[572] King also asserted that corporate takeover rules, provisions on secret liquidity support, and the EU Market Abuse directive hampered the Bank from carrying out the actions it wanted. Each of King's assertions was disputed by Treasury and FSA officials. See pp. Ev 2-15, Ev 22-23, Ev 35, Ev 89, Ev 183, Ev 199-201 in House of Commons (vol. II, 24 January 2008).

[573] House of Commons (vol. II, 24 January 2008): Ev 4.

couldn't take out management and take control before its solvency was under threat."[574] Others noted that the Bank of England and FSA may have wanted to avoid any actions that invited lawsuits from Northern Rock shareholders and junior bondholders.[575] This lack of early and direct intervention by British regulators—whether due more to legal inability or more to reluctance—worsened public confidence in Northern Rock. However, the Bank argued that not only was its course of action regarding Northern Rock correct, but also that it should be accorded *more* power by directing the special resolution of failing banks.

What ensued after the Northern Rock debacle was a year of wrangling between the Bank of England and FSA to expand their respective mandates within the British regulatory structure. Normally not an issue of high political salience, the division of regulatory responsibilities became a prominent partisan football. At first, it appeared that the Bank would lose out to the FSA; yet it not only gained control of the new Special Resolution Regime, but also grew its regulatory authority entirely at the expense of the FSA.

In January 2008, the British government proposed granting more powers to the FSA—*not* to the Bank—and specifically, control to trigger and run a special resolution regime for deposit-taking institutions. In the weeks following HM Treasury's proposals, the Bank of England vigorously lobbied for those mandates.[576] In the House of Commons, the Treasury Select Committee agreed with the Bank that the FSA might be fearful of being blamed for a failing bank and thus too reluctant to exercise special resolution powers.[577] With the support of Conservatives, Liberal Democrats, and the Treasury Select Committee, the Bank had a powerful hand to play against HM Treasury on who would run the special resolution regime. Treasury soon reversed itself and proposed handing control of the impending special resolution regime to the Bank.[578]

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574 Interview with Peter Brierley, London (2 February 2012).

575 House of Commons (vol. I, 24 January 2008): 77.

576 King quoted in House of Commons (29 April 2008): Ev 19.

577 Giles and Parker (2008).

578 Mathiason (2008).

Passed in February 2009, the Banking Act outlines a Special Resolution Regime (SRR), which grants powers to the Bank akin to those of the US Federal Deposit Insurance Corporation (FDIC).[579] Special resolution is triggered when a deposit-taking institution (i.e. not including investment banks or other financial firms) breaches certain "threshold" conditions, such as low capital and liquidity levels or "fit and proper" management, which can no longer be met by remedial action.[580] "Pulling the trigger" is a regulatory judgment that takes into account, but is not limited to, quantitative measures.[581]

Once it is triggered, special resolution can be implemented through a number of tools held by the Bank. Each have specific conditions for their use: facilitating and financing all or part of a failing bank's business to a private sector purchaser; taking control of all or part of a failing bank's businesses through a "bridge bank" run by the Bank; temporary public ownership; and an insolvency procedure that prioritizes paying insured depositors first.[582]

Not only did it gain control of the SRR, but the Bank also managed to consolidate nearly all regulatory authority in the British regulatory structure. King had persuasively argued that the prevailing regulatory structure of the "Tripartite Authorities"—the Bank, FSA, and HM Treasury—functioned poorly, and that the Memorandum of Understanding (MoU) governing its operation was impotent in the Northern Rock crisis.[583] As a result, the FSA was subsumed within the Bank as the Prudential Regulatory Authority (PRA). Following the "twin peaks" model, prudential regulation is now housed within the central bank,[584] while the new Financial Conduct Authority (FCA) will focus on consumer

[579] House of Commons (vol. I, 24 January 2008): 77-78, 82-83.

[580] Section 7 of the Banking Act 2009, c. 1.

[581] HM Treasury (2010): 13-19.

[582] Temporary public ownership allows the British government to acquire shares in the failing bank. The establishment of a bridge bank transfers property of the failing bank to a company owned by the Bank of England, which controls assets and runs management until the bridge bank's businesses can be sold to a private buyer. Brierley (2009): 7, fn 9.

[583] House of Commons (vol. II, 24 January 2008): Ev 4.

[584] The Netherlands and Australia use the twin-peaks model as well. See Goodhart (2002); Taylor (2010).

protection and market abuse issues. These authorities, focused on day-to-day supervision, are overseen by the macroprudential Financial Policy Committee within the Bank. All in all, the consolidation of regulatory authority was an impressive coup for the Bank. It is little surprise, then, that the Bank could hardly wait to implement the institutional reforms and dismissed the idea of an interim memorandum of understanding with the FSA and Treasury—"the faster we make the switch the better."[585]

II. Incentives for a non-legally binding standard on bail-in

The two-step theory suggests that regulators in fragmented states seek international standards when they are dissatisfied domestically. But, how could the Bank of England possibly be dissatisfied? It had turned a possible institutional disaster—caused by its response to the Northern Rock crisis—into a coup, and it managed to assume nearly all regulatory authority within the British tripartite structure. In turf wars with Treasury and the FSA, it won a major victory in gaining responsibility for running the Special Resolution Regime (SRR). The two-step theory suggests that regulators become dissatisfied if their policy preferences cannot be enacted domestically or their autonomy is threatened. Indeed, the Bank of England faced obstacles to its policy preferences and remaining challenges to its autonomy.

There are serious questions as to whether the SRR can handle the failure of a *globally active* British bank, such as Barclays or HSBC. It leaves future taxpayer bailouts of big banks as a viable option—and, if this option is exercised, then HM Treasury, *not* the Bank, would assume extraordinary powers in a crisis. Thus, the Bank of England found itself needing a credible alternative to bailouts—not only because avoiding bailouts is arguably good public policy, but also because its institutional autonomy would again be at stake in a future crisis.

Crafted in response to the Northern Rock crisis, the Special Resolution Regime does not fully meet the Bank's objective of handling the failure of any British bank; it is suited to handle the failure of small to medium-sized deposit-taking institutions. If the largest

[585] Mervyn King in House of Commons (1 March 2011).

British banks, such as RBS, HSBC, and Barclays, were to begin faltering, the Bank of England's special resolution tools would not suffice. A major tool is a bridge bank, created by splitting the failing bank's "good" and "bad" assets and temporarily operating as a subsidiary of the Bank of England; other parts may be sold to another bank. [586] But, the operations and cross-border structure of a globally active British bank are too complex to quickly split assets, which are spread across the world; recalling these assets to the UK is devilishly difficult.[587]

The inapplicability of the SRR to systemically important British banks means that temporary public ownership—a taxpayer-funded nationalization and bailout—may be the only feasible option. As the IMF notes, the SRR's "usefulness in the resolution of a complex group may be limited (particularly international groups), unless the TPO power [temporary public ownership], which is meant to be a last resort under the SRR, is exercised."[588]

However, the exercise of temporary public ownership or taxpayer bailouts (including less-than-majority government stakes) would result in HM Treasury's control of the resolution process, severely reducing the Bank's autonomy.[589] According to a Memorandum of Understanding between the Bank and Treasury, the presence of "material risk" to taxpayer money requires the Bank to notify Treasury; authorization for actual financial assistance to a failing bank will be issued by Treasury.[590] Referring to draft legislation to finalize the new regulatory structure, Chancellor George Osborne emphasized, "There is a very clear statutory duty on the Bank of England to inform the Chancellor when, for example, public

[586] On partial property transfer in the special resolution regime, see HM Treasury (2012).

[587] IMF (2011): 22-26; Interview with Peter Brierley, London (2 February 2012).

[588] IMF (2011): 25.

[589] House of Commons (19 October 2011): 60-61.

[590] According to one Treasury official, the effectiveness of this arrangement will be based on the relationship between the Chancellor of the Exchequer and Governor of the Bank. Interview with Martina Garcia, London (12 March 2012); HM Treasury (2012); Part 54, Section 54(1) of Financial Services Bill 2010-2012 (as introduced).

money is materially at risk."[591] For the sake of the Bank's autonomy in a crisis, it would need to find a plausible alternative to bailouts.

The motivation to find an alternative to taxpayer bailouts of major banks—one might argue—is not merely a means for the Bank to preserve its autonomy, but an objective worthy of pursuit as its own end. After all, in October 2008, Prime Minister Gordon Brown was forced to announce the recapitalization of the Royal Bank of Scotland (RBS) and Lloyds-HBOS, resulting in majority government stakes in both banks. In addition to the recapitalization program, the government later sought to unblock interbank lending through the Credit Guarantee Scheme. As of autumn 2011, the comprehensive bailout was estimated to have cost taxpayers £25.6 billion.[592]

The near-constant public refrain of the Bank of England has been that taxpayer bailouts, whether nationalization or any taxpayer-financed recapitalization, *must* be avoided in the future. In addition to publicity in the press,[593] King and his colleagues used nearly every opportunity before the Treasury Select Committee in the House of Commons to expound on the necessity of avoiding future bailouts. They pointed to the burden on public finances posed by the potential failure of the British financial sector, which stands at 500 percent of GDP.[594]

Yet, far from being panned, the British bank bailout in autumn 2008 was *hailed*. It was quite unlike the negative reception given by the US Congress to the bailout initially proposed by the Bush Administration in October 2008. Gordon Brown's poll numbers steadily increased as the crisis unfolded and spiked after the announcement of the recapitalization program, frustrating Conservatives, who expressed "grudging admiration"

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[591] House of Commons (October 2011): Ev 68. Clause 42 of the Financial Services Bill.

[592] Office for Budget Responsibility (2011): 120.

[593] E.g., Moore (2011).

[594] E.g., Mervyn King in House of Commons (vol. II, March 2010): Ev 19-20. Measured by total assets to GDP in House of Commons (vol. I, March 2010): 3.

for Brown's handling of the crisis. The bailout had allowed Brown to successfully project himself as "a serious man for serious times" and a "leader born for this hour."[595]

Nor was there consensus among British regulators that bailouts were indisputably bad. Unlike the Bank of England, the FSA played down the centrality of bailouts to the special resolution debate, arguing that "exceptional central bank liquidity support, treasury funding guarantees and equity injections … while significant turn out to be small relative to the overall costs produced by financial instability." Central bank liquidity is provided at market or penal rates, the use of Treasury's guarantee is conditional and may not be fully used, and equity stakes in banks are not substantial relative to GDP. Consequently, "it is quite possible that the total overt costs of the UK's big bank rescues will not exceed 5-10% of GDP; indeed, it is possible that the figure will be much less."[596] While the use of taxpayer funds is not ideal in addressing financial crises, its perniciousness is not settled fact, despite the Bank's contentions.

From bailouts to bail-in

In sum, the Bank of England had strong incentives to find a credible alternative to bailouts. This was not only for the arguable sake of sound public policy, but also to preserve its autonomy. But, what should the alternative be? In early 2010, the global bank Credit Suisse announced its support for *bail-in*. The bank had been working on developing contingent-convertible (coco) bonds to meet new stringent capital requirements in Swiss banking regulation. As a type of market-based, "contractual" bail-in, cocos would be converted into equity at a pre-defined trigger to prevent a disorderly collapse. The application of this idea to resolution—as a type of "statutory" bail-in—was presented as a way to transcend the choice that Britain and other states faced in 2007 and 2008: bailouts or collapse of the banking system. According to Credit Suisse, if statutory bail-in had been

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[595] US Embassy (2008).

[596] House of Commons (vol. II, March 2010): 78. UK fiscal debt in the aftermath of the crisis, FSA chairman Adair Turner argued, was the result of a "volatile credit supply first under-priced and too easily available and then severely constrained"—not the result of bailouts.

applied to Lehman Brothers before it filed for bankruptcy in September 2008, it would have doubled the firm's capital base, eased liquidity concerns, and allowed the firm to survive.[597]

The Bank of England agreed on the merits of contractual and statutory bail-in. As a Credit Suisse executive recounted, "Friends at the Bank had been playing around with ideas like this. After the experience of 2008, they were doing some hard thinking about new options."[598] In November 2009, Paul Tucker, Deputy Governor for Financial Stability, was keen: "If cocos [contingent capital] could form a material part of recovery plans, the landscape might just be transformed."[599] Appearing before the Treasury Select Committee in January 2010, the Bank mooted bail-in as an option to eliminate the need for taxpayer bailouts.[600] According to a former Bank official, "The Bank wanted to be the intellectual leaders on this. They adopted the Credit Suisse proposal and accepted their Lehman analysis."[601]

Bail-in is a prudential tool and authority within the framework of special resolution because it is intended to boost regulatory capital. As the Bank of England perceived it, to bail in some wholesale creditors involves a regulatory judgment about the viability of the firm because it "enables recapitalization without splitting up the legal entities [of the failing bank]. It recapitalizes the existing institution, but avoids moral hazard by combining it with other measures, such as the power to dismiss senior management and require a new business plan."[602] Instead of operating through the courts, a regulator would determine the extent to which unsecured wholesale creditors would be bailed in, in order to exceed minimum regulatory capital ratios and restore market confidence.[603]

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[597] Calello and Ervin (2010).

[598] Interview with Wilson Ervin, phone (26 January 2012).

[599] Tucker (2009).

[600] House of Commons (vol. II, March 2010): 16, 19, 31.

[601] Interview, Washington, DC (5 January 2012).

[602] Interview with Peter Brierley, London (2 February 2012).

[603] Tucker (2012): 24.

Bank and HM Treasury officials confirm that bail-in is a way to avoid the use of taxpayer money *and* direction by Treasury of the Bank's special resolution powers. As one Treasury official described the Bank's motivations, "It [the Bank] wants the maximum number of tools with the maximum amount of discretion. It is a totally legitimate perspective. It wants a very wide statutory scope on bail-in. One that does not necessarily trigger resolution, so it is not constrained in designing the resolution it wants."[604] A Bank official described how the successful operation of bail-in meant that taxpayer funds were *not* at "material risk," thus obviating the need for Treasury control:

> If you bailed in the bank so that it is adequately recapitalized, the hope would be that the institution which emerges from the bail-in is with new senior management and a business plan. So, it qualifies for all normal facilities, including the discount window and liquidity facilities, which would not require Treasury approval if the Bank assesses it as solvent and viable. This is just temporary liquidity support.[605]

Yet, there was no consensus in the UK banking industry on bail-in,[606] and Standard Chartered and HSBC were strongly opposed.[607] Critics focused on worries about increased funding costs, lack of a market for such bonds, and how triggering bail-in would only increase the risk of systemic panic. One banker maintained that "the incremental capital gained [through bail-in] is outweighed by negative market perceptions about triggering bail-in."[608] The CEO of Standard Chartered stated, "If we roll in triggers while the bank is still running, my instruction to my treasurer is that as soon as I see a bail-in, I want my money out of that bank—and that will be the reaction in the market."[609] In other words, contrary to the Bank's confidence in bail-in, some argued that the tool might not keep a bank alive and would instead cause systemic panic. But, if it worked, it would avoid the use

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[604] Interview with Martina Garcia, London (12 March 2012).

[605] Interview with Peter Brierley, London (28 March 2012).

[606] Or elsewhere, for that matter. Credit Suisse's national peer, UBS, did not support bail in. Not-for-attribution interview, London (2 February 2012). See also Bart (2011); Samuel (2011).

[607] Kar-Gupta (2011).

[608] Interview with Tom Sandall, London (11 October 2011).

[609] Hickley (2010).

of taxpayer funds—and protect the Bank's remit on resolution from falling under Treasury direction.

With a non-legally binding standard on bail-in as a prudential regulatory tool,[610] the Bank of England would increase its leverage over major UK banks and also overcome skepticism from the FSA and HM Treasury. For example, in contrast to the confidence expressed by Bank officials, FSA chairman Adair Turner testified, "Will that [bail-in] necessarily forever exclude categories of bailout? I do not know."[611] To pursue a legally binding international standard on bail-in would have at least required a domestic consensus between regulators (hopefully bolstered by industry support), which did not exist.

However, with a soft standard in hand, the Bank of England would be able to simultaneously set the UK and European Union agendas on crisis management. The UK coalition government, which assumed power in May 2010, established the Independent Commission on Banking chaired by economist Sir John Vickers, to propose recommendations for domestic banking reform.[612] With the Vickers Commission set to issue recommendations in September 2011 on all facets of British banking regulation—from the feasibility of separating retail and investment banking to capital requirements—its report would be an important opportunity for the Bank of England to set the domestic regulatory agenda.[613]

The eventual British regulatory reform would be accompanied and partially defined by a legally binding EU framework. In addition to proposing new rules on alternative investment fund managers and credit rating agencies, the European Commission (EC) began to moot ideas for a directive on cross-border crisis management and resolution. To that end, in October 2009, the EC launched a public consultation that sought national

[610] Bail-in as a prudential regulatory tool means that it would serve the purpose of preventing failure, such as by increasing regulatory capital levels, rather than the traditional meaning of resolution, which is to facilitate liquidation and/or sale to a private purchaser.

[611] House of Commons (vol. II, March 2010): Ev 79.

[612] HM Government (2010): 10.

[613] Interview with John Vickers, Oxford (14 March 2012).

authorities' and industry's views on early supervisory intervention, reorganization and revitalization of failing banks, and banking insolvency law.[614] A non-legally binding international standard on bail-in would thus set the concomitant EU agenda on crisis management.

III. The Financial Stability Board: a "new" standard-setter on the scene

Where would the Bank of England propose a non-legally binding standard on bail-in and bargain over its substance? It chose the Financial Stability Board (FSB). In the aftermath of global financial panic in autumn 2008 and at the urging of the United States and (eventually) Britain, major states chose to expand an existing focal point institution's membership and responsibilities: the Financial Stability Forum, which transformed into the Financial Stability Board.[615] With its Secretariat housed in the Bank for International Settlements in Basel, the establishment of the FSB was officially announced at the G-20 Leaders Summit in April 2009.

This section briefly details how US Treasury officials and UK regulators sought to make the FSB the soft international institution at the head of the global financial regulatory architecture—at the expense of the International Monetary Fund, which Prime Minister Gordon Brown initially preferred. It then describes the flexible organizational structure and open decision-making rules of the FSB, which the Bank of England used to set a non-legally binding standard on bail-in.

Origins of the Financial Stability Board

The FSB is the direct successor of the Financial Stability Forum, which had been set up to coordinate new, non-legally binding international financial standards and codes in the aftermath of the Asian financial crises in the late 1990s. At that time, the US successfully

[614] European Commission (10 October 2009).

[615] For background and analysis on the organization, see Helleiner et al. (2010) and Woods (2011). On G-20 Leaders, see Woods (September 2010). See also Helleiner (June 2010); (October 2010); and (2011).

promoted the G-7 "club" instead of the treaty-based International Monetary Fund (IMF), which could have gained a global macroprudential role in addition to its macroeconomic mandates.[616]

The US and most of the other G-7 countries were reluctant to entrust the Fund's powerful staff and executive board with a macroprudential role—*despite* restrictive decision-making rules that gave the US and European states 45 percent of the voting power.[617] Britain did have a major proponent, however, of the IMF as a global financial regulator. Chancellor of the Exchequer Gordon Brown favored a prudential role for the IMF, but he was isolated in his preference among the G-7 finance ministers. Instead, the G-7 endorsed the creation of the Financial Stability Forum, a new international financial institution focused on raising prudential standards for emerging markets. Its membership was limited to the G-7 and a few other jurisdictions, such as Hong Kong, and its secretariat had only a handful of staffers (7.5 full-time equivalents).[618] It made decisions according to consensus-based, open decision-making rules.

In autumn 2008, Brown, now UK Prime Minister, again pushed for the IMF to take center stage in global financial governance. French President Nicolas Sarkozy joined him in calling for a revamped Bretton Woods financial order. As one senior French regulatory official elaborated, "For us, the ideal is a legally binding institution with a full dispute resolution mechanism. I mean, that is the *utopia*."[619] However, it was not clear what Brown preferred beyond endowing the IMF with increased financial resources and with

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[616] Drezner (2007); Goodhart (2011). See Woods (January 2010) on the IMF after the most recent crisis.

[617] Despite his emphasis that member states at the IMF usually follow a norm of consensus, Drezner (2007, 134-135) concedes: "Critics of the IFIs [International Financial Institutions] are undeniably correct in pointing out that despite these mitigating circumstances [of consensus norms and an expert staff], the underlying voting structure influences governance decisions." This evidence—that the US and other states did not choose an institution despite favorable decision-making rules—concurs with the theoretical division presented in Chapter 2, which argues that states choose to negotiate in institutions that correspond to their preferred form.

[618] Blustein (2012): 10; Tietmeyer (1999).

[619] Interview with Edouard Vieillefond, Paris (4 December 2012).

power to "coordinate oversight" of the largest global banks.[620] US Treasury Secretary Tim Geithner, who favored the G-20 as a negotiating forum to legitimize new standards among emerging markets and developing economies, did not share Brown's preference.

Brown also faced strong resistance within Britain to his preference for the IMF—unlike the coordinated preference of French officials for a legally binding, focal point standard-setting institution. Still in charge of the consolidated UK financial supervisor,[621] FSA chairman Lord Adair Turner strongly endorsed the Financial Stability Forum—instead of the IMF—just before the crucial April 2009 G-20 Summit in London.[622]

Turner criticized the IMF for representing "a widely held and authoritatively asserted conventional wisdom" that financial innovation had reduced the concentration of credit risk and made more stable the global financial system.[623] Further, Turner specified that the IMF had no prudential role:

> The IMF has treaty-based powers and functions in the arena of macroeconomic support and plays a role in macro-prudential surveillance discussed in Section 2.6, but it has no role relating to bank regulation, standards in bank supervision or crisis coordination for cross-border firms. International agreements on bank regulation, and encouragement to increased but voluntary coordination on supervision, are

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620 Cohen (2008).

621 The Bank of England had not yet wrested control of UK prudential standard-setting away from the FSA, and Turner had an opportunity to establish the regulatory agenda through the drafting of what became known as the *Turner Review* report; FSA (2009).

622 "Areas where the UK must contribute to global decision-making about big impact regulatory levers, in particular those relating to capital adequacy. Here the key institutions are the Financial Stability Forum (FSF) and the Basel Committee on Banking Supervision, in which the FSA—along with the Bank of England and, in the case of the FSF, the Treasury—is intensively involved." FSA (2009): 115. Turner also emphasized that the FSF had already developed principles for cross-border supervisory colleges for major global banks (116), a responsibility that Brown wanted given to the IMF.

623 Excerpt from IMF *Global Financial Stability Report* (April 2006) is quoted on FSA (2009): 85.

> achieved via multiple non treaty based fora e.g. the Financial Stability Forum, The Basel Committee on Banking Supervision, the Senior Supervisors Group.[624]

If the IMF gained standard-setting authority, the FSA and the Bank of England would be required to coordinate with Her Majesty's Treasury to project a consolidated UK position—a costly, time-consuming process that outweighed the advantage restrictive IMF decision-making rules could offer. Other states' preferences were not the FSA and Bank's primary concerns in deciding between institutions: the cleavage in preferences would be similar between major players at the IMF and a soft standard-setter composed of G-20 countries.[625]

Instead, consistent with the two-step theory, the Bank of England and FSA preferred to negotiate soft law standards in a correspondingly soft law institution. Disagreeing with Gordon Brown, the Bank of England and FSA preferred the US initiative to make the Financial Stability Board a focal point soft law institution with "infinite flexibility."[626]

Organizational structure of the Financial Stability Board

Depending on whom you talk to, the US Treasury, French officials, or Gordon Brown and HM Treasury deserve the most credit for the creation and organizational structure of the FSB. What I have found is that in winter 2009, US Treasury Secretary Tim Geithner proposed "institutionalizing the Financial Stability Forum" and transforming it into the FSB—a proposal that largely survived G-7 and G-20 negotiations.[627] It was a way for the

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[624] The Senior Supervisors Group is a group of senior financial supervisory officials from major industrialized countries, including Canada, France, Germany, Italy, Japan, The Netherlands, Spain, Switzerland, United Kingdom, and the United States. Fn 48 in FSA (2009): 100.

[625] Drezner (2007, 135) argues that wider differences in actors' preferences between the IMF and the G-7 lead the US, UK, and other major industrialized states to favor "club" bodies. I argue that their preference is based on form.

[626] Fidler et al. (2009); Interview with Jamie Franco, Washington, DC (14 September 2011); at the time of the crisis, Franco was Senior Advisor to the US Assistant Treasury Secretary for International Affairs.

[627] Interviews with US Treasury officials.

US Treasury to become increasingly involved in soft law international standard-setting, to the chagrin of US regulators, such as the Federal Reserve, OCC, FDIC, and SEC. As one official recounts, "You could say from a purely practical perspective, there was no time at the height of the crisis to create something with a more legal footing. But, this time pressure was not really the issue. We intended the FSB to be member-led and flexible."[628]

The US Treasury proposal called for: increased scope of membership, non-legally binding standard-setting, and open decision-making rules in committees and working groups. Political oversight of international financial standard-setting shifted from the G-7 to the G-20 at Geithner's urging, in order to provide the new FSB with "accountability, credibility, and buy-in. Developing countries were not going to accept new standards endorsed by a small club."[629] The FSB also included states that are not part of the G-20[630] but were part of the Financial Stability Forum, such as Switzerland, Hong Kong, and Singapore.

Despite French preferences to create legally binding international financial standards through a "hardened" FSB,[631] the US prevailed in ensuring the FSB would not produce hard law or contain a dispute resolution mechanism. The current FSB Chairman Mark Carney also believes it is "not imminent" that FSB standards will create legally binding obligations on members.[632] Another senior official does not envisage the FSB gaining enforcement capacity anytime soon: "FSB does not have the capacity, and I don't see it

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[628] Interview with Jamie Franco, Washington, DC (14 September 2011).

[629] Interview with US Treasury official, Washington, DC (31 December 2012).

[630] Formally established in September 1999, the G-20 is composed of heads of state, as well as finance ministers and central bankers, of Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, Turkey, the United Kingdom, the United States, and the European Union (represented by President of the European Council and President of the European Central Bank).

[631] French representatives have repeatedly expressed preferences for the FSB to be a legally based organization and for its standards to create legal obligations upon members. Interview with Edouard Vieillefond, Paris (4 December 2012).

[632] Interview with Mark Carney, phone (31 January 2012).

having that capacity, to impose sanctions. The FSB is not the WTO [World Trade Organization]."[633] The FSB has very recently gained a legal personality as a non-profit Swiss legal association, but its Charter clearly states: "This Charter is not intended to create any legal rights or obligations."[634]

FSB members' compliance with international financial standards is evaluated through the FSB peer review process and as part of the IMF-World Bank Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSC).[635] Non-compliance as determined by FSAP does not entail any legally enforceable sanctions or link to IMF conditionality.[636] With a part-time chairman, an under-resourced secretariat, and inability to produce either hard law or to enforce its standards beyond a peer review process, the FSB is firmly a soft law institution.

The FSB also operates on the basis of open decision-making rules that closely conform to the ideal type outlined in Chapter 2. During the time period considered in this case study, no Rules of Procedure were established at the FSB to govern the setting up of committees, appointment of chairs, voting rules, or proposal and amendment processes.

At the top of the organizational structure of the FSB, a Steering Committee composed of senior financial supervisors, central bankers, and finance ministry officials oversees permanent committees and working groups.[637] The FSB Steering Committee oversees three Standing Committees on Assessment of Vulnerabilities (SCAV), Supervisory and Regulatory Cooperation (SRC), and Standards Implementation (SCSI), as well as the

[633] Interview with Tiff Macklem, phone (3 January 2012).

[634] Article 23 in FSB (2012).

[635] Interview with Jamie Franco, Washington, DC (14 September 2011).

[636] Helleiner (2011): 10; Drezner (2007): 139-40.

[637] In 2009, then-Governor of Banca d'Italia Mario Draghi proposed transforming the Financial Stability Forum's Working Group on Market and Institutional Resilience into the top-level Steering Committee for the FSB.

Resolution Steering Group (ReSG), where the bail-in debate took place.[638] It also oversees a number of Regional Consultative Groups that reach out to non G-20 and non-FSB members in Asia, the Americas, Africa, the Middle East, and Europe. A Plenary of all FSB members approves standards, principles, guidelines, and papers produced by these various committees.

Open decision-making rules operate at all levels of the FSB. In the committees and working groups, members from various national regulators, central banks, and finance ministries bargain over the substance of proposed standards or principles on the basis of "consensus," although this term is not defined anywhere. In practice, "consensus" at the FSB refers to a preponderance of explicit agreement among major players[639] and, at minimum, acquiescence of all members. Any member can voice an objection at any time in the standard-setting process and submit amendments through cooperation with the FSB Secretariat. As a result, newer members, such as China, India, and Singapore, are able to voice objections to financial standards that may unduly harm their interests, for instance, credit rating agency standards that mis-judge the riskiness of developing countries and their banks.[640]

Despite formal member equality, the FSB standard-setting process advantages large and well-resourced members, who can assign technically expert officials to engage in multi-year negotiations on the substance of a single standard. Officials from larger states usually lead the working groups that report draft standards, principles, and papers to the relevant Standing Committee, which in turn deliberates on the proposed standards. These two stages—working group and Standing Committee—are crucial because the standard-setting process may stall at the objection of a member. Draft standards can return to the working group level indefinitely.

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[638] Since the time period discussed in this case study, FSB members have agreed to create a Standing Committee on Budget and Resources (SCBR), chaired by Jens Weidmann, President of the Bundesbank.

[639] By observation, the most frequent participants in formal meetings are officials from the United States, Britain, France, Germany, Switzerland, Canada, and Japan.

[640] FSB, IMF, and the World Bank (2011).

If the proposed standard survives these two stages, wherein the most technically informed officials have considered the policy substance, then the standard will most likely survive the overall process. If members of the Standing Committee achieve consensus, then the standard proceeds to the Steering Committee for cursory consideration and, assuming endorsement at the Steering Committee, to the Plenary for approval. Finally, the FSB places the standard for consideration at the next meeting of G-20 finance ministers and central bankers or heads of state, who then endorse the FSB standard for adoption and implementation in member countries.

This flexible, open bargaining environment enticed the Bank of England. Merely with the consent of the Secretariat and other major players, Bank officials could initiate bargaining on the substance of a non-legally binding bail-in standard without needing to coordinate with either the FSA or, even more importantly, Her Majesty's Treasury. Prior coordination would have been necessary to make a first move at the EU—a non-starter, given that part of the Bank's motivation for the standard was to keep HM Treasury at arm's-length. Nor did the Bank consider bargaining at the United Nations Commission on International Trade Law (UNCITRAL), which had previously produced a Model Law on Cross-Border Insolvency that many observers cited as a possible guide for cross-border resolution of global banks.[641] Instead, the FSB offered a standard-setting forum legitimized by G-20 heads of state that would help the Bank control both the EU and UK regulatory agendas.

Key participants recognized the value of the FSB for the Bank of England. In addition to serving as Deputy Bank Governor and defending the Bank's interests in the new Special Resolution Regime before Parliament, Paul Tucker assumed leadership in 2009 of the FSB's Cross-Border Crisis Management Group (CBCM). Tucker then successfully pushed for the creation of the Resolution Steering Group (ReSG) at the FSB as a standing committee; CBCM fell under ReSG, which also oversaw a number of technical working groups.

[641] IMF (2010).

This put the Bank of England in an enviable position to drive bargaining at the FSB and set the EU and UK agendas on bank crisis management. If the FSB endorsed bail-in as a way to avoid taxpayer bailouts of major banks, then EU would be compelled to follow the FSB standard when drafting its own directive. As Andrew Procter, global head of regulatory affairs for Deutsche Bank, stated, "I don't have any concern about inconsistencies between the FSB, EU, and UK. FSB proposals are driven by the ReSG committee that Tucker chairs and is controlled by the Bank. And they [the Bank] include the FSA that they will take over…. And the [European] Commission will follow the accommodative language of the FSB."[642]

IV. Bargaining for a deep standard at the FSB

In the winter of 2009 and '10, there existed strong incentives for the Bank of England to pursue a non-legally binding standard on bail-in at the FSB. It sought an alternative to bailouts and temporary public ownership in the future case of a major, failing British bank to prevent HM Treasury from usurping its authority. It found such an alternative in bail-in, which some major UK banks strongly opposed; HM Treasury and the (soon-to-be-dissolved) FSA further disagreed on whether bail-in could prevent future bailouts. Without a domestic regulatory consensus on the need for bail-in for systemically significant banks, it would be a costly, protracted, and politicized process to seek a legally binding standard. But, a soft international standard would determine whether the UK would implement bail-in as part of its resolution regime, since the Bank could set the agenda for a future EU crisis management directive. With the Bank chairing the FSB Resolution Steering Group, it was well placed to pursue such a standard.

In terms of the two-step theory, the Bank pursued a *deep* standard, that is, bail-in was a policy preference that meant a significant deviation from the international status quo. As in all the cases presented in this thesis, first-movers prefer deep standards during bargaining—but decision-making rules affect how successful those first-movers are. Open

[642] Interview, London (2 December 2011).

rules, I have argued, make for substantively shallow standards when there is an actor satisfied or mostly satisfied with the status quo. This was precisely the case in bargaining over the substance of bail-in at the FSB. The US FDIC successfully negotiated a much shallower standard than the Bank's proposal, *despite* the willingness of the French *Trésor* and New York Federal Reserve to support a deeper standard.

International status quo: traditional, closed-bank resolution tools

The international status quo represents the exogenous international policy outcome if bargaining fails. What would happen if the FSB failed to produce a standard on bail-in? Most likely, national authorities would continue to rely on traditional resolution tools that apply once regulators have *closed* and shut down banks.

National resolution regimes can be roughly classified into three types, but all contemplate closed-bank tools.[643] Special resolution regimes have a wide range of powers, allowing authorities to transfer assets and liabilities to private acquirers or to create "bridge banks" without asking for shareholder, creditor, or counterparty approval. The UK Special Resolution Regime established in the Banking Act 2009 reflects this approach, as do the US, Canadian, Japanese, Mexican, and Swiss regimes. In special administration regimes, bank regulators appoint a special administrator to manage an open-bank restructuring, which, if it fails, can lead to a bankruptcy process often conducted through the courts. Regimes of this type include Australia's, Belgium's, and Italy's, and the special administrator's powers may not be as extensive as under a special resolution regime. Mixed regimes have elements of both types, but certain tools are conditional on shareholder or creditor approval, and courts may lead insolvency proceedings, as in Luxembourg. In all of these regimes, the emphasis is on the use of closed-bank resolution tools.

At the time of the bargaining on bail-in, many states were moving to bolster their closed-bank resolution regimes by adding new powers and tools. These include powers to "sell

[643] This summary is drawn from Basel Committee (July 2011). The exception is nationalization of a bank, which may remain open and functioning instead of shutting down.

assets and transfer liabilities, terminate unnecessary contracts, continue needed contracts, and create bridge institutions."[644] The tools and powers also include supervisory intervention to close operations as capital is depleted, replacement of senior management, restriction of shareholder rights, temporary moratoria on enforcement of third-party claims, a deposit insurance or other fund to finance ongoing essential bank operations (e.g. access for retail depositors), and time limits on the use of powers. Most states, including Germany (through the Bank Restructuring Act) and Spain, had begun to move to adopt closed-bank resolution tools that they did not already have. Given the imperative to conduct resolution swiftly, lest assets lose much of their value, states such as the Netherlands began to concentrate tools in a special resolution authority, instead of the courts.

Bail-in was a completely non-traditional bank resolution tool when the Bank of England proposed it in 2010. Bail-in of bank creditors did not exist in statute anywhere at the time of bargaining in the Resolution Steering Group at the FSB. Indeed, it was not even briefly mentioned as a policy issue in the *Report and Recommendations of the Cross-border Bank Resolution Group* issued by the Basel Committee in March 2010. The IMF highlighted the distinctiveness of bail-in as an "additional and complementary tool for the resolution of an ailing SIFI [Systemically Important Financial Institution] on an open (going-concern) basis"—as opposed to traditional special resolution tools, which apply to failed banks on a closed or gone-concern basis.[645]

Reflecting the status quo, a textbook definition of the purpose of a bank insolvency framework was: "One of the most important aims will be to ensure continuity of business and the avoidance of losses for creditors. What the bank insolvency regime will not be primarily concerned about is protecting shareholders and preserving institutions."[646]

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[644] Basel Committee (July 2011): 14.

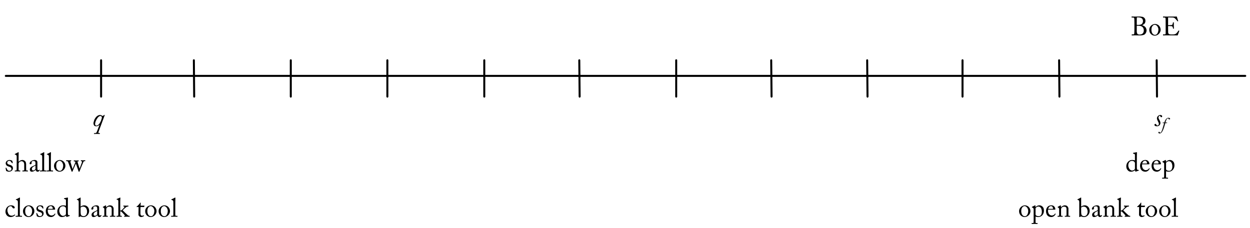
[645] Zhou et al. (2012): 8-9.

[646] Campbell and Lastra (2011): 41.

Because bail-in intends to preserve a bank by imposing creditor losses,[647] it runs counter to the status quo of closed-bank tools: "Bail-in effectively transforms certain non-equity obligations into equity at the point of intervention (but prior to formal declaration of insolvency) so that the bank can absorb the losses that led to the need for intervention and *continue to operate as a going concern. This avoids the need to liquidate the bank or to split it into a good bank and bad bank*."[648]

Figure 5.1 illustrates a unidimensional policy space defined by traditional closed-bank resolution tools, where the status quo is located, to non-traditional tools, typified by bail-in. (Another example of a non-traditional tool would be requiring service providers for banks to continue executing their contracts with a failing or failed bank that has entered the resolution process; for example, back-office IT support based in Dublin or Delhi would continue its relationship with a resolved US bank.)

Figure 5.1: Policy dimension on bail-in



Support at the FSB for bail-in

The Bank of England found the international status quo unsatisfactory. Officials argued that traditional, closed-bank (gone-concern) tools would not be applicable in the case of a global bank operating across many jurisdictions that required rapid, efficient resolution. At the FSB, the Bank often used the example of a faltering global bank for whom bail-in

[647] "Continuity of business" refers to certain functions, such as payments and settlements or retail depositor withdrawal, allowed to continue under the management of the resolution authority.
[648] Huertas (2010): 12.

would help avoid a "death spiral," especially if the bank held a large and complex derivatives portfolio.

The ability of a bank to constantly hedge its derivatives trades dissolves when counterparties refuse to trade with the bank. If the bank closes, central bank liquidity can provide enough financing until these trades are completed—but this assistance, the Bank of England argued, exposes the government to losses. Instead, if regulators conservatively valued the extent of asset losses and triggered bail-in at the "point of non-viability" (a point prior to insolvency), then they could send a credible signal to market participants that the bank can remain a viable going-concern. As a result, funding would remain at the bank, and personnel would not leave.

At the FSB, Bank officials also argued that bail-in could end the implicit funding subsidy that "too big to fail" banks received. Whereas shareholders had seen their investments wiped out during the financial crisis, government intervention often resulted in creditors experiencing minimal or no losses. The prospect of losses under bail-in would incentivize unsecured debtholders, who are generally the most popular lenders to large banks, to better monitor banks and, ideally, raise the cost of funding for banks taking excessive risks. However, the Bank stressed that the application of the bail-in tool could not be trusted to supervisory discretion, but instead required statutory backing across jurisdictions, "otherwise it would seem too scary or arbitrary an action to the markets."[649]

The French *Trésor* led continental European support for bail-in as an open bank resolution tool. Given how robustly French banks weathered the financial crisis, unlike Britain, France's regulators did not move quickly to implement a special resolution regime for its banking system, much of which benefits from a nearly explicit state guarantee that no major financial institution would be allowed to fail. But, this was a situation in which the Bank of England and the *Trésor* found themselves in agreement on the attractiveness of bail-in.

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[649] Interview with Peter Brierley, London (28 March 2012).

The *Trésor* was motivated by its experience in bailing out Dexia, which was the result of a merger in 1996 of Crédit Local de France and Crédit Communal de Belgique, and partially specialized in lending to local French governments. The French sovereign wealth fund, Caisse des Depots et Consignations (CDC), owned 11 percent of Dexia.[650] In late September 2008, Dexia came under severe pressure in the short-term funding markets, and its investors worried about the state of its US subsidiary.

After early morning talks concluded on 30 September 2008, Belgium, France, and Luxembourg agreed to recapitalize the bank by €6.4 billion, with Belgium and France each investing €3 billion and Luxembourg contributing €376 million. A few days later, the three countries agreed to a joint guarantee mechanism that would backstop Dexia's access to financing while parts of its business were sold or closed.[651]

This cross-border intervention was conducted without the use of the existing statutory resolution frameworks. In France, this would have involved the appointment of an administrator by the *Commission Bancaire* (CB), which can request a court order to transfer shares and/or recommend liquidation, which in turn is supervised by courts pursuant to commercial law.[652] This existing framework could not possibly facilitate a rapid enough resolution, however, to satisfy Dexia's creditors and broader market participants.

Moreover, the Dexia experience was a sobering lesson for EU Member States on how difficult finding agreement on cross-border resolution could be. As one IMF official outlined, the impending failure of a cross-border bank means that "*ex ante* sharing costs of guaranteeing cross-border banks is tough. Look at Dexia and the antagonism in its resolution. Who didn't supervise which bit [of the bank] properly? Who has creditors who will face the most losses? What are the political and social ramifications? An *ex ante* formula [for burden-sharing] will not subsume the complexity involved. An *ex ante*

[650] *Agence France Presse* (2008).

[651] Basel Committee (March 2010): 11-12.

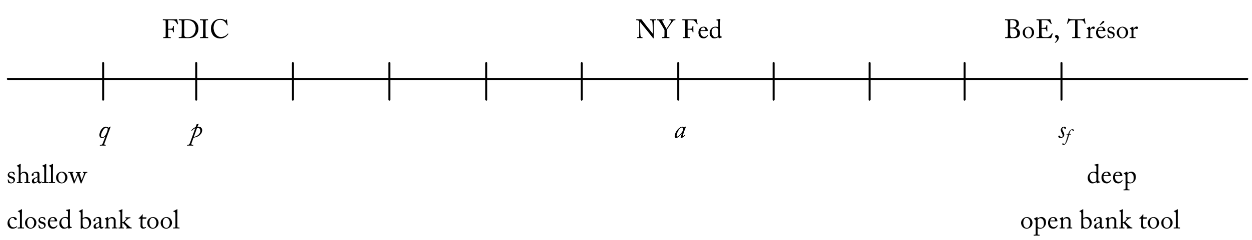
[652] Čihák and Nier (2009): 9.

solution doesn't line up with whose fault it was."[653] While the state guarantees were designed to be proportionate to the share ownership of public and private investors in the three countries, Dexia's continuing and growing burden has been more than sufficient motivation for French interest in new resolution tools.

When the Bank of England began pushing for bail-in to be considered by the FSB Resolution Steering Group (ResG), there was no consensus yet within the coordinated French state on special resolution tools. The banking regulator, *Autorité de Contrôle Prudentiel* (ACP; successor to *Commission Bancaire*), was "reluctant" to rely on bail-inable debt instead of recapitalization. The Banque de France was "more open" to bail-in, but thought that "further reflection [was] probably needed."[654] For a country in which major banks are more or less explicitly guaranteed by the state, bail-in is mostly a moot point.

The *Trésor* was nevertheless interested because of the high-profile status of the issue and its influence on eventual EU legislation. Indeed, Hervé de Villeroché, a high-ranking *Trésor* official and member of ResG, led a smaller, technical subset (FSB Working Group on Bail-in) of the steering group that produced the report, which in turn fed into the section on bail-in in the final FSB standard.[655] Even though "Europe was never of one mind on bail-in,"[656] the cooperation between the Bank of England and the French *Trésor*—despite their situation in very different banking systems—entailed a robust coalition on behalf of other European states.

Figure 5.2: Preferences on substance of the FSB bail-in standard



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[653] Interview with Marc Dobler, Washington, DC (5 January 2012).

[654] Interviews with Laurent Clerc and Olivier Vigna, Paris (19 January 2012).

[655] Interviews in Paris, Washington, DC, and phone.

[656] Interview with Marc Dobler, Washington, DC (5 January 2012).

The US FDIC's preference, which I explore below, was not the only American interest in the Resolution Steering Group at the FSB. Under Secretary of the Treasury Lael Brainard and First Vice President Christine Cumming of the New York Fed officially represented the US delegation. Whereas Treasury did not strongly express a preference, the New York Fed appeared receptive to bail-in as a tool to keep a failing bank open.

For example, Cumming cited testimony by the General Counsel of the New York Fed that keeping part of Lehman Brothers investment bank open prevented an even worse panic,[657] a "piece of the overall Lehman story [that] is rarely told, and yet it deserves attention."[658] Cumming stopped short of a full-throated endorsement of the Bank of England's conception of bail-in, but indicated that she viewed bail-in as a possible open-bank tool:

> Where can bail-in fit? … In my personal view, the possibility of a restructuring prior to insolvency with potentially more forceful outside supervisory or contractual intervention is interesting and deserves more study. Given the number and range of stakeholders in a large financial company, such a mechanism could help solve a coordination problem that can be costly in terms of time and sub-optimal in terms of ensuring equitable treatment of stakeholders for a financial company *on the threshold of, or in, distress*.[659]

The Bank of England, French *Trésor*, and New York Fed all preferred a deep change from the status quo of closed bank resolution tools. The FDIC did not. Why?

US FDIC & resolution, pre- and post-crisis

Although its relationship among US regulators and with industry associations is extremely fragmented,[660] the Federal Deposit Insurance Corporation (FDIC) carved itself a niche in

[657] The Lehman Brothers parent or holding company entered the corporate bankruptcy process, whereas New York Fed's liquidity financing allowed the broker-dealer to remain open and to be sold to Barclays a few days later.

[658] Baxter (2010).

[659] Cumming (2010).

closing failing US commercial banks. The FDIC was created in the aftermath of the 1933 banking crisis, during which bank runs became commonplace, thousands of banks suspended operations, and remaining depositors were unable to access their funds. By insuring depositors up to a certain limit, the FDIC has successfully prevented runs on US commercial banks.[661] As John Kenneth Galbraith summed up, "The anarchy of uncontrolled banking had been brought to an end not by the Federal Reserve System but by the obscure, unprestigious, unwanted Federal Deposit Insurance Corporation."[662]

The FDIC is a unique agency, in that it insures deposits, supervises state-chartered banks (that are not members of the Federal Reserve System), and receives failed banks. The FDIC has the statutory responsibility to implement the least costly resolution plan, minimize losses to the deposit insurance fund, and recover as much value in insolvency as possible. As such, it participates in contentious debates on prudential regulation with the Federal Reserve and Office of the Comptroller of the Currency (OCC), but it operates with autonomy in its roles as insurer and receiver.[663]

Not subject to court supervision, the FDIC has run a bank resolution regime for over seventy-five years using three primary methods. The first method, deposit payoff, involves paying all insured depositors of a closed bank their entitled amounts, while uninsured depositors and other creditors are able to claim proceeds from the closed bank's asset liquidation and sales. A closed bank may also be part of a purchase and assumption transaction ("P&A"), in which a healthy bank acquires some or all of the failed bank's assets and liabilities; this has historically been the most common FDIC resolution method. The third and least popular method is open bank assistance, in which the FDIC directly lends to or buys assets of a failing bank.[664]

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[660] See Chapter 3 on Basel rules, pp. 55-60.

[661] See FDIC (1984).

[662] Galbraith (1975): 97.

[663] As the FDIC states, "The courts have long recognized the FDIC's legal ability to operate in different capacities, with its different capacities conducting arms' length transactions with each other." Fn 2 in FDIC (2003): 211.

[664] FDIC (2003): 55-56.

Over time, FDIC has been granted powers to demand that a bank under its jurisdiction improve its capital and liquidity positions and to establish a "bridge bank" if it fails, buying time to manage a private purchase. For failed large and complex banks, however, the FDIC cannot quickly facilitate acquisition of a failed bank by a healthy bank through its three basic methods. As a result of the Savings & Loan (S&L) crisis, Congress passed legislation in 1987 that allows the FDIC to conduct a full evaluation of the failed bank's condition, wipe out senior management, provide financial assistance, and facilitate a private sale.[665]

The FDIC Improvement Act of 1991 (FDICIA) was a direct response to the depletion of the deposit insurance funds as a result of the S&L crisis the previous decade (losses amounted to over $125 billion).[666] It created the Prompt Corrective Action regime (PCA), which is also operated by the Fed, that classifies banks into several categories: as a bank's capital level falls, it becomes under-, significantly under-, or critically under-capitalized, and each category can entail recapitalization, change in business practices, and/or change in senior management.[667] The FDIC framework was purposefully followed by the Bank of England in its proposal for a special resolution regime after the run on Northern Rock.[668]

Yet, the collapse of Lehman Brothers revealed a major gap in the US framework: non-deposit taking institutions, such as investment banks, could not be resolved in a manner similar to the FDIC regime for commercial banks. Nor was it obvious that the FDIC could resolve a systemically significant firm that conducts both deposit-taking and securities activities, such as Bank of America. To the chagrin of Federal Reserve officials, Congress supported the FDIC's assuming broader powers to resolve any systemically significant financial firm without recourse to taxpayer bailouts.[669]

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[665] See Chapter 6 in FDIC (2003).

[666] GAO (July 1996).

[667] GAO (2011): 6-11.

[668] Interview with Peter Brierley, London (2 February 2012).

[669] Kaper (2009).

Broad powers for the FDIC comprise the Orderly Liquidation Authority (OLA) of the Dodd-Frank Act, passed by Congress in 2010. The FDIC is appointed receiver of a failed or failing systemic financial firm[670] and promptly establishes a bridge financial company, to which "good" assets and certain financial contracts (such as derivatives transactions) of the failed firm (now the "covered" company) are transferred and run by FDIC, after removing senior management.

The FDIC moves to sell the bridge company as quickly as possible to the private sector, while distributing payments, as a result of asset sales, to unsecured creditors of the covered company. The FDIC can draw on a credit line from the Department of the Treasury to finance the bridge company until it is sold off and to liquidate the covered company. No taxpayer losses can be legally borne; if asset sales cannot recover enough funds to repay the Treasury's financing, then the industry will be charged *ex post*.[671] Along with extensive powers to begin resolution planning in advance of a firm's default, the FDIC thus broadened its authority over the special resolution process in the US.

FDIC: No desire for a deep standard on bail-in

In the United States—and unlike in Britain—the resolution of a commercial or investment bank essentially means *liquidation* is the answer to "too big to fail." The Bank of England embraced bail-in as a tool to *keep alive* a failing bank: "By haircutting creditors in a going concern, there would be no need to close the business immediately (or, if regulators wished, even at all)."[672] As one US Treasury official put it, "We asked Europeans how they define 'resolution.' In the US, it means closing the bank, selling [its] portfolios, and so on. For the UK, it means resolving the problem. That implies open bank assistance."[673]

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[670] To become receiver of a systemic institution "in danger of default," two-thirds of the boards of the FDIC and Governors of the Federal Reserve must make a recommendation to the Secretary of the Treasury, who authorizes such action in consultation with the President.

[671] FDIC (2011).

[672] Tucker (March 2010): 4.

[673] Interview with Susan Baker, Brussels (6 December 2011).

An IMF and former Bank of England official had a similar interpretation: "In the US, the view is, close the damn thing. Europeans say, keep it open…. The UK pushed it [bail-in] because they cannot do a purchase and assumption [transaction] [P&A] or a bridge bank for RBS. No one has ever done a bridge bank or P&A on a bank that is that big and complex. Can the FDIC do it? If anybody can do it, they can."[674]

Confidence in the FDIC also partially results from the dispersion of the US banking sector, which is less concentrated than those of other major economies. For example, whereas banking assets are nearly 500 percent of GDP in Britain, total banking assets are about 100 percent of US GDP; ratios similar to the British figure exist in France and the rest of continental Europe.[675] The total assets of JP Morgan Chase, the largest financial firm in the US, measure about 15 percent of GDP; compare that to Britain, where the total assets of its top three banks are *each* at or over 100 percent of GDP.[676]

Starting in the mid-2000s, the FDIC had led the Cross-Border Resolution Group (CBRG) of the Basel Committee, producing the first major international survey of resolution regimes around the world—and did *not* mention bail-in as a possible prudential tool. Indeed, bail-in was a "late arrival to the party."[677] The CBRG was an opportunity for the FDIC and resolution experts to contribute their expertise and urge other countries to consider upgrading their bank insolvency laws. CBRG produced a final report and recommendations in March 2010; in the FDIC's view, the FSB's work on resolution amounts to "really just elaborations of the CBRG report."[678] In no way would the US be interested in a legally binding agreement on resolution tools: "Some countries would raise the issue of a treaty, but we'd say, 'We thought we addressed this at CBRG. This [a legally binding agreement] is a complete non-starter.'"[679]

[674] Interview with Marc Dobler, Washington, DC (5 January 2012).

[675] Geithner (2011).

[676] Figures from Capital IQ database.

[677] Interview, Washington, DC (4 January 2012).

[678] Ibid.

[679] Ibid.

In sum, the FDIC had no desire for a deep standard on bail-in at the international level. It did not agree with the basic premise of bail-in as proposed by the Bank of England. On the basis of its experience in resolving commercial banks, the FDIC preferred closing systemically important financial institutions—*not* allowing them to continue in operation by imposing losses on unsecured creditors. It moreover easily gained its authority to close investment banks with the support of influential US senators, and so further consolidated its autonomy in this area of financial regulation.

However, support from the Bank of England, French *Trésor*, and New York Fed ensured bail-in would remain in the circulated draft proposals, given Deputy Bank Governor Tucker's chairmanship of the Resolution Steering Group. The FDIC would have to push back. Compliance with the final FSB standard would be monitored mainly through peer review with no sanctions for non-compliance. But unless the FDIC was able define the FSB bail-in standard as a closed bank tool—and thus part of its own regime—it would appear out-of-step internationally.

The FDIC objects

As the most vocal objector to the Bank of England and French *Trésor*, the US FDIC fought hard to substantively dilute the FSB bail-in standard. While recognizing the predicament of the Bank of England in resolving very large British banks, the FDIC had no appetite for bail-in, which as proposed by the Bank would be used to keep a failing bank alive:

> We pushed our concerns. Paul Tucker and I had a round-robin discussion in the fall of 2010, and I felt that Tucker was pushing the idea of bail-in when were we were not ready to accept that as a solution. My argument was that we should have substantively similar national laws and for regulators to have the authority to close a firm. … I think it strained my relationship unfortunately with Tucker.

> We [the FDIC] just had a lot of difficulty agreeing on bail-in for a going concern.[680]

One participant characterized Tucker and the Bank of England's presentation of bail-in as a "panacea" that they "probably oversold."[681] Other US officials were dismissive of the presumption that the Bank of England could actually use bail-in effectively: "It [bail-in] is intuitively appealing. But, you have to put it in context. They [the Bank] don't have any experience with resolution, so they're just dreaming up fun."[682]

A major concern of the FDIC is that implementing bail-in for a failing (but not closed) global bank will spark a market-wide panic: "Illiquidity is killer for cross-border firms. Lehman and AIG went down because of illiquidity, not [low] capital. As did RBS." According to the FDIC, market participants will lose confidence in the failing bank and withdraw their funding, even if capital levels are above a danger zone; "this means the central bank will have to provide liquidity, and this is very close to a bail-out."[683] In the words of another US official, "Why would anyone continue funding a bank that just got bailed in?"[684] Bail-in of one firm may lead to systemic instability that again forces massive intervention by the central bank and, possibly, the government.

In the end, a compromise was struck. The FDIC sought to establish the presumption that bail-in was intended to facilitate the liquidation of a financial firm and so pushed to regard it as "bail-in *within resolution*." As part of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, bail-in within resolution actually confers two options, the first of which reflects the Bank of England's preference and the latter that of the FDIC:

> Carry out bail-in within resolution as a means to achieve or help achieve continuity of essential functions either (i) by recapitalising the entity hitherto providing these

[680] Ibid.

[681] Interview, Washington, DC (5 January 2012).

[682] Not-for-attribution interview, Brussels (6 December 2011).

[683] Interview, Washington, DC (4 January 2012).

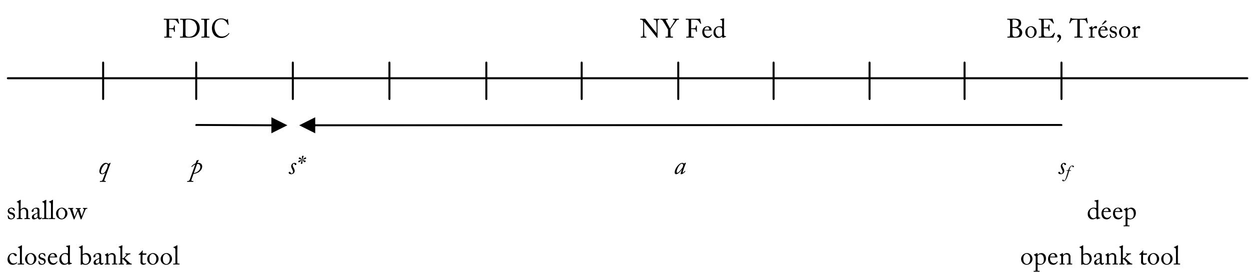
[684] Not-for-attribution interview, Brussels (6 December 2011).

> functions that is no longer viable, or, alternatively, (ii) by capitalising a newly established entity or bridge institution to which these functions have been transferred following closure of the non-viable firm (the residual business of which would then be wound up and the firm liquidated).[685]

The second option is simply what the FDIC already does when it creates bridge banks for commercial banks—and what it plans to do for non-deposit taking institutions under its new Orderly Liquidation Authority. The FDIC process creates separate legal entities; in the view of the Bank of England, this process would be too difficult for, say, Barclays. Accordingly, as an IMF official described, "Bail-in of a going concern seeks to replicate the economic effect of a bridge bank, but without transferring to a new legal entity."[686]

In order to achieve assent from the FDIC in the consensus-based FSB, the Bank of England had to acknowledge that the bail-in standard could encompass not only steps taken to keep a major bank alive, but also steps taken in liquidation that were already used by the FDIC. The FDIC was not willing to halt bargaining completely in the FSB on an overall non-legally binding framework. Instead, in Figure 5.3 below, I place the FDIC's preference just to the right of the status quo, a position to which the Bank of England and its supporters were forced to move. But by digging in, the FDIC ensured that the FSB bail-in standard would be substantively shallow.

Figure 5.3: Bargaining on the FSB bail-in standard



Bail-in in the FSB Key Attributes

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[685] Section 3.2(ix) in FSB (October 2011).

[686] Interview with Marc Dobler, Washington, DC (5 January 2012).

The bail-in standard constitutes a prudential regulatory tool within the non-legally binding FSB Key Attributes of Effective Resolution Regimes. It is a type of prudential regulation because it is the only tool in the FSB Key Attributes framework that can clearly apply to open financial firms, whereas the other resolution powers, such as asset transfers, bridge institutions, and temporary stays on early termination rights in contracts, generally apply to closed financial firms. The standard specifies that bail-in can be applied "in conjunction with other resolution powers (for example, removal of problem assets, replacement of senior management and adoption of a new business plan) to *ensure the viability of the firm or newly established entity* following the implementation of bail-in."[687] In short, bail-in is a complement to, not a substitute for, traditional closed-bank tools.

In addition to recommending the set-up of a lead resolution authority and resolution financing, the Key Attributes call for the establishment of Crisis Management Groups (CMGs) to facilitate cooperation between home and host regulators of a failing global financial firm; national regulators are, however, merely asked to "consider the impact on financial stability in other jurisdictions" of their actions.[688] The Key Attributes are focused on setting a standard for national resolution regimes; to that end, incorporating bail-in as part of this standard legitimizes the Bank of England's efforts at the UK and EU levels. Moreover, each aspect of the Key Attributes, including bail-in, is non-binding; "the G20 and the FSB are calling on countries to undertake the reforms necessary to implement this standard," while compliance will be monitored though "an iterative process of peer reviews of its [FSB] member jurisdictions."[689]

Post-bargaining outcomes for the first-mover Bank of England

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[687] Section 3.6 in FSB (October 2011).

[688] Section 7.2 in FSB (October 2011).

[689] FSB (November 2011): 2.

As the product of the Resolution Steering Group led by the Bank of England, the FSB Key Attributes include bail-in as an option for national regulators confronting a failing bank.[690] The FSB bail-in standard, soft and shallow, overcame industry opposition and domestic skepticism, setting up the eventual EU directive on crisis-management to reflect the Bank of England's preferred policy.

The Bank pursued a comprehensive strategy to use certain major banks to help convince the rest of the marketplace of the feasibility of bail-in. It also pushed major banks to issue bail-inable "contractual" bonds (contingent convertible bonds, or "CoCos"). By relying on these contingent convertible bonds with predefined triggers for bail-in, "at an earlier stage, the bank can avoid recapitalization and going into resolution."[691] The Bank drew on the work of Credit Suisse, and also found another private-sector ally in Deutsche Bank: "The Bank and Tucker had to test their ideas [for bail-in]. They were open, interested, wanted to understand. So we organized seminars with the investor community, which was concerned about pricing. We invited the Bank, FSA, European Commission, and others."[692]

Supporters of bail-in argued that investors could either face up to 90 percent loss of value, as occurred in the insolvency of Lehman Brothers, or they could have their claims discounted and converted to equity. With the Bank in the lead, "when the FSB talked again and Tucker reported [on bail-in], the discussion moved on. Retail banks knew they could not oppose this, and investors were exposed."[693]

The Bank appears to have succeeded in using the soft FSB standard to place its preference for bail-in on both the domestic and European Union regulatory agendas. The UK Independent Commission on Banking, led by Sir John Vickers, produced its final report

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[690] Key Attribute 3.5 in FSB (October 2011).

[691] Interview with Peter Brierley, London (2 February 2012).

[692] Interview with Andrew Procter, London (2 December 2011).

[693] Ibid.

with a strong recommendation for statutory bail-in, but was less sanguine on contractual bail-in;[694] the Bank believes, "Vickers clearly endorsed us."[695]

Vickers himself stated that his commission sought to "dovetail" with the Bank's work,[696] and that "Paul Tucker is a central figure in taking forward the international debate…. We did not want to duplicate his work."[697] In its response to the Vickers Report, in addition to requiring banks to hold more bail-inable debt, the UK government announced that it "agrees that the resolution authorities should have a statutory bail-in power to assist in bank resolution. The Government will seek to ensure agreement on including a robust bail-in power in the European crisis management framework."[698]

Nevertheless, as predicted by the two-step theory in the case of fragmented states, there remains considerable debate within the UK on the design and eventual implementation of bail-in. Although the Bank of England is confident of its feasibility, Her Majesty's Treasury is not as certain:

> If we're not careful, it [bail-in] could be a resolution tool for the shelf, never to be used. We are trying to detail the practical barriers and determine whether this course of action is feasible. The policy is not yet decided…. The key constraint is, who are you bailing in? A pension fund? There may be important systemic effects. Where do you bail in? At the level of the group or the subsidiary?[699]

Despite the Chancellor of the Exchequer's confidence that there will be no confusion over responsibilities in a future crisis,[700] the memorandum of understanding between the Bank and Treasury is ambiguous. When I asked whether emergency liquidity provided by the Bank to facilitate a bail-in would constitute a "material risk" to taxpayer money and thus

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[694] ICB (2011): 100-106.

[695] Interview with Peter Brierley, London (2 December 2012).

[696] Interview, Oxford (14 March 2012).

[697] Ibid.

[698] HM Treasury (2011): 7.

[699] Interview with Martina Garcia, London (12 March 2012).

[700] Osborne (2012).

trigger HM Treasury's involvement, a senior Treasury official responded, "It probably depends on the size of the operation. Does the Bank feel comfortable assuming that contingent liability? Does it feel okay absorbing that or does it have to go to the Treasury?"[701] The Financial Secretary of the Treasury, Mark Hoban, was noncommittal in his response to my question: "A good flow of information between the Bank and Treasury is necessary. We need to understand the risks, in order to determine what materiality actually is."[702] Without a prior domestic consensus on the feasibility of bail-in, the Bank of England has been forced to address competing views on its implementation.

At the EU, the Bank of England moved early to set the agenda on crisis management. In a widely noted speech at a Brussels conference in March 2010, Paul Tucker emphatically argued for bail-in to keep a failing bank open: "One possible way to cut through Too-Big-To-Fail is to adjust our sense of what 'Fail' involves. Perhaps it does not have to involve liquidation or administration. Perhaps it does not have to involve a binary shift from 'going concern' to 'gone concern'. But it <u>does</u> have to involve loss for equity holders and uninsured creditors."[703] By the time bail-in was under heavy criticism from the FDIC within the FSB in September 2010, Tucker maintained in Brussels that "there is no good reason of public policy why resolution should always involve closing the firm, provided that shareholders, uninsured creditors, the board and management pay the appropriate price."[704]

UK officials at the EU worked to embed the Bank of England's bail-in tool within an EU directive, whose proposal was long delayed by the European Commission (EC). The EC was originally expected to issue its legislative proposal by November 2011. EC staff maintained that the delay was due to an otherwise busy EU agenda,[705] but others

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[701] Interview with Martina Garcia, London (12 March 2012).

[702] On-the-record comment by Mark Hoban, Chatham House, London (19 March 2012).

[703] Tucker (March 2010). Emphasis in written remarks.

[704] Tucker (September 2010).

[705] Interviews with Mario Nava, phone (21 December 2011) and Laszlo Butt, Brussels (6 December 2011).

maintained that discussion of bail-in "spooked" capital markets, where the cost of senior unsecured funding spiked for major banks.[706]

But, when the EC finally proposed the Bank Recovery and Resolution Directive in June 2012, the proposal directly reflected the Bank of England's preference, much more so than the FSB standard:

> The bail-in tool will give resolution authorities the power to write down the claims of unsecured creditors of a failing institution and to convert debt claims to equity. The tool can be used to recapitalise an institution that is failing or about to fail, allowing authorities to restructure it through the resolution process and restore its viability after reorganisation or restructuring. This would allow authorities greater flexibility in their response to the failure of large, complex financial institutions.[707]

One lawyer considered the European Commission as having "slavishly" followed the Bank of England's lead.[708]

The EC's proposed Directive and bail-in soon became wrapped up in the eurozone dual sovereign and banking crises. A euro-area summit in late June 2012 endorsed the creation of a "single supervisory mechanism" that would centralize EU financial supervision, a condition for euro-area-wide bank recapitalization through the European Stability Mechanism (ESM). In addition to nationally harmonized deposit insurance schemes, the Bank Recovery and Resolution Directive has become the "third pillar" of a nascent EU banking union, which would mean a consolidated EU financial supervisor, a common deposit insurance fund, and single resolution authority for all euro-area financial institutions (and open to non-euro-area Member States).[709]

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[706] Toeman and Down (2012); Interviews with Andrew Procter, London (2 December 2011) and Susan Baker, Brussels (6 December 2011).

[707] European Commission (June 2012): 13.

[708] *Euroweek* (2011).

[709] *EurActiv* (October 2012).

Negotiations among the Commission, European Parliament, and the Council of Ministers are ongoing, and EU officials aim to finalize the Bank Recovery and Resolution Directive by mid-2013. The single supervisory mechanism, located in the European Central Bank, may begin operating from June 2013.[710] The Commission has stated that it will propose the single resolution authority to operate alongside the single supervisory mechanism, once the Bank Recovery and Resolution Directive is adopted.[711]

Whatever the political uncertainty surrounding the EU banking union as a whole, UK and EU officials, as well as market participants, clearly expect bail-in to serve as a prudential regulatory tool during resolution. When the Commission proposed the Bank Recovery and Resolution Directive, credit rating agency Moody's described it as intentionally unfavorable for unsecured bank bondholders, and elaborated: "Although the exact provisions of the plan will remain uncertain until final adoption by the EU and individual countries, the proposal further illustrates the intention of governments to impose losses on bank creditors *outside* liquidation."[712]

Conclusion

The idea that some banks are simply too big to fail quickly took hold in the aftermath of the global financial panic in September 2008. The Bank of England found itself facing clear public policy interests *and* domestic institutional incentives to find an alternative to taxpayer-financed bailouts of large UK banks. In addition to the moral hazard involved in bailouts, the Bank faced a threat to its newly found regulatory autonomy in the aftermath of the global financial crisis: if temporary public ownership or other type of taxpayer bailout was likely in a future crisis, then Her Majesty's Treasury would consequently take over the special resolution process. The Bank of England needed an alternative to bailouts that would coincide with its policy preference and its institutional incentive: bail-in of unsecured creditors in order to keep a large, faltering British bank alive.

[710] *EurActiv* (December 2012).

[711] Véron and Wolff (2013).

[712] Brereton-Fukui (2012).

The lack of a domestic regulatory consensus with FSA and HM Treasury meant that it would be excessively costly for the Bank to seek a hard standard on bail-in. It also meant that international institutions such as the IMF or EU, which privileged consolidated national representation, would not be a good fit for the Bank. Instead, the Bank of England preferred to quickly negotiate a soft standard at the FSB that could set the EU and UK agendas on crisis management.

While the flexible organizational structure of the FSB allowed the Bank to quickly project its preferences and initiate bargaining on bail-in, open decision-making rules also advantaged a recalcitrant actor whose preference lay close to the status quo of closed-bank resolution tools: the US FDIC. The FDIC not only comfortably controlled resolution authority in the US, but also argued against the Bank of England because it found bail-in to be an impractical concept and feared being out-of-step internationally.

Not only did the consensus-based voting rule allow the FDIC to veto the deep standard proposed by the Bank, but the open *membership* rule also allowed the FDIC to participate in bargaining even when it was not an official member of the US delegation.[713] The FSB bail-in standard, however soft and shallow, legitimized the novel concept of bail-in, a boon to the Bank of England's efforts to shape UK and EU banking reform while preserving its institutional interests.

This case serves as a "less-likely" case of the first stage of the two-step theory because the UK is not nearly as fragmented as the US in terms of its regulatory structure. The UK FSA has served as consolidated financial supervisor of individual firms, a task undertaken by several federal regulators in the US. Now the Bank of England has assumed that role. The UK also has access to a hard law focal point standard-setting institution where the US

[713] FDIC General Counsel Michael Krimminger was *de facto* FDIC representative, but sat at the FSB Resolution Steering Group as co-chair of the Basel Committee Cross-Border Resolution Group. FDIC does not have an official seat at the Resolution Steering Group.

is not a member: the EU. Thus, the UK could be more pre-disposed to prefer hard law than the US.

However, the highly specialized and internationalized City of London does not feature encompassing industry associations that either have standard-setting authority or formally participate in rule-making. Further, with the regulatory structure overhauled roughly once every ten years, credible commitments among the Bank of England, HM Treasury, and FSA (and its predecessors and successors) are weak. This reduces the likelihood of finding a coordinated position on any given issue that can be projected quickly at a hard law institution such as the EU. Though not as fragmented as the US, actors in the UK structure also pursue soft law to enhance their domestic political standing.

Alternative explanations

Are there alternative explanations for the form and substance of the soft, shallow FSB standard on bail-in? There is a very strong rationalist case for a legally binding standard on bail-in; moreover, large global banks preferred legally binding form. I also consider alternative explanations for substance: regulatory coordination among "great powers"; bargaining power as function of a unified bargaining team; and first-mover advantage. Yet, all three of these explanations fail to explain the substantively shallow FSB standard.

<u>Form</u>

Given that bail-in is a prudential resolution tool meant to be applied to large, interconnected *global* banks, its effectiveness depends on whether national host regulators across jurisdictions recognize the use of bail-in by the national home regulator. For example, say the Bank of England triggers a bail-in of Barclays; whether the Bank can properly write down assets, value liabilities, and allocate losses to unsecured creditors depends on the cooperation of Barclays' host regulators, such as the US Federal Reserve or Bundesbank and BaFin, across the world.

If a host regulator is afraid that its local creditors will lose out disproportionately in recovering assets, then it is tempted to "ringfence" the national assets and capital of that global bank within its jurisdiction—instead of allowing the home regulator to use the global assets of the bank to pay out creditors in an orderly process. In terms of the rationalist/legalization perspective, "states should use hard legal commitments as assurance devices when the benefits of cooperation are great but the potential for opportunism and its costs are high."[714]

Indeed, at the FSB, the IMF advocated that states consider joining an international treaty on cross-border resolution, which would recognize the application of recovery and resolution measures, such as bail-in and bridge banks, across jurisdictions.[715] IMF staff pointed out that "a resolution framework will be ineffective unless it is accompanied by a robust cross-border coordination mechanism," the most desirable (and least politically possible) being a treaty:

> Although large, complex financial institutions operate globally, their resolution is subject to national legal frameworks. One solution to this problem would be the conclusion of a multilateral treaty that would obligate countries to defer to the resolution decisions of the jurisdiction where the financial institution or group has its main activities. There are examples in other areas of international relations where treaty frameworks have been put in place (e.g., regulation of shipping accidents) but the adoption of such an approach in the area of financial regulation would not appear to be feasible in the foreseeable future.[716]

Other observers, including legal scholars, have asserted that "more is needed to change the ad-hoc nature of cross border resolution and insolvency of banks and other financial institutions. In a crisis *ex ante* binding commitments and rules work better than *ex post* ad-hoc solutions…. The need for *ex ante* binding rules providing predictability and legal certainty calls for a convention or treaty."[717]

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[714] Abbott and Snidal (2000): 429.

[715] Interview with Marc Dobler, Washington, DC (3 January 2012).

[716] IMF (2010): 5.

[717] Lastra (2012): 10. See Chan Ho and Lastra (2011) and Lastra (2011).

Large global banks also preferred a legally binding standard, which would provide greater reassurance to their unsecured creditors and thereby lower the banks' cost of funding. For example, Standard Chartered Bank argued:

> We are concerned that without a requirement for co-operation agreements to be legally binding, the ultimate result will be a greater capacity and likelihood for national pre-emption…. This increases market uncertainty around how stress scenarios would evolve for individual institutions, driving pre-emptive ring-fencing that fragments liquidity and capital pools, and increasing the likely speed of a firm's collapse if stress does occur.[718]

The notion of a legally binding agreement was a non-starter at the FSB Resolution Steering Group. Paul Tucker, ReSG chair and Deputy Bank of England Governor, believed it would be an excessively politicized process:[719] "But would countries be prepared to tolerate the loss of fiscal independence and the overturning of national insolvency laws that this model would entail?... That is most definitely not a question for central bankers."[720] A US policymaker involved in FSB discussions maintained to me: "There was no prospect of a treaty. Neither the US nor the UK would accede to decisions of another country."[721] Even those countries most interested in a legally binding agreement could not agree in the first instance whether to favor home or host regulators.[722]

<u>Substance</u>

Can market power explain the shallow substance of the FSB standard on bail-in? Partially. Drezner argues that "Great powers will be unable to use economic coercion to alter the regulatory standards of another great power…. Between great powers, effects of power

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[718] Meddings (2011): 2.

[719] Interview with Stuart Willey, London (30 November 2011).

[720] Tucker (March 2010).

[721] Interview, Washington, DC (4 January 2012).

[722] Interviews with Laurent Clerc and Olivier Vigna, Paris (19 January 2012).

largely wash out."[723] The bail-in standard is admittedly shallow, that is, it mostly endorses its use as a closed-bank tool complementary to other resolution tools. But, the standard does also endorse its use as an open-bank tool, so the effects of power did not entirely wash out the Bank's efforts.

While the headline conclusions of my bargaining model and Drezner's model are the same—little or no change from the international status quo—the underlying incentives for and causal chains leading to, international agreement are wildly different between our theories. Drezner's model assumes unitary states promote their domestic status quos;[724] in mine, the Bank of England is a fragmented state actor seeking to *change* its domestic status quo. Using Drezner's state-centric model, it is inconceivable to consider that the preference of a single sub-state actor, the US FDIC, which did not even hold an official seat in the bargaining forum, would be responsible for a substantively shallow standard—even though the better-resourced New York Federal Reserve agreed more with the Bank of England.

Some scholars have advanced an explanation of bargaining success based on the cohesiveness of bargaining teams, namely that more unified teams succeed more often.[725] This alternative explanation, however, would predict that the FDIC should fail to effectively project its preference for a shallow standard. The New York Fed was far more favorable to the Bank of England's push for open bank bail-in, while the US Treasury Department focused its efforts on avoiding a legally binding standard. However, as predicted by my model, open rules prevented the Bank of England and its allies from exploiting any divisions among the US representatives.

This case also supports my contention that restrictive rules create a first-mover advantage, whereas open rules do not. All three necessary conditions for first-mover advantage existed for the Bank of England. High demand for regulatory change emanated from the failure of

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[723] Drezner (2007): 58.

[724] Drezner (2007): 40.

[725] Hug (1999). König and Slapin (2006) come to a conclusion similar to mine.

Northern Rock, parliamentary scrutiny, and regulatory institutional shuffle in the City of London. The Bank of England possessed the requisite expertise to develop detailed proposals for a bail-in standard, assisted by supportive global banks, such as Credit Suisse. Institutional complementarity also existed: the open membership rules of the FSB allowed the Bank of England to move quickly, assuming leadership of the Resolution Steering Group and tabling proposals for bail-in—without coordinating with the UK FSA or Her Majesty's Treasury. Yet, these seemingly propitious conditions amounted to little in the end. Open decision-making rules allowed the FDIC to rebuff the Bank of England. Demand, expertise, and complementarity appear to be necessary—but not sufficient—conditions for first-mover success in bargaining.

In this case, the two-step theory does not directly account for a scenario in which a first-mover can directly shape the decision-making rules of the international institution where it proposes a hard or soft standard. The second stage of the two-step theory takes the "menu" of international institutions as a given—but in the medium or long run, this menu is not fixed.[726] Central bankers and finance ministers altered the global financial regulatory architecture in the aftermath of the 2007 and '08 crisis by widening the membership and remit of the Financial Stability Forum and re-branding it as the Financial Stability Board.

It is conceivable, therefore, that some actors, such as the Bank of England, expressed institutional reform preferences consistent with the policy preferences they sought to pursue. Current FSB chairman (and new Governor of the Bank of England) Mark Carney described to me that the FSB is "much more action-focused than the FSF, instead of being an analytic exercise, and focused on emerging vulnerabilities and dynamics." This heightens the need for actors to consider the impact of institutional rules.

But, it is not obvious that much has changed between the FSF and FSB. Carney added that despite the expanded membership, "I'm not sure there's a big difference between

[726] Mattli and Woods (2009), as well as Büthe and Mattli (2011), take the international institutional supply as given.

having it as an arm of the G-7 or the G-20."[727] Although there are now over forty working groups sitting under several committees with newly represented jurisdictions, the FSB operates according to the same open decision-making rules that the FSF did.

Will the FSB always be quite as open in its decision-making rules and flexible in its organizational structure? Lacking a legal identity for nearly four years, it could have been disbanded at any time by an inter-governmental press release. That is no longer the case. Members met in Zürich on 28 January 2013 and agreed to establish the FSB as a Swiss legal association, a small step towards providing the organization with a sounder footing.[728] A new Standing Committee on Budget & Resources will explore ways to increase the technical expertise and resources of the Secretariat, although members have not yet agreed to pay dues; for now, the Bank for International Settlements will continue to foot the bill. The institutional construction of the FSB—what US Treasury Secretary Tim Geithner called the "fourth pillar" of postwar international economic cooperation alongside the IMF, World Bank, and WTO—is still underway.[729]

[727] Interview with Mark Carney, phone (31 January 2012).

[728] FSB (February 2013); Carney (2013).

[729] Geithner (2009).

Table 5.1: The two-step theory and the FSB bail-in standard

Proposition	**Evidence**
Fragmented state: low level of integration, low degree of competition, no public authority for industry	UK FSA or Bank of England is consolidated financial supervisor, but both operate at arm's length from HM Treasury and fragmented industry associations; frequent structural change reduces credible commitments between actors
Tenuous domestic regulatory status quo in fragmented state	UK Special Resolution Regime cannot handle the failure of a large, internationally active British bank without exercising temporary public ownership or recourse to taxpayer bailout
Fragmented state regulator has strong incentives to pursue non-legally binding international standard	Temporary public ownership or other taxpayer bailout would transfer control of special resolution process from Bank of England to HM Treasury; bail-in would protect the Bank's institutional autonomy
Fragmented state regulator makes first move at soft law international institution	Bank of England assumes leadership of Resolution Steering Group at the Financial Stability Board (FSB)
Recalcitrant actor prefers status quo on substance	US FDIC prefers closed-bank resolution tools, has no threat to its control over domestic special resolution process
Open decision-making rules advantage recalcitrant actor during bargaining; leads to shallow standard	Bail-in standard includes both open bank and closed bank options, the latter conforming to the FDIC's preference; open bank option is a complement to, and not substitute for, other resolution tools

CHAPTER SIX

Seeking Assurance:
The UK FSA's Pursuit of International Insurance Regulation

On 27 July 2012, while Londoners celebrated an auspicious start to the Summer Olympics, one of the oldest institutions in the City quietly began a new era. Lloyd's, the unique marketplace where tankers, airplanes, and satellites are insured and their potential risks spread around different underwriters, began to regulate itself in a new way. The central management of Lloyd's submitted thousands of pages detailing its internal models for calculating risk to the UK Financial Services Authority (FSA). Internal risk modeling anticipates how much capital the marketplace and its participants need to set aside to protect Lloyd's from expected and unexpected losses. Previously, insurance companies worldwide had been governed by statutory requirements that crudely measured the risk of losses. How and why did the UK arrive at this milestone in the history of insurance regulation? Why did it do so despite the fact that the FSA negotiated only a shallow international standard that mentioned (but did not prescribe) internal modeling-based capital requirements?

The two-step theory suggests that a dissatisfied regulator from a fragmented state pursues a soft international standard to improve its domestic political position. In the late 1990s, the UK government charged the newly created FSA with the regulation and supervision of the London Market, one of the world's largest general insurance markets, in addition to its remit over banking and securities markets. The first stage of the two-step theory suggests that a regulator becomes dissatisfied if it cannot autonomously pursue its policy preferences over the objections of rival regulators. What would incentivize the unrivalled FSA?

I argue that the supervisory consolidation in the UK regulatory structure did not entail structural coordination—rather, the legacy of fragmentation persisted. Domestic interactions between a fragmented British insurance industry and the consolidated FSA reflected the lack of a regulatory consensus. Given the frequency of institutional reform in the British regulatory structure, the FSA was cognizant of how quickly its statutory mandate could be eroded. Resource constraints, parliamentary scrutiny, and the need to legitimize its preference for internal modeling all motivated the FSA to seek a non-legally binding standard—as I consider counterfactually, these incentives did not exist for regulators from coordinated states. Confronting these demands, the FSA sought a low-cost method to regulate the Lloyd's marketplace and general insurance companies in the London Market: this method was risk-sensitive capital standards based on internal modeling. At the time, no other national regulator had created or implemented such standards. It was an untested and novel method that imposed few costs on the FSA, but meant high adjustment costs for the London Market (also contrary to coordinated states' incentives for public *and* private distributional gains). There was no domestic—let alone international—regulatory consensus on the feasibility or effectiveness of internal modeling.

To meet its domestic demands and set the nascent EU agenda on insurance regulatory reform, the FSA sought to legitimize its preference for internal modeling by bargaining for a deep standard at the International Association of Insurance Supervisors (IAIS). At the IAIS, the FSA found support from French and German officials, who joined the FSA in supporting a move from static and risk-insensitive capital requirements to internally calculated and risk-sensitive capital requirements.

Yet, despite overwhelming support from most major jurisdictions (Australia, Canada, France, Germany, Japan, and Switzerland), the IAIS issued an extremely shallow standard—the Principles on Capital Adequacy and Solvency—in 2002. The standard merely acknowledged the possible regulatory use of internal modeling, but issued no prescriptions or guidelines for its use. Why?

As the second stage of the two-step theory suggests, open decision-making rules favor the preference of the actor closest to the status quo. At the IAIS in 2000, British representatives confronted the US National Association of Insurance Commissioners (NAIC), which attempts to represent the interests of all fifty states and the nation's overseas territories. The NAIC, which had devised a static, fixed-ratio, risk-based capital standard, strongly opposed an international standard that endorsed or prescribed internal modeling. Open decision-making rules allowed the NAIC and state regulators to effectively thwart any British effort to set such a deep standard—even though the NAIC is an under-resourced and fragmented organization that often lags in international negotiations.

The UK FSA only partially legitimized its preference for an internal modeling-based approach to insurance capital, but nevertheless met its domestic demands and set the EU agenda on new prudential insurance regulation known as Solvency II. Concerned with bolstering its domestic capacity, the FSA did not wait for the European Commission, France or Germany to proceed with implementing internal modeling requirements for the London Market—years before the European Commission finally proposed Solvency II.[730] As with several other EU directives setting prudential financial standards, the US NAIC and newly created Federal Insurance Office must now meet a test of equivalence for US insurers to access the EU market.

International political economists have paid virtually no attention to the politics of global insurance regulation. Indeed, one of the more attentive, David Singer, states, "Insurance regulation is puzzling because of the very limited efforts of regulators to create international standards."[731] The extensive empirical evidence offered in this chapter is not consistent with Singer's assertion.

In the conclusion, I suggest that this case is not an easy one in light of the two-step theory. The UK regulatory structure is somewhat fragmented (but far from the ideal-type fragmented state). The UK FSA had consolidated regulatory and supervisory authority

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[730] This refutes a counter-argument that the UK FSA was primarily concerned about boosting the competitiveness of the London Market by establishing an international "level playing field." As predicted by the two-step theory in the case of a fragmented first-mover, the UK FSA did not seek private distributional gains, which would be an incentive of a coordinated state to pursue an international standard.

[731] Singer (2007): 112.

over British financial markets, yet it did not directly incorporate industry associations in its domestic standard-setting. This arm's-length interaction suggests that the development of a domestic regulatory consensus depends not only on regulatory consolidation, but structural coordination among competing industry associations and collaboration between industry associations with regulators.

To highlight this point and provide a useful overview of some of the empirical evidence presented later in this chapter, I summarize the structure, domestic outcomes, incentives, and preferences of the UK, France, and Germany below in Table 6.1. This underscores my counterfactual argument: supervisory consolidation in the UK was merely a façade for a continuing legacy of fragmentation, and accordingly the FSA was incentivized as the two-step theory predicts a dissatisfied regulator from a fragmented state would be.

Table 6.1: States' structures, domestic outcomes, and incentives for an international insurance standard

State	**Structure**	**Domestic status quo or consensus?**	**Incentives**	**Preference**
UK	Financial Services Authority (FSA) is consolidated regulator/supervisor Association of British Insurers, International Underwriting Association, Corporation of Lloyd's, and Lloyd's Market Association represent different sectors of UK insurance industry	Status quo: Different rules for different parts of the London Market – UK Department of Trade and Industry supervised general insurance companies under risk-insensitive EU Solvency I rules, but Lloyd's practices self-regulation	No consensus on how to regulate the overall London Market: FSA hampered by resource constraints; scrutiny after company failures not resolved in collaborative process; no agreed-upon approach with general insurance or Lloyd's industry associations on internal modeling	Sought to quickly negotiate a non-legally binding standard at the IAIS that legitimizes and prescribes internal modeling-based capital requirements

State	Structure	Domestic status quo or consensus?	Incentives	Preference
France	*Commission de Contrôle des Assurances* (CCA) is primary regulator and supervisor *Fédération Française des Sociétés d'Assurances* (FFSA) is peak-level, national industry association	Consensus: risk-insensitive EU Solvency I rules for all insurance companies	Receptive to FSA's call for internal modeling, but did not want to move quickly because of different accounting tradition; no incentive to quickly pursue new standard at EU or IAIS to change international status quo	Gradual reform through the legally binding EU Solvency II project
Germany	BaFin is consolidated supervisor *Gesamtverband der Deutschen Versicherungswirtschaft* (GDV) is peak-level, national industry association	Consensus: risk-insensitive EU Solvency I rules for all insurance companies	Originally skeptical of risk-sensitive rules (1997 Müller Report), but receptive to FSA's call for internal modeling and GDV adopted more risk-based (non-internal modeling) rules in 2002; no pressing incentive to change international status quo	Gradual reform through the legally binding EU Solvency II project

Additionally, while the two-step theory accounts for strategic interaction in domestic and international settings that other theories ignore, a number of alternative explanations are consistent with the soft and shallow IAIS Principles on Capital Adequacy and Solvency. These consistent explanations include the rationalist/legalization perspective on form, as well as the influence of domestic constraints on substance; however, an argument based on great power regulatory coordination is imprecise and falls short.

A brief note on insurance regulation

The economic value of insurance has been long recognized in Britain. In the words of early 17th century Parliament, the insurance of trading vessels means that "upon the losse or perishinge of any Shippe there followethe not the undoinge of any Man, but the losse lightethe rather easile upon many, then heavily upon fewe, and rather upon them that adventure not then those that doe adventure, whereby all Merchantes, specialie the younger sorte, are allured to venture more willinglie and more freelie."[732]

In contemporary parlance: insurance companies collect premiums from policyholders, who want to insure themselves against certain risks and do not receive insurance benefits unless they place claims that those risks have materialized. In turn, insurance companies and underwriters invest the funds from those premiums in different assets. By spreading risk around companies and underwriters, insurance markets facilitate the exchange of goods and services.

Why regulate insurance companies? It is difficult for a client of an insurance company to monitor how the company has invested its funds and how large its buffers are to protect against unexpected losses. Losses can suddenly arise on the liability side of the company's balance sheet through miscalculations of technical provisions, a string of catastrophic losses, and risks of large and successive reinsurance claims ("primary" insurers buy reinsurance in order to further transfer risk). Similarly, losses on the asset side of the balance sheet can occur through, among other things, poor investment performance, poor liquidity, changes in interest rates, or depreciation. (Market conduct regulation seeks to prevent insurance companies from mis-selling policies to general consumers and improperly pricing products, but it is not the focus here.)

As a result, capital adequacy regulation (also known as solvency regulation) seeks to ensure that insurance companies do not fall short of their obligations to policyholders. As one scholar puts it, "Capital standards are the linchpin of solvency regulation. Capital and surplus provide a cushion against unexpected increases in liabilities and decreases in the value of assets."[733] If an insurance firm becomes insolvent, capital is used to rehabilitate or liquidate the firm without causing losses to policyholders.

[732] *An Acte concerninge matters of Assurances, amongste Merchantes*, 1601, 43 Eliz., c. 12 (Eng.).

[733] Klein (1995): 369.

Because insurance companies use funds received from policyholders to invest in certain assets, regulations can also exclude certain investments, such as equities or lower-quality securities; competitive pressures, such as demands for higher investment returns or lower policy rates, can lead insurance companies to invest in a variety of derivatives. Calculating the amount of capital required to absorb losses can be more or less risk sensitive. A simple ratio based on the total amount of liabilities assumed by the firm is conservative because it does not account for how likely losses are. On the other hand, a more sensitive ratio can either assume the scale of risks (a static, factor-based ratio) or can attempt to precisely calculate such risks through internal modeling (using market prices when available).

I. Fragmentation of the London Market and the status quo in the 1980s/1990s

The rise of London as an international financial center is in many ways tied to the rise of the London Market. Even though the same Lutine Bell still hangs in the Underwriting Room of Lloyd's,[734] increasing internationalization and specialization, along with dollops of crises, have transformed the institutional structure surrounding the London Market from coordinated to fragmented.

The London Market is composed of the Lloyd's marketplace and general insurance companies, as opposed to retail or life insurance companies. It was already well-developed by the late 1600s alongside the Bank of England and the nascent stock exchange.[735] Near Tower Wharf, Edward Lloyd's Coffee House offered news of ships damaged or lost at sea and served as a focal point for insurance transactions.[736] Detailing ship casualties and industry developments, *Lloyd's List* began its weekly run in 1734, making it one of the world's oldest continuously published periodicals. Largely self-regulated, the London Market steadily grew to dominate the worldwide market in large-scale risks over the next two centuries.

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[734] The Lutine Bell, recovered from the *HMS Lutine* in 1799, used to inform Lloyd's underwriters and brokers whether a delayed ship had arrived (two rings) or had been lost at sea (one ring).

[735] John (1958).

[736] For more on Lloyd's at different points in its history, see Wright (1928); Gibb (1957); Brown (1987); Mantle (1992); Langmead (2002).

In 1720, Parliament vested commercial authority to write marine insurance in two companies, London Assurance and Royal Exchange Assurance; however, this legislation did not affect individual Lloyd's underwriters, and the two companies developed business lines and spin-offs apart from marine insurance.[737] The Society of Lloyd's, which oversees the underwriters, received a self-regulatory mandate in Lloyd's Act 1871 to establish its governing rules and regulate the marketplace; the legislation did not change the unlimited liability that members of Lloyd's assumed for their risks. The government did not supervise the general insurance companies either, but did establish solvency requirements for them in the Assurance Companies Act 1946.[738] While the Bank of England began to increase its direct supervision of City banks, the government purposefully decided not to create a separate independent insurance regulator in the 1970s, citing the virtues of its prevailing regulatory philosophy—"freedom with publicity"—that mandated full disclosure of insurers' ability to settle claims.[739]

By the end of the 1970s, the London Market was among the most prosperous general insurance centers in the world. It was also highly internationalized. In 1977, 60 percent of the net premium income of British Insurance Association general insurance member companies was generated overseas.[740] Lloyd's had more than 14,000 underwriting members, known as "Names" (1,200 were foreign), organized into syndicates: marine, aviation, non-marine, and motor.[741] The underwriters in these syndicates accepted risks proposed by brokers, who in turn represented clients seeking insurance.

But, the Lloyd's marketplace then entered nearly two decades of turbulence, in many ways brought about by internationalization and growing conflicts of interest between arm's-length brokers and underwriters. In 1975, a Lloyd's syndicate took advantage of lax

[737] Supple (1970); Hodgson (1984).

[738] Ford (2011): 255.

[739] Ibid.: 260.

[740] Central Office of Information (1979): 21.

[741] Ibid.: 25-6.

supervision in the Lloyd's Policy Signing Office by delegating authority to accept new business to an American broker, which in turn contracted an American underwriter.[742] Soon thereafter, the syndicate grossly exceeded its premium limit; once risks materialized in its computer-leasing and property businesses, many Names in the syndicate were furious. The Names, subject to unlimited liability for the losses, sued Lloyd's itself for poor market regulation—a first in its history—when they were expected to contribute to coverage of the ensuing claims.[743]

Moral suasion could no longer govern Lloyd's market participants. A former deputy chairman of Lloyd's decried, "In the old days, the chairman would call someone in and tell him, 'You've been a naughty boy,' and be sure there would be no repetition. No more. Now the chap is likely to say, 'According to whom?' And we have no ability to regulate without going through the most horrendous, time-wasting process."[744] The investigations that followed the so-called Sasse syndicate affair eventually led to new legislation in the 1980s addressing the corporate governance of Lloyd's, but did not establish prudential standards, which remained within the remit of the Society of Lloyd's.[745]

The "Big Bang" of the Financial Services Act 1986, which brought much of the life insurance sector under the purview of self-regulatory organizations,[746] did not affect the prudential regulation of general insurance companies or Lloyd's. Rather, the Department of Trade and Industry laid down bare-minimum solvency requirements for general insurance companies consistent with European Union non-life directives (detailed below on pp. 266-267).

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742 Moore (1980).

743 Ibid.

744 Peter Foden-Pattinson quoted in Apple Jr. (1980).

745 Cockerell (1984): 90-2; Moore (1982).

746 Under the Financial Services Act 1986, life insurance companies were regulated under the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO), which was itself under the Securities and Investments Board (SIB), the predecessor to the Financial Services Authority (FSA). However, LAUTRO only supervised the marketing of life insurance, not the actual underwriting practices of life insurers. *Lloyd's List* (1992).

The lack of extensive formal regulation was surprising in the context of the major losses experienced by the London Market in the 1980s. Despite the clear inability of Lloyd's to properly prevent fraud and misappropriation on a massive scale,[747] the 1986 Act exempted Lloyd's underwriters from being defined as engaging in "investment business." Given that dozens of Tories were simultaneously Lloyd's members, this carve-out did not please the Labour opposition, which called Lloyd's "the City's biggest slurry pit," and regarded the former chairman as "manifestly dishonest" in his reporting of the solvency margins of troubled syndicates.[748] (From the mid-1990s onward, the regulatory history of the London Market becomes wrapped up in debates over capital adequacy standards, and so is discussed in the next section.)

Despite informal political influence, Lloyd's and other insurance industry associations have long formally operated at arm's length from the government and regulators, although considerable attempts at consolidation have occurred. The most prominent association, the Association of British Insurers (ABI), does not represent the London Market. Founded in 2001, the Lloyd's Market Association (LMA) succeeds previously separate Lloyd's underwriting associations that represented the marine, non-marine, aviation, and agents associations.[749] The Corporation of Lloyd's, which approves business plans and sets market standards, negotiates nationally and internationally.

Both British and international general insurance companies join the International Underwriters Association (IUA), which helps issue member guidance on policy signing, accounting, and information technology systems.[750] Lloyd's is not formally linked to either the ABI or IUA. While Lloyd's considers the IUA to be competitively operating in the same general insurance market as its members, it does not foresee a merger with the ABI,

[747] Known as the PCW and Howden affairs, resulting in liabilities for Lloyd's and its members in the hundreds of millions of pounds. See Moore (1985); Chiafullo (1996): 1403-1405.

[748] Wolman (1986); Bunker (1986).

[749] *Lloyd's List* (2001).

[750] Howard (1991). The International Underwriters Association (IUA) is the product of a merger between the Institute of London Underwriters (ILU) and London Insurance and Reinsurance Market Association (LIRMA).

which it views as domestically focused and its priorities defined by the interests of life insurance companies.[751]

Despite the fragmented representation of the London Market, market participants recognize the value of projecting a single voice in discussions with the UK government, European Union, and international counterparts and institutions: "It is time that the ABI, LIRMA, ILU, and the brokers joined forces…. the Anglo Saxon way of doing insurance business needs to be demonstrated as the better way." [752]

The London Market industry associations are involved at the international level through the *Comité Européen des Assurances* (CEA), which was founded in Paris in 1953 to monitor the work of the OECD on insurance standards. The CEA (now known as Insurance Europe) is composed only of the national insurance associations, and thus the ABI represents British interests. Given the divergence of interests, though, between the ABI, IUA, and Lloyd's, these three associations, along with the UK P&I Club (which represents ship owners and operators) meet together in the British Insurers' European Committee to attempt to project a collective UK general insurance industry preference at the CEA. In turn, the CEA lobbies on behalf of the national bodies to the European Commission and other international institutions.[753]

But as in the UK banking and securities markets (see chapters 5 and 4), the London Market is filled with competing industry associations that do not coalesce into a single, peak-level body. Even Lloyd's itself is split: the Corporation of Lloyd's handles prudential issues, while Lloyd's Market Association concerns itself with syndicates' interests. Within associations such as the IUA, which represents both British and international firms, it is difficult to collect and publish data on the nature of members' businesses, as each is "afraid

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[751] Interview with Alastair Evans, London (4 May 2012).

[752] Nicholas Davenport, managing director of Willis Corroon (insurance broker), quoted in *Lloyd's List* (1993).

[753] Interviews with Alastair Evans and Nick Lowe, London (4 May 2012).

others will get a competitive advantage if trends in business or risk profiles are disclosed."[754] The associations respond to consultations from the UK government or the FSA at arm's-length and, unlike in France or Germany, their boards are not composed of both industry representatives and regulatory officials. For such a consolidation to occur, UK insurance industry associations would likely have to combine into more encompassing bodies. Yet, as one official stated, "Merger discussions never go anywhere."[755]

Tumultuous domestic regulatory status quo: laissez faire *approach to the London Market*

This section details the prudential regulation of the London Market—and its failures—in the late 1980s and early 1990s, demonstrating the need for capital adequacy standards and effective supervision. The Insurance Directorate of the Department of Trade and Industry (DTI) supervised general insurance companies (but not Lloyd's). Although nominal statutory regulation existed, generalists in the DTI practiced light-touch supervision of a rapidly changing and internationalized market. In the late 1980s and early 1990s, a series of catastrophic losses struck both parts of the London Market. Ministerial regulation of general insurance companies through the DTI, as well as Lloyd's self-regulation, were revealed as clearly inadequate. Lloyd's and the general insurance companies made small moves towards simple risk-based approaches to improve their solvency, but the status quo remained a tentative *laissez faire* regulatory approach as the Financial Services Authority (FSA) opened its doors.

The Insurance Directorate of the DTI operated in an extremely fragmented structure, wherein it did not have an encompassing or well-defined mandate over the London Market. The Insurance Directorate was run by generalist staffers without expertise in insurance, and it supervised the general insurance companies in the London Market through "informal understandings, voluntary compliance, and minimal public accountability."[756] Compared to the French and German insurance regulators, each of

[754] Interview with Nick Lowe, London (4 May 2012).

[755] Ibid.

[756] Ford (2011): 267.

which employed roughly three hundred staffers, the DTI had only one hundred staffers. DTI effectively admitted the poor quality of its supervision by "the decision to bring in outside skills, which a DTI spokesman said reflected the need to 'improve the knowledge and analytical skills of individuals.'"[757]

In the late 1980s and early 1990s, the London Market followed solvency standards set in a 1973 EU Directive on non-life insurance.[758] The EU "solvency margin" was a backward-looking, risk-*in*sensitive standard based on calculations of premiums and claims (i.e. focused only on the liability side of the balance sheet). Two triggers could set off regulatory intervention: the first, if the insurer fell below the margin, it would have to submit a short-term plan for rehabilitation; the second, if capital fell below one-third of the margin, the insurer would immediately have to raise capital or its authorization to operate would be withdrawn.[759]

Although the EU standard was 16 to 18 percent of premiums, the DTI set a higher statutory minimum of 30 percent for general insurance companies. The Corporation of Lloyd's compiled figures for its syndicates and submitted an overall solvency figure for the marketplace to the DTI.[760] Still, observers commented that this crude ratio told shareholders or policyholders little about the actual strength of a given insurance company: "What is lacking from the returns of a general insurance company is any description of how the provisions have been arrived at, what account has been taken of the relationship between assets and liabilities, how reinsurance recovers have been taken into account, and so on."[761]

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[757] Bagnall (1973).

[758] 73/239/EEC First council directive of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of direct insurance other than life assurance, and 73/240/EEC Council directive of 24 July 1973 abolishing restrictions on freedom of establishment in the business of direct insurance other than life assurance.

[759] Daykin (October 1987).

[760] Gibson (March 1992).

[761] Daykin (May 1987).

The ratio—net assets divided by premium income—assumed that premiums are linked to risk, that is, the higher the premium income, the higher the risk being assumed. As a result, a general insurance company that sought to reduce its risk of insolvency by charging higher premiums would reduce its solvency ratio, whereas a company seeking market share could cut its premiums and increase its solvency ratio. The ratio also made no distinction between the risks associated with insuring, for example, an automobile versus an oil rig.[762]

The DTI did not supplement reporting of solvency ratios with information about the risk profile of general insurance companies. Yet, by the autumn of 1992, four of Britain's top seventeen general insurance companies were failing or about to fail the statutory minimum of 30 percent. Despite this situation, DTI clarified that its authorization of insurance companies does not guarantee their solvency "nor is the DTI allowed to issue warnings to the public if an insurer is heading for trouble—all the information held by its staff is confidential."[763]

DTI's light-touch approach led to a number of notable supervisory failures. The Municipal Mutual Insurance (MMI) company suffered a £140 million loss in 1991.[764] MMI not only operated in the general insurance London Market, but also backed individual homeowners and local UK authorities.

Showing considerable forbearance, DTI allowed MMI to continue underwriting policies as it fell under the minimum solvency margin.[765] As *The Guardian* put it, "If MMI is close to collapse then the DTI may eventually be forced to relinquish this last vestige of its financial supervision,"[766] while *Financial Times* declared, "An independent inquiry is needed to determine the facts. Then a judgment to be made on whether the regulatory framework itself is adequate."[767]

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[762] Lapper (1992).

[763] Atkinson (1992).

[764] Whitebloom (1992).

[765] Nelson (1992).

[766] *The Guardian* (1992).

[767] *Financial Times* (1992).

Paralleling troubles in the general insurance company market, the Lloyd's marketplace almost completely crumbled in the "LMX spiral." The London Market Excess-of-Loss spiral was a process by which "catastrophe risks," such as oil rigs or windstorms, were handled in the Lloyd's market; the normally profitable process could, however, generate total *gross* claims well in excess of the total insured losses that resulted from a single event.[768] Instead of dispersing risk through the London Market, the LMX spiral concentrated risk and made much of Lloyd's vulnerable. Catastrophic losses came hard and heavy, arising from the destruction of the Piper Alpha oil rig, Hurricane Hugo in the US, the Exxon Valdez oil spill in Alaska, and earthquakes in San Francisco and Australia.

Lloyd's syndicates misjudged their estimates of likely maximum losses, quickly generating massive claims.[769] This string of "short-tail" catastrophic losses, along with cumulative "long-tail" asbestos, pollution, and health claims,[770] put the solvency of Lloyd's in doubt. Liable individual Names would not cover claims they believed to be generated as a result of brokers and underwriters' desire for commissions.[771]

While devising plans to rehabilitate the marketplace, Lloyd's internally revamped its prudential regulation and created risk-based capital standards (RBC), partially in the hopes that self-regulation would stave off legislative actions.[772] It would be the first time that syndicates writing catastrophe risks would face higher regulatory costs—because of higher capital requirements—than syndicates writing motor insurance.[773]

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[768] For details, see Bain (1999): 230-1.

[769] Bain (1999): 240-1; Chiafullo (1996): 1408. For example, in the Piper Alpha disaster, 43,000 claims were sent through the Lloyd's Underwriting Claims and Recovery Office, resulting in gross claims within the LMX spiral of $15 billion, whereas the total insured loss was only $1.4 billion.

[770] Evers (1989).

[771] Gibson (February 1992).

[772] Shapiro (1992); *Review* (1988); *Reinsurance* (1996).

[773] Ladbury (1994).

The Lloyd's RBC system was used to calculate how much capital each member, at minimum, would be required to contribute to the "rainy day" Central Fund depending on the expected loss and volatility of the member's portfolio.[774] Ultimately, however, the Lloyd's standard did not actually define capital and was still a *fixed ratio* system that did not incorporate potential correlation among risks.[775]

Given the considerable step forward taken by Lloyd's on risk-based capital rules, general insurance companies in the London Market took notice. On the eve of transformative institutional change in the British regulatory structure, the largest companies, such as Swiss Re, were researching the usefulness of internal models to determine their own economic capital needs.[776] The work was still based on backward-looking and fixed ratios, but it was far beyond what the UK Department of Trade and Industry or the EU had prescribed in their prudential regulation of general insurance companies.

In sum, major losses in the London Market—both at Lloyd's and among general insurance companies—shook the domestic regulatory status quo in the 1990s. The Insurance Directorate of the Department of Trade and Industry practiced *laissez faire* supervision and used antiquated capital requirements based on 1970s EU non-life insurance standards. DTI failed to request or disclose extensive risk profiles of participants in the London Market, and thus did not anticipate the near-complete breakdown of Lloyd's or the general insurance company insolvencies. Despite efforts at Lloyd's to improve its capital standards and among major companies to experiment with internal models, with an incoming Labour government in 1997, a regulatory shake-up for the London Market appeared in the offing.

When a Labour government assumed power in 1997, it swept away the fragmented regulatory structure that had existed since the 1986 Financial Services Act. The government felt emboldened because the notorious failure of Barings Bank discredited the

[774] The details of the RBC system are outlined in Rodriguez (2000).

[775] European Commission Appendices (2002): 73.

[776] Howard (1996).

supervisory capabilities of the Bank of England.[777] A pensions mis-selling scandal highlighted the failure of one of the several self-regulatory organizations (in this case, the Personal Investment Authority) in the fragmented structure under the Securities and Investment Board. All of these regulatory failures across markets buttressed Chancellor Gordon Brown's case for supervisory consolidation and the creation of the FSA.[778] The creation of the UK Financial Services Authority in the late 1990s served as an opportunity to finally bring a specialized, high-risk, and internationalized London Market into the statutory fold.

The FSA's mandate on insurance regulation was not initially the highest priority. While the government unveiled first the timetable for the development of prudential banking regulation and conduct of business rules for securities firms,[779] plans for the prudential regulation of the London Market remained embryonic.[780] DTI transferred its authority and staff to the insurance division of Her Majesty's Treasury before they moved to the FSA.[781] Upon passage of the Financial Services and Markets Bill in 2000, the FSA finally gained full statutory authority to set prudential insurance standards.[782] In the meantime, it found itself in a unique position: its officials could begin proposing its preferred standards while unthreatened by rival regulators.

II. Incentives to pursue non-legally binding international standard

If the FSA as a consolidated supervisor was not threatened by turf wars with other regulators, then what would incentivize it to pursue an international standard? I posit that supervisory consolidation did not entail the structural coordination and collaborative standard-setting typical of coordinated states. Instead, the FSA was systematically disadvantaged in supervising the London Market because of severe resource constraints.

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[777] See also p. 202; Prabhakar (2011).

[778] *Financial Times* (1997).

[779] Wilkinson (1997).

[780] Bromwich (1997).

[781] *Lloyd's List* (1997).

[782] Graham (1998); Adams (1998).

Challenges posed by the insurance industry—through the *bancassurance* conglomeration trend, inconsistent London Market regulation, and notable company failures—did not spark collaborative *domestic* efforts between the FSA and industry associations to find a consensus on a new regulatory approach. There was (and is) no peak-level, encompassing industry association for British insurance companies and Lloyd's. Thus the FSA could not immediately propose a new legally binding EU prudential insurance standard. But, for the FSA, a soft international standard that contained its preferred substance would set the corresponding EU agenda. And so the FSA sought an international standard that would legitimize and prescribe a risk-sensitive, internal modeling-based capital standard for the London Market.

Resource constraints and industry challenges

In addition to supervising over 500 life insurance companies, the FSA covered 186 general insurance companies and 140 Lloyd's syndicates under its mandate. But, the FSA operated with such low costs that it raised doubts about how effectively it could regulate and supervise insurance firms, let alone the banking and securities markets also under its remit. In its 2000-2001 Annual Report, the FSA reported $330 million in resources. By comparison, US regulators collectively had $4.5 *billion* in resources to supervise banks, securities firms, insurance companies, and pensions companies annually between 1998 and 2000. While the US and UK spent roughly the same in terms of expenditures-per-personnel (approximately $108,526 in US versus $119,349 in UK), this apparent equivalence resulted from the exceptionally low numbers of FSA personnel (2,765).[783]

The now-infamous "light touch" approach of the FSA partially arose out of its statutory obligation to operate with minimal costs. As Helen Liddell, economic secretary to HM Treasury, put it: "Not only must the FSA use its resources effectively, it must show the

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[783] Jackson (2005): 33-36. Nor can these differences be explained by relative sizes of the economy and financial sector: considering that US financial regulatory resources exceeded those of the FSA by nearly 14 times, US GDP in 2003 was only 6.8 times that of the UK, while US banking assets were only 2.2 times that of the UK.

public and the industry that it is doing so. After all the costs of regulation are met by the firms under regulation. This means they are ultimately passed on to consumers in the form of higher charges or lower returns."[784] For BaFin in Germany, by contrast, relatively low financial resources were easily compensated for by the collaboration with industry associations in standard-setting and auditing of regulatory compliance, obviating the need for high, ongoing supervisory costs.[785]

The FSA sought a low-cost method that would address two objectives: supervision of financial conglomerates and equivalent regulation of both general insurance companies and Lloyd's, which still retained much of its own standard-setting authority. The first objective arose as major financial firms consolidated worldwide into *bancassurance* companies. The 1998 merger of Citicorp and Travelers Group in a $70 billion deal was only the most notable example.[786] In Britain, Lloyd's TSB (a bank) purchased the Scottish Widows insurance company for £7.3 billion, while National Westminster had pursued a £10.7 billion purchase of Legal & General.[787]

The ability of different arms of a conglomerate to book risks in different ways could reduce its overall capital requirements. As FSA chairman Howard Davies noted, "There are risks of regulatory arbitrage between the insurance and banking businesses within a group, since capital requirements for insurance companies and banks differ in a number of ways."[788] Complex *bancassurance* business models posed significant challenges for the FSA's supervisory effectiveness.

Domestically, the FSA sought a level playing field between the two major sides of the London Market: Lloyd's and the general insurance companies. Both sides wanted to preserve exceptions. General insurance companies wanted Lloyd's syndicates to be subject

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[784] Quoted in Brown-Humes (1998).

[785] BaFin (2002): 180.

[786] Martin (1998).

[787] Felsted (2000).

[788] Quoted in Felsted (2000).

to the same regulations, but general insurance companies—despite the frequent overlap between business lines within large companies—also wanted to be treated apart from life insurance companies.[789] Meanwhile, Lloyd's wanted to completely prevent prudential standard-setting by the FSA, arguing "Lloyd's itself retains a properly managed authorization system of its own and has a mutual fund at an appropriate level commensurate with the business being underwritten."[790]

At first, the FSA was not keen to begin prudential regulation of the Lloyd's marketplace. Chairman Howard Davies admitted, "While there remains a lot of uncertainty about our scope, I cannot say it will cost x," adding that regulating Lloyd's would entail a greater strain on resources.[791] The FSA authorized Lloyd's underwriters and took in twenty-five to fifty members of Lloyd's regulatory staff, but otherwise, the FSA permitted Lloyd's to mostly continue self-regulation.[792]

Lloyd's had won a clear victory for the time being, as it noted that FSA authorization "confirms the approach which we advocated in 1997 to strengthen the external regulation of Lloyd's in some areas, whilst retaining internal control (subject to FSA direction) for areas such as prudential supervision and the transfer of capacity."[793] Thus, the FSA still needed to set standards for Lloyd's without drawing down on its already limited resources.

In addition to resource constraints and industry challenges, the FSA faced criticism after a series of high-profile insurance company failures. The FSA was accused of not warning customers and investors of the declining solvency of Equitable Life, a major life insurance company. Politicians and consumer groups charged the FSA of failing to intervene once HM Treasury warned the FSA that the "information received [from the firm] to date is unconvincing, and raises serious questions about the company's solvency."[794]

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789 Beatty (1998).

790 Adams (1997); Banks (1999).

791 Quoted in Harris (1997).

792 Adams and Graham (1998).

793 David Gittings, director of regulation at Lloyd's, quoted in Felsted (1999).

794 Quoted in Bolger (2000).

Similarly, French insurance regulators warned the FSA about operations at Independent Insurance before the firm failed in 2001, jeopardizing the coverage of 600,000 policyholders. It later emerged that Independent fraudulently concealed claims, which the FSA asserted it had begun to investigate.[795] But, it did not help matters that Independent Insurance failed just days before the FSA announced it had cut back on resources devoted to routine supervisory monitoring because the "sort of work being scaled back is lower priority, non-urgent tasks."[796]

The FSA tried to deflect legislative scrutiny in the aftermath of the company failures. Before the House of Commons Treasury Select Committee, FSA chairman Howard Davies asserted that the regulator would soon present "an overhaul of the prudential rules for insurance companies more generally."[797] In France or Germany, one might expect the formation of joint regulator-industry committees and working groups to develop a consensus on a new regulatory approach, as in the case of hedge funds in France (see Chapter 4) or capital adequacy in Germany (see Chapter 5). But, no such formal, collaborative public-private undertaking between the FSA and the London Market occurred. What did the FSA pursue instead?

FSA favors internal modeling

Given these resource constraints and the imperative of regulatory change, the FSA drew on ongoing work in banking regulation as a model for risk-based capital standards in insurance regulation. FSA officials favored the use of internal models to calculate the capital sufficient for an insurer's operations. They sought to complement internal modeling with market-based valuation (instead of more conservative valuation) that took into account risks arising from both assets and liabilities.

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[795] Quoted in Bolger (2001).

[796] Quoted in Guerrera et al. (2001).

[797] Quoted in House of Commons (October 2001).

Martin Roberts, director of the FSA insurance division, explained: "Banking and securities supervisors have tended to concentrate on the assets side of the balance sheet, whereas insurance supervision usually starts from an appropriate assessment of the liabilities of an insurance company. We are obviously considering what lessons there are for insurance supervisors in the way in which banking and securities regulators identify and quantify risks on the assets side."[798]

The Basel II framework—with its internal ratings-based approaches—had not yet been completed (see Chapter 3). Still, in early 2001, the FSA proposed adopting a similar approach for insurance companies. Chairman Howard Davies argued, "The basic 'three pillars' concept of the new Basel Accord, including the emphasis on supervisory review of internal capital adequacy assessments and strategies and on enhanced disclosure, are highly relevant." This risk-sensitive approach meant that "insurance companies will be expected to identify adverse scenarios in which any of—or a realistic combination of—underwriting, expense, credit, market or other losses or risks might occur or crystallise."[799] This would be a far cry from the static, factor-based ratios that assumed the likelihood of given risks and assumed the correlation of different risks.

The FSA sought to justify the considerable compliance costs in creating models for "identifying realistic adverse scenarios in which the outcome for either liabilities or assets or both may differ from expectations."[800] The FSA believed internal modeling of capital adequacy would be especially crucial for the London Market, given that "Lloyd's has to deal with lots of CAT [catastrophe] risks. The London Market is made up of specialist insurers. Life and annuity insurers have other risks. So, conceptually speaking, modeling allows individual risks to be properly accounted for in insurers."[801]

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[798] Quoted in *Asia Insurance Review* (June 2000).

[799] *M2 Presswire* (2001).

[800] Ibid.

[801] Interview with Hector Sants, Oxford (11 May 2012).

The FSA sought legitimacy at the international level for its approach to prudential insurance regulation. No national regulator anywhere in the world set regulatory capital standards on the basis of internal risk models. And there existed no domestic consensus among industry with which the FSA could have pursued a legally binding standard. France had an encompassing industry association in the *Fédération Française des Sociétés d'Assurances* (FFSA), as did Germany in the *Gesamtverband der Deutschen Versicherungswirtschaft* (GDV). But, the FSA was faced with a cacophony of views expressed by the ABI, IUA, and LMA, among others. An FSA official acknowledged, "We had to convince everybody in the London markets that our risk assessment approach was feasible."[802]

Setting the EU agenda

The two-step theory suggests that a regulator from a fragmented state pursues an international standard to improve its political position because it is dissatisfied with the domestic status quo. Without a domestic consensus on insurance regulatory reform, the FSA could not pursue legally binding standards at the international level. But a non-legally binding international standard would legitimize the FSA's preference for internal modeling and ensure that the course of the EU project on insurance reform (Solvency II) would proceed along the FSA's preferred track.

In April 1997, the EU Conference of the Insurance Supervisory Services published a comprehensive report written by the vice-president of the German federal insurance supervisor. While the Müller Report acknowledged that a larger safety cushion could address unanticipated risks, it was less sanguine on a risk-based approach to prudential standards: "it remains to be seen if this [risk-based capital] system has proven its worth and if it can be transferred to circumstances in the EU."[803]

At this point in the late 1990s, the EU was only mooting the possibility of more risk-sensitive capital standards. Fulfilling the Müller Report's call, the European Parliament

[802] Interview with Ed Forshaw, London (8 May 2012).

[803] Conference of Insurance Supervisory Services of the Member States of the European Union (1997): 12.

and Council of Ministers negotiated Solvency I, which was a basic revision of the existing, risk-insensitive solvency margin. The European Commission then began consultations with insurance industry associations and the largest firms to discuss the basic internal models that a few global companies had devised, but not yet implemented: "although the [insurance] business appears to be very busy thinking about risk in economic terms, there is little evidence so far of it implementing any of the results."[804]

As the Commission began to survey the industry, the FSA sought to influence the direction of future EU reform: "What we really want to see in the long term is a system along the lines of what we're already proposing—an integrated prudential approach to all firms, whether they be building societies, banks or insurers."[805] By pursuing a non-legally binding international standard, the FSA could achieve its preference for less resource-intensive, risk-based insurance capital standards both at the EU and UK levels. An international standard would represent policy commitments that the EU could not ignore in the Solvency II agenda.

In sum, the FSA had strong incentives to quickly pursue an international insurance capital standard. In terms of the two-step theory, the FSA sought to change the domestic status quo, as well as the international status quo. Although the FSA was a consolidated financial supervisor, the UK insurance market was not structurally coordinated: the days of norm-based regulation and implementation through moral suasion had long ended in the London Market. With divergent member interests and competition for resources, none of the insurance industry associations could project a single voice in discussions with the FSA on regulatory reform. However, the FSA could forge ahead in pursuing a non-legally binding standard without prior coordination with the industry associations or any other state actor.

An internal modeling-based approach satisfied the FSA's need to maximize the effectiveness of its standard-setting in light of resource constraints; despite overseeing capital markets of comparable size to the United States, the FSA was remarkably under-

[804] *Reactions* (2001).

[805] Quoted in Alcock (2002).

funded and under-staffed. Financial conglomeration between banks and insurance companies only magnified the difficulties of insurance regulation and supervision in the late 1990s. Furthermore, the FSA wanted to end the long and uneven history of *laissez faire* London Market regulation by bringing both Lloyd's and the general insurance companies under the same overall prudential regulatory framework. Unlike in coordinated states, the FSA and industry were not ensconced in collaboration. Domestic scrutiny after a series of insurance company failures placed direct pressure on the leadership of the FSA to take action.

III. Institutional choice: the IAIS, not the OECD

Where would the FSA pursue soft international capital standards for insurance companies? Two institutions appeared to be promising venues for bargaining. Through its Insurance Committee, the Organisation for Economic Cooperation and Development (OECD) had long been involved in setting non-legally binding international insurance standards. More recently, the International Association of Insurance Supervisors (IAIS) had been elevated to the status of a key international standard-setter by the G-7, placing it alongside the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

Compared to the IAIS, the Insurance Committee at OECD has a much longer track record in standard-setting.[806] In 1964, the OECD issued a non-legally binding Recommendation on common classification of classes of insurance. This Recommendation defined different types of insurance business to help national authorities set various rules for investment and liability assessment to reflect different types of risks. In 1971, the

[806] There are currently thirty four members of the OECD: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, South Korea, Luxembourg, Mexico, The Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States. The IAIS has a more encompassing membership in terms of economic development. In 1995 the IAIS had sixty one members, and by 2006, had 116 members.

Insurance Committee developed and the OECD adopted a Recommendation that established principles for supervisory cooperation between home and host insurance authorities. In the early and mid-1990s, the OECD focused on risks in the global reinsurance market and called for member state authorities to request more disclosure from insurers and reinsurers during supervisory assessments. At the same time, the Insurance Committee also studied the feasibility of setting solvency standards, citing some of the same policy concerns that the UK FSA later cited: "the creation of financial conglomerates, the marketing of financial products by insurers, and companies' investment policies."[807]

Yet, backed by the wealthiest countries, the IAIS dislodged the OECD from its status as the focal point international institution for insurance standards. In the aftermath of the 1997 and '98 Asian financial crisis, the G-7 and IMF blessed the IAIS as part of a new architecture overseen by the Financial Stability Forum. As one founding member of the IAIS recounted discussions in the late 1990s:

> When I joined, the IAIS still did not see itself as *the* standard-setter for insurance. It did not see itself in the same light as the Basel Committee or IOSCO. It was really a matter of dumb luck or coincidence that the IAIS was beginning to establish itself just as the folks in Washington started looking about for a standard-setter in the insurance space.[808]

The IAIS had been established at the annual meeting of the *United States* National Association of Insurance Commissioners (NAIC) in June 1992. The NAIC decided to formally create the IAIS as the successor to a distinct set of meetings with international regulators that had, in the past, been held in parallel to NAIC meetings.[809] In 1994, the IAIS met for the first time in Baltimore, Maryland to discuss its first recommendation, an admittedly "not 'earth-shattering'" document on information-sharing between home and host supervisors.[810]

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[807] Laboul (1992).

[808] Quoted in Seddon (2012).

[809] *World Insurance Report* (1992).

[810] Otis (1994).

Founded two decades after the Basel Committee, the IAIS did not achieve prominence or any actual influence until it joined the G-7 Financial Stability Forum, as proposed by Bundesbank President Hans Tietmeyer.[811] The G-7 and FSF directed the banking, securities, and insurance standard-setters to set core regulatory principles. The IMF then used these core principles to assess the strength of jurisdictions' financial standards through the Financial Sector Assessment Program (FSAP). As a result, the IAIS' first significant standard was the non-legally binding Insurance Core Principles.

In the early 2000s, the IAIS was composed of over 100 national insurance regulators, each of whom sent at least one representative. As one senior IAIS official characterized the organization, "The IAIS is influenced, as it should be, by its members, the national authorities that drive the process there."[812] Supported by the Secretariat at the Bank for International Settlements (BIS), the IAIS is composed of an Executive Committee and Technical Committee, the latter overseeing subcommittees and working groups. The General Meeting of all members ultimately passes or rejects standards.

Whereas neither the Basel Committee nor FSB has bylaws, IAIS members agreed to relatively precise bylaws that have been slightly modified over the past decade. The Executive Committee is composed of up to 15 members and generally accounts for geographic and market diversity, with no more than one person per jurisdiction.[813] In contrast to the membership rules of other standard-setters, firms can be non-voting observers and contribute to substantive deliberations at the discretion of committee chairs.

The Technical Committee is powerful because of its role in overseeing the work of subcommittees and working groups, such as the Solvency & Actuarial Issues Subcommittee: it "brings bits and pieces together. It steers and guides strategy and

[811] Tietmeyer (1999).

[812] Interview with Sebastian von Dahlen, phone (30 April 2012).

[813] The 2005 Bylaws are more specific on this point than the 1999 Bylaws, which only generally refer to "different areas and different interest groups."

responds to high-level, political requests…. It is an environment where consensus is necessary."[814] Most, if not all, of the substance of principles or standards is developed in the subcommittees.

IAIS decision-making rules

Decision-making rules at the IAIS vary depending on the level of the organization. The General Meeting adopts principles, standards, and guidance according to a two-thirds majority. The Bylaws permit the US NAIC to designate up to 15 members to exercise their votes.[815] The Executive Committee votes according to simple majority rules, whereas a decision-making rule is not specified for the Technical Committee. But despite the specification of voting rules in the Bylaws, the current chair of the Technical Committee recalled, "My understanding is that the organization has had only one formal or contested vote in its history."[816] A former chair of and current participant on the Solvency & Actuarial Issues Subcommittee recalled, "We have never, and the subcommittee still has not, taken a formal vote."[817]

The IAIS Secretariat defines decisions on standard-setting as "consensus-based."[818] The voting rules, however, do not define "consensus," which former IAIS members do not recall as equivalent to unanimity. Instead, practice suggests it means a large preponderance of members' support. Vigorous objections from members of larger jurisdictions can delay or derail bargaining over proposed standards in the subcommittee. As a former chair of the Technical Committee put it:

> From my experience the committees and sub-committees (including the Technical Committee), operated according to consensus and rarely voted on issues, including for proposed principles or standards. In practice, this did not mean there had to be

[814] Interview with Sebastian von Dahlen, phone (30 April 2012).

[815] Article 6, section 4 in IAIS (1999).

[816] Correspondence with Michael McRaith, email (26 November 2012).

[817] Interview with Rob Curtis, London (30 May 2012).

[818] Interview with Sebastien von Dahlen, phone (30 April 2012).

> total unanimity, but it did mean an issue would not be agreed to if a few members (especially from major jurisdictions) strongly opposed it.[819]

In this environment, the chair is especially influential:

> That [consensus] is the way they try to get policy through. I was chair of the solvency subcommittee for four years and involved in many negotiations. It's not an easy process. Chair is a really important position because whoever chairs holds the pen on policy. The IAIS Secretariat does not take the lead or hold the pen. The chair is very influential in determining direction and speed of policy. If the chair is from a jurisdiction that doesn't believe in a certain 'glide path', then actual progress will be very slow.[820]

The lack of consensus on a standard in subcommittees and working groups prevents the Technical Committee from considering that standard. Some observers have blamed the meager pace of standard-setting at the IAIS on the open decision-making rules; a World Bank official stated the IAIS needs "less consensus" in standard-setting and "needs to be able to deliver its policies and standards away from industry and political pressures."[821]

In addition to an open decision-making rule that slowed substantive deliberations in the late 1990s and early 2000s, former IAIS members note that the organization lacked resources and expertise. As one participant recalls, "The secretariat had half a dozen people. Quite a few people from national authorities are involved in committees and task forces, but the work is done by the same people. They tend to be from the developed jurisdictions that have the time and resources."[822] One former chair of the Technical Committee attributes his selection as chair to the meager pool of candidates: "I am not trying to be rude here, there were a limited number of high quality people in the organization, so it almost sort of happened by itself [that I was selected]."[823]

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[819] Correspondence with Tom Karp, email (6 December 2012).

[820] Interview with Michael Hafeman, phone (7 May 2012).

[821] Young (2005).

[822] Interview with Michael Hafeman, phone (7 May 2012).

[823] Seddon interview with Tom Karp, phone (6 December 2011).

In December 1999, low resources and US advocacy drove the decision to invite non-regulators into IAIS meetings: for a fee, these "observers" would be allowed into the annual meeting and allowed to contribute to consultations and standard-setting discussions.[824] Although national regulators convene meetings that are closed to non-regulators, observers, including *Comité des Assurances*, Lloyd's, and A.M. Best (insurance credit rating agency), can participate on subcommittees and working groups at the discretion of the chairs. As one industry official characterized the set-up: "It is a bit strange that the IAIS relied on funding from its member-observers. It's a slow moving beast, which is quite helpful to us actually."[825]

One industry official I spoke to jokingly called the IAIS a "global traveling roadshow."[826] The IAIS was certainly in the early stages of institutional development in the late 1990s and early 2000s. Former IAIS members believe that the institution served a useful information-sharing role in the 1990s, instead of a standard-setting one, given the lack of consensus on a substantive direction.[827] It did not—and still does not—produce legally binding principles or standards, although the IMF's use of the Insurance Core Principles to monitor countries' financial systems have "given the IAIS more credibility."[828]

In sum, the FSA chose to push for a non-legally binding international standard on risk-based capital at a largely under-staffed and under-resourced IAIS in the early 2000s. The IAIS appeared the most satisfactory soft international institution available because the FSA could take the lead there. Not only had the G-7 and IMF snubbed the OECD Insurance Committee, but also financial supervisors such as the FSA would not have been the lead representatives at the OECD. The OECD Insurance Committee membership rules

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[824] Interview with Tom Karp, phone (10 May 2012); *Asia Insurance Review* (February 2000).

[825] Interview with Alastair Evans, London (4 May 2012).

[826] Ibid.

[827] Interviews with Tom Karp, Rob Curtis, Michael Hafeman.

[828] Interview with Alastair Evans, London (4 May 2012).

instead favored government ministries (e.g. Department of Commerce represented the US).

Furthermore, despite its open rules, the exchange of views at the IAIS greatly assisted the FSA in learning the preferences of countries, especially other EU Member States. This is consistent with the propositions made on the usefulness of open rules in Chapter 2 (pp. 44-46). As one FSA official recounted, "In the early days, the FSA considered IAIS as a useful debating forum for issues that would come up later in Solvency II. We could have a freer discussion among regulators in IAIS than in Europe."[829] The frank exchange of views helped the FSA's efforts to develop a technical consensus for an internal modeling-based standard at the EU level.

IV. Bargaining

In the early 2000s, the UK FSA wanted to set a soft, international, and internal modeling-based capital standard at the IAIS. Although it was the consolidated regulator and supervisor in the UK regulatory structure, the FSA did not have a consensus with the fragmented UK insurance industry on how to regulate the London Market. Nevertheless, an IAIS standard would allow the FSA to set the EU agenda on insurance regulatory reform and legitimize its preference for an internal modeling-based standard for the London Market.

However, the FSA's bargaining efforts produced only a shallow IAIS standard that did not significantly change the international status quo. In the same standard, the FSA sought an endorsement of market-based valuation, an accounting standard that would complement internal modeling. The IAIS Principles on Capital Adequacy and Solvency, adopted in 2002, merely *acknowledge* the possible use of internal models by firms (subject to supervisory discretion) and make no endorsement of specific accounting standards.[830]

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[829] Interview with Ed Forshaw, London (8 May 2012).

[830] In this case, it was difficult to determine all the individuals who actually negotiated the IAIS Principles of Capital Adequacy and Solvency in the early 2000s. With only a handful of staff at the IAIS Secretariat,

In the following, I first define the international status quo and describe the preferences of actors from key jurisdictions, including Germany and France, who supported the FSA at the IAIS. However, this broad international momentum crashed into the resistance of the US National Association of Insurance Commissioners (NAIC) and US state regulators. The NAIC attempts to represent a completely fragmented, state-based regulatory structure, and so would not seem to be an able defender of the status quo. Yet, it was. The IAIS used consensus-based, open decision-making rules during standard-setting negotiations, which allowed the US NAIC and state regulators to dilute the UK FSA's proposals for a substantively deep standard.

After bargaining at the IAIS, the UK FSA quickly implemented a more risk-sensitive framework for the London Market and set standards prescribing internal models, despite the substantial compliance costs for the general insurance companies and Lloyd's. The UK FSA has further sought to establish its regulatory approach as the *de facto* global standard through the equivalence process associated with Solvency II. The EU's progress on Solvency II has forced the NAIC and US state regulators to consider a more risk-sensitive framework for insurance capital standards.

International status quo

As outlined in the two-step theory, the international status quo is the exogenous international policy outcome in case bargaining fails. What would the international status quo be if the UK FSA failed to forge an IAIS standard? There would be no coordinated, international approach to insurance capital adequacy based on internal modeling. Most

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record-keeping of attendance and meetings appears to have been poor. For example, when I requested a list of members of the Solvency & Actuarial Issues Subcommittee during this time period, the IAIS Secretariat informed me that no such list existed. Interviews that I conducted partially fill this gap. Participants involved in bargaining valiantly attempted to recall their and others' views. But it is not surprising that international political economists have ignored the efforts to create an international standard on insurance capital rules; perhaps the only other account, in Singer (2007), devotes only four paragraphs to the bargaining I describe below. Interview with Sebastian von Dahlen, phone (30 April 2012).

likely, national regulators would continue to develop risk-sensitive standards based on cash-flow and scenario-based internal models, instead of the US NAIC's static risk factor formula. The US NAIC appeared to be the lone hold-out among major jurisdictions in the move to more risk-sensitive standards.

In the early 2000s, Germany and France, while receptive to the FSA's proposals at the IAIS, sought to change their own standards through the legally binding EU process.[831] The Australian and Canadian insurance regulators launched a "total balance sheet" regulatory approach, which accounts for both the asset and liability sides of the balance sheet and interactions between different risks.[832] Swiss authorities were developing what would become known as the Swiss Solvency Test, a comprehensive scenario-based, dynamic framework that incorporated internal modeling.[833] In Asia, Singapore had begun to move from a risk factor-based framework to considering underwriting and interest rate risks under a more dynamic scenario-based framework.[834]

For EU Member States, the status quo was defined by a non-life insurance framework directive, the latest version adopted in 1992. As with other financial services directives, the non-life directive permitted EU insurers to operate with a single passport throughout the internal market, subject to home-country control and supervision of insurers' capital adequacy.[835] As discussed above on pp. 266-267 in the context of the UK, the EU non-life capital standards crudely and statically measured risk. The required EU "solvency margin" was equal to the higher of two calculations based on annual premium income and average claims paid. The directive required each insurer to maintain a minimum guarantee fund depending on the categories of risks the company insured, and it regulated the types of assets in which the insurer could invest.[836]

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[831] CCA (2002).

[832] Interview with Tom Karp, phone (10 May 2012).

[833] Holzmüller (2009).

[834] CEA and Mercer Oliver Wyman (2005): 9.

[835] This directive (92/49) further amended the first non-life (1973) and second non-life (1988) insurance directives.

[836] Clifford Chance (1997): 22-25.

Support for internal modeling-based standard at the IAIS

At the IAIS, the UK FSA was well-positioned to influence the standard-setting process. Key FSA officials in important positions at IAIS could direct appropriate subcommittees to develop initial drafts of principles or standards, which would then proceed for approval or redirection to the Technical and Executive Committees, followed by possible adoption at a General Meeting.[837]

Martin Roberts, Director of the FSA Insurance and Friendly Societies Division, served as chairman of the Technical Committee, while the FSA's Paul Sharma served as chair of the Asset Valuation Subgroup, an influential offshoot of the Accounting Subcommittee.

The Solvency & Actuarial Issues Subcommittee chairman recalled, "Martin [Roberts] was supportive of the direction that we were going in. The UK was generally quite aligned on our solvency work."[838] Another participant stated, "The UK was philosophically agreeable to the path for dynamic modeling and principles-based regimes. Though they hadn't moved domestically yet at that point, they were going to move quickly."[839]

The UK FSA's most important supporters at the IAIS were French and German regulators. French and German officials were content to generally support the FSA at the IAIS, but focused more of their engagement at the EU level. Policy differences did exist in this European coalition, especially regarding the accounting rules to be used in the calculation of capital requirements. Nevertheless, all three EU Member States preferred to move away from the prevailing risk-insensitive capital standards and towards risk-sensitive internal modeling-based standards.

[837] Kawai (2004).

[838] Interview with Michael Hafeman, phone (7 May 2012).

[839] Interview with Tom Karp, phone (10 May 2012).

In 2002, Germany was home to the largest insurance sector in Europe. Its leading insurer Allianz collected €60 billion in gross premiums. Munich Re was the country's largest re-insurer and second-largest primary insurer. The acquisition of Dresdner Bank, one of the largest German commercial banks, by Allianz exemplified the *bancassurance* conglomeration trend that also confronted UK regulators.[840] As a result, just a few years after the tepid conclusions of the Müller Report, German officials began to explore more risk-sensitive capital standards.

German regulators and industry alike were interested in capital standards reform. The secretary-general of the IAIS, Knut Hohlfeld, previously led the German Federal Insurance Supervisory Authority (BdV), and found risk-based approaches appealing.[841] In early 2001, the head of the German insurance industry association (GDV) declared that "any future-oriented supervision would have to put more emphasis on the individual risk exposure and financial strength of the individual insurance company…. It is necessary for insurance supervisors to create a set of instruments for asset liability evaluation and risk control."[842]

In 2002, the GDV industry association issued a standard model for life and non-life insurers.[843] Similar to the FSA risk-based standards for general insurance in the early 2000s, the GDV standard was classified by *Comité des Assurances* as a risk factor-based model, considering investment, loss reserve, and business risks, among others. Developed in conjunction with the BAV regulator, the standard was regarded as a relatively sophisticated model with highly differentiated risk classifications.[844] At the same time, the GDV advocated the use of internal models for larger insurance companies.[845]

In France, regulators of the third largest insurance sector in Europe were not as far down the path towards risk-based rules or internal modeling as Britain and Germany.

[840] Economist Intelligence Unit (March 2002).

[841] Quoted in Ratcliffe (2000).

[842] Klaus-Wilhelm Knauth quoted in *Asia Insurance Review* (2001).

[843] Schubert and Grießmann (2007): 133.

[844] CEA and Mercer Oliver Wyman (2005): 9-10, 14, 28.

[845] Ibid.: fn13, 11.

Nevertheless, French regulators perhaps most acutely faced the difficulties of supervising large *bancassurance* companies.[846] Banks distributed 60 percent of life insurance products, which are a popular savings vehicle for French citizens. Most of the largest companies have strong links to banks, such as the largest insurance company, Axa, which owns its own bank, and CNP Assurances, the leading life insurer that is owned by the publicly supported CDC Group and savings banks.[847] Mutual and cooperative insurers are not as small or medium-sized as in Germany and make up a large proportion of the French insurance sector.[848]

French rules shared a number of similarities to the FSA's framework in the early 2000s. For example, as in the UK, French authorities permitted companies considerable freedom on how to statistically assess provisions for outstanding claims,[849] while the French insurance regulator used its own model to assess companies' solvency.[850]

The greatest contrast with the UK was the result of different accounting traditions: whereas the French used a so-called prudent approach ("cost basis") in valuation, the UK used a market value ("fair value," "mark-to-market") basis that could result in more volatility in the measured solvency of an insurer.[851] In this regard, the French rules could be more conservative than the British rules: when the market value of an asset is greater than its cost, solvency was underestimated under French rules.[852]

Although French officials at IAIS supported moving towards a risk-sensitive standard, they were only amenable to a standard that did not endorse a particular accounting regime. At the Technical Committee level, the French representative had "very strong views on the issue of valuation," and declined to endorse any language that could have implied standards

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[846] Economist Intelligence Unit (October 2002).

[847] Ibid.

[848] Dupont and Kujawa (2005).

[849] European Commission (May 2002): 87-88.

[850] Ibid.: 94. This was cited as "emerging best practice."

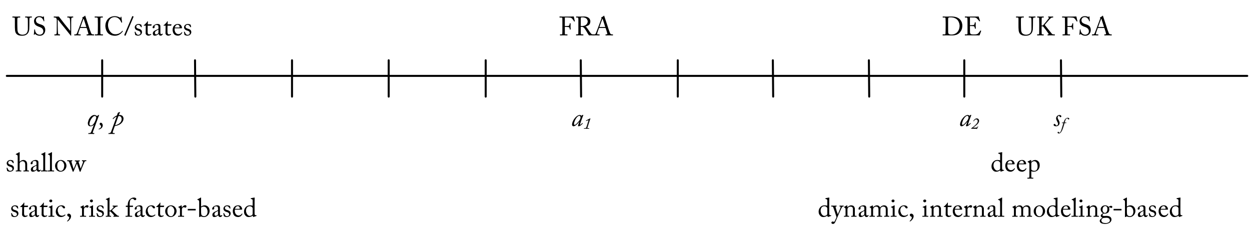
[851] Ibid.: 113.

[852] Ibid.: 116.

differing from the French Generally Accepted Accounting Principles.[853] Despite their resistance on valuation, the French did not seek to halt the standard-setting process.[854]

With varying progress domestically towards risk-sensitive rules, Germany and France generally supported a move towards the UK FSA's preference; they all faced common challenges in the conglomeration of financial firms and markets and had already demonstrated openness to different types of risk assessment. As one participant recalls, "Britain, France, and Germany were generally on the same page, but they weren't great at coordinating. They would often opine separately."[855] With support of national regulators from the largest European insurance markets (as well as Denmark, Finland, Italy, the Netherlands, and Switzerland),[856] the FSA had considerable momentum towards a non-legally binding standard—until it confronted the recalcitrance of the US NAIC (see Figure 6.1 below).

Figure 6.1: Preferences at the IAIS on risk-based capital standards



US NAIC & state regulators: fragmented state with minimal international engagement

The US insurance regulatory structure conforms to the ideal-typical presentation of a fragmented state and its concomitant tensions: poorly integrated regulators and industry associations, competition between states and with the federal government over regulatory

853 Interview with Ed Forshaw, email (23 May 2012).

854 Interview with Rob Curtis, phone (30 May 2012).

855 Interview with Alastair Evans, London (4 May 2012).

856 Belgium, Portugal, and Spain appeared content to wait for a final EU standard before reforming national rules. Taylor-Gooby (2007).

mandates, and concentration of public authority in state regulators. This section historically details this structural fragmentation and traces the NAIC's efforts to establish national solvency regulation, resulting in a preference for the international status quo that it sought to defend at the IAIS.

Fragmentation in the US insurance market and regulatory structure has been long entrenched. Massachusetts established requirements for annual reporting in 1818, New Hampshire set up the first state insurance regulator in 1851,[857] and the Supreme Court established the primacy of state regulation in 1868, deciding that insurance did not fall under the definition of "interstate commerce" and thus could not be regulated by the federal government.[858] However, as the US insurance market grew, the Supreme Court decided in 1944 that insurance actually does constitute interstate commerce, thereby threatening to deprive states of $120 million in annual premium taxes.[859]

To the states' defense came the National Association of Insurance Commissioners (NAIC), which was created in 1871 as a forum for exchanging views among state regulators and developing common approaches to financial reporting among life insurers.[860] Along with the insurance industry, the NAIC successfully lobbied Congress to retain the states' regulatory prerogative by drafting a model bill that formed the basis of the McCarran-Ferguson Act of 1945.[861] Despite the policy interest of Congress in health insurance and environmental issues, states retain regulatory authority over the life and general insurance markets.

Until recently, the insurance industry has wholeheartedly supported state-based regulation. Smaller, regionally or locally focused insurers fear a higher regulatory burden that might be associated with federal regulation,[862] whereas the larger life insurance companies have been

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[857] Webel and Cobb (2005).

[858] *Paul v. Virginia*.

[859] 1945 figures, see fn 33 in Webel and Cobb (2005): 8; *US v. South-Eastern Underwriters Association*.

[860] Klein (2009): 32-33.

[861] Webel and Cobb (2005): 10.

[862] Webel (2003): 4.

dissatisfied by the compliance costs required to conform to fifty-six different jurisdictions' requirements.[863] Nevertheless, the opportunity for regulatory arbitrage is prominent, as states widely differ in levels of resources and expertise devoted to supervision and monitoring.[864] The NAIC attempts to mitigate arbitrage through inter-state cooperative agreements, but major jurisdictions often do not join them. For example, California, New York, and Florida did not join NAIC-coordinated reciprocal agreements on licensing of insurance brokers (despite the agreement of thirty-eight states).[865]

As expected in fragmented states, a multitude of industry associations compete to increase membership and jostle to influence regulators. The life industry is represented by the American Council of Life Insurers (ACLI).[866] ACLI co-exists with state-based associations, such as the powerful Life Insurance Council of New York and National Conference of Insurance Legislators. General insurance companies are represented by the American Insurance Association, Property Casualty Insurance Association, National Association of Mutual Insurance Companies, and Reinsurance Association of America, while health care associations and brokers associations also abound; the American Bankers Insurance Association promotes interests of financial conglomerates created after the Gramm-Leach-Bliley Act of 1998. No national, peak-level association exists to synthesize these many different organizational and policy interests.

US NAIC & state regulators: no incentive to change the status quo

In the early 2000s, the US NAIC had no incentive to change the international status quo on prudential regulation of insurance companies. It had just gone through a grueling decade of trying to convince state regulators to implement common risk-based capital rules, which were based on static fixed factors. This section details how a string of failures in the US general insurance market (known as "property and casualty insurers") pressured the

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[863] Klein (2009): 34.

[864] GAO (1987): 12.

[865] Webel (2003): 3.

[866] Webel (2008): 2.

NAIC to create solvency regulation, even though it was unable to make its rules binding on state regulators. Despite structural fragmentation, the NAIC's proposed solution of simple risk-based capital rules sufficed to keep the federal government at arm's length.

In the 1980s, US state insurance regulators failed to stem a cascade of general insurance company failures because of low resources, poor information-sharing, and weak regulation. Aware of mis-pricing of premiums and fraud, state guaranty fund associations failed to warn regulators out of fear of litigation, despite their material interest in avoiding insolvencies.[867] State regulators were divided in their willingness to share information with other states for fear that sharing would hurt efforts to rehabilitate failing companies.[868]

A majority of states had insurance supervisors unqualified by NAIC standards.[869] The Insurance Superintendent of New York, one of the best-resourced states, admitted, "The problems relate mainly to personnel. We need more actuaries, for example…. We have become increasingly sophisticated, but with more funds, we can do more."[870]

The NAIC and its lack of binding authority over state regulators received much of the blame for the inadequacies of the fragmented insurance regulatory structure. In 1990, the federal government auditor (General Accounting Office; GAO) reported that state regulators found the NAIC's Insurance Regulatory Information System (IRIS) unhelpful because it relied on untimely, unverified annual statements and failed to consider management factors in insolvency or provide available sources on solvency, such as prior examinations and ratings.[871] The GAO testified before Congress that it "does not believe that NAIC can successfully establish a national system of uniform insurance regulation because it does not have the authority necessary to require states to adopt and enforce its

[867] GAO (1987): 13-14.

[868] GAO (1989): 24.

[869] GAO (1989): 22.

[870] Salvatore Curiale quoted in *Reactions* (1991).

[871] GAO (1990): 22.

standards," adding that even if states ceded their authority to NAIC, they could always revoke it: "In effect, NAIC would regulate at the pleasure of those it regulates."[872]

In an influential report, a congressional subcommittee criticized the occurrence and handling of insurance insolvencies: "They encompass scandalous mismanagement and rascality along with an appalling lack of regulatory controls to detect, prevent and punish such activities."[873] Powerful congressman John Dingell introduced legislation to create an independent federal insurance regulator to oversee new solvency standards.[874] The specter of federal regulation finally pushed the NAIC to pursue risk-based capital rules in the form of a non-legally binding model law that states could adopt.

When the NAIC finally finished standard-setting for general insurance companies,[875] its risk-based capital (RBC) requirement for each company was based on a static formula (i.e. no stress testing, except for life insurers' reserves) that accounted for four kinds of general insurance risk: asset, credit, underwriting, and growth.[876] As capital fell in an under-performing or failing company, regulators could increasingly intervene to boost the capital base of the company.[877]

The NAIC RBC rules were part of a broad solvency program accepted in 47 states and the District of Columbia by 1999. Despite considerable weaknesses remaining in the NAIC process of monitoring and accreditation,[878] the GAO nevertheless concluded that the NAIC RBC rules had helped achieve a "level of consistency far superior to what existed before the [solvency] program."[879] Thus, it appeared that the NAIC response to federal

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[872] Fogel (1991).

[873] Representative John Dingell of Michigan quoted in McLaughlin (1991).

[874] *Federal & State Insurance Week* (1992).

[875] Simpson and Kellogg (February 1994).

[876] CEA and Mercer Oliver Wyman (2005): 28; Bannister (1993).

[877] Atchinson (1997): 64.

[878] GAO (2001): 14.

[879] GAO (2001): 7.

pressure in the early 1990s had helped secure its autonomy and dampen the prospect of federal regulation.

Also in the 1990s, the NAIC began its half-hearted engagement at the international level. It helped create the IAIS as part of an effort to bolster its international standing.[880] The IAIS was an offshoot of the NAIC's International Insurance Relations Task Force (which had previously discussed insurance services liberalization).[881] Before it established itself in Basel, the IAIS relied on the NAIC for its secretariat functions in the mid-1990s.

Although the IAIS was conceived as "more mission and issue-oriented than model law-oriented,"[882] one of the first discussions at the IAIS involved accrediting Mexico for implementing the NAIC's risk-based capital rules. Yet, domestically oriented NAIC officials were not eager to export their standard, arguing that "several years" would be needed for NAIC examiners "to look at its [Mexican] laws, regulations and examination practices and procedures and certifying its implementation of the RBC rules."[883] Given that domestic pressure and interests more than dominated NAIC resources, it has historically discounted international dimensions: "It's [NAIC] basically a way for state regulators to hash out problems in an open public forum, make decisions and then go back to their state Legislatures to move them forward."[884]

In sum, the NAIC devised its simple risk-based capital rules under heavy scrutiny and pressure from Congress and the US insurance industry. It also established the IAIS, albeit with a meager budget, as a forum for information exchange and discussion. The NAIC was well into the process of writing its proposals for new risk-based capital rules by the time the IAIS was established; as a result, the NAIC did not have access to an international

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[880] Fletcher (1992).

[881] *The Review* (1990).

[882] David Walsh, founding IAIS chairman, quoted in *Bestwire* (April 1994).

[883] *Bestwire* (July 1994). This observation contradicts a "level playing field" argument, which would suggest that the US NAIC would be motivated to export its rules abroad if it was primarily concerned with the industry's competitiveness.

[884] NAIC spokesman quoted in Mitchell (1998).

institution that would increase its leverage vis-à-vis state regulators and Congress. With new standards that sufficed to keep Congress from usurping states' insurance regulatory prerogatives, in the early 2000s, the NAIC did not want to disturb either the domestic or international status quo.

The US NAIC & state regulators object to UK FSA's proposals

Despite the lack of coordination among NAIC and US state regulators, they agreed on one thing: resisting the development of any standard at the IAIS that would endorse a more risk-sensitive, internal modeling-based approach. Such a standard would require extensive changes to the NAIC risk-based capital rules, as well as prevailing insurance accounting practices. US fragmentation was actually an asset at the IAIS, which had flexible membership rules: different NAIC and state officials could easily serve on the Solvency Subcommittee, relevant working groups, and the Technical Committee.

According to a former chair of the IAIS Technical Committee, "There was no strictly *American* representative, but only some individual state commissioners. The commissioners from West Virginia, Maine, and maybe Iowa would come along. Their effectiveness depended on their expertise as individuals, and they were more often political appointees than professional insurance officials."[885]

As laggards, the NAIC and state regulators often engaged only after the UK FSA had negotiated with other IAIS members and circulated proposals for comment. According to a senior FSA official involved in the process:

> The Americans always came in late. We [FSA and other members] would spend time negotiating, send the paper out for consultation, and that's when the NAIC responded. They did not regard the IAIS as a priority for them. France, Germany, UK, Italy, we all engaged actively. The coordination was not there at the NAIC to develop positions, so they always came in very late in the day.[886]

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[885] Interview with Tom Karp, phone (10 May 2012).

[886] Interview with Ed Forshaw, London (8 May 2012).

The consensus-based, open decision-making rules at the level of subcommittees and working groups advantaged US representatives. No matter how disorganized or late they seemed, they could easily defend the status quo. According to the Canadian chair of the Solvency Subcommittee:

> The US representatives did not want to move their system. They believed that their risk-based capital system worked well, and so why should they tinker with it in a significant way? It's a long process to update standards with all the states agreeing through NAIC and then getting state governments on board. They weren't too keen to make significant changes.[887]

The NAIC was fighting a battle on multiple fronts. The UK FSA's proposals at the IAIS included major changes in accounting rules and practices that would render balance sheet and regulatory capital calculations more sensitive to market price changes—and if market prices were unavailable, then internal models could be used as substitutes. The International Accounting Standards Board (IASB) supported similar changes, but the NAIC and state regulators had long sought to prevent the use of such fair-value or "mark-to-market" accounting for regulatory purposes. Instead, as reflected in its risk-based capital rules, the NAIC supported a more conservative approach that did not subject an insurance company's capital base to mark-to-market adjustments or stress test scenarios.[888]

The NAIC believed the FSA's favored combination of internal modeling and fair-value would introduce unnecessary and unfounded volatility: "Fair value estimates are inherently based upon the judgment of the enterprise. Estimates for interest rates, inflation and credit risk are just some examples of variables subject to significant amounts of management judgment."[889] The NAIC stressed that such accounting is not appropriate for regulatory purposes, which it argued require "conservative valuations of assets and liabilities. A fair value accounting model, where liabilities are established on the basis of best estimate

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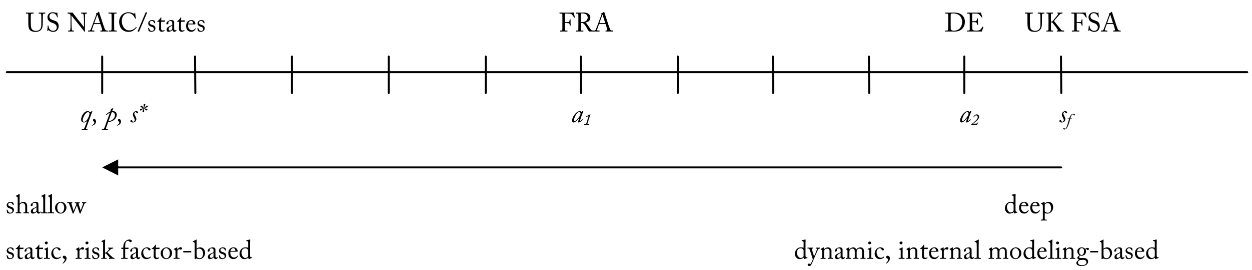
[887] Interview with Michael Hafeman, phone (7 May 2012).

[888] Simpson and Kellogg (December 1994).

[889] Kelley (2000).

assumptions together with market value margins, may not provide sufficient solvency information to the regulator."[890]

Figure 6.2: Bargaining on the IAIS Principles of Capital Adequacy and Solvency



The US NAIC and state regulators prevented the UK FSA and other regulators from writing an IAIS standard that endorsed or prescribed internal modeling and fair-value accounting for insurance capital standards (Figure 6.2). The result was that the subsequent Principles of Capital Adequacy and Solvency reflected the international status quo (*q*). A former chairman of the IAIS Technical Committee described that "[t]he NAIC wanted to slow the exercise down because they do not use a true economic accounting model. It's a model with locked-in assumptions. If they let this discussion on a market-based approach go too far, they could end up with something that would leapfrog where they were."[891]

US representatives at the IAIS were easily outnumbered in their views, while FSA officials had support from other European officials. EU Member States supported moving towards International Financial Reporting Standards (IFRS) that embraced fair-value accounting; without a common EU accounting standard, they "preferred an international standard instead of just signing up to the US standard."[892]

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[890] Ibid.

[891] Interview with Tom Karp, phone (10 May 2012). Dating from the 19th century (or earlier), net premium valuation is a simple actuarial method for calculating a life insurer's liabilities. See Carroll (1974).

[892] Interview with Michel Prada, Paris (20 November 2012).

The NAIC and state regulators had no interest in being leapfrogged by the UK FSA and other regulators through an IAIS standard that relied on internal modeling and fair-value accounting. The chair of the Solvency Subcommittee recalled trying to forge a deep standard:

> The US held up the process. At one point, I proposed a common framework for developing a solvency standard and tried to pull things together instead of continuing to do piecemeal work. I met with Svein [Andresen, Secretary-General of the former Financial Stability Forum] to talk about it. But, the Europeans tried to have a side meeting with the American representatives about moving in the direction of a common standard, and the meeting blew up.[893]

Thus, US officials from the NAIC and state regulators forced bargaining on the substance of the FSA's proposals to a standstill. Under open decision-making rules, they were the pivotal voter (Figure 6.2). Under a more restrictive decision-making rule, the UK FSA would have been able to negotiate a far deeper standard than what was produced by the end of 2001.

IAIS Principles on Capital Adequacy and Solvency

The IAIS Principles on Capital Adequacy and Solvency are most notable for their vagueness and lack of endorsement for any specific regulatory approach to capital adequacy. The fourteen Principles, which were adopted in January 2002, cover areas ranging from technical provisions to overall risk management. The Principles on Capital Adequacy and Solvency followed up on the Insurance Core Principles, which only generally described the need for national implementation of capital standards and which the IMF used in assessment of national insurance regulation across jurisdictions. The scope of the principles on capital adequacy is wide, applying to both life and non-life (general) insurance companies.

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[893] Interview with Michael Hafeman, phone (7 May 2012).

The IAIS Principles adopted in 2002 were not prescriptive; instead, they represented the international status quo. For example, Principle 6 suggests that "capital adequacy and solvency regimes have to be sensitive to risk," but punts on critical issues such as valuation ("the valuation of assets and liabilities depends on the accounting framework of the jurisdiction"), and provides no endorsement for—only acknowledgement of—the use of internal modeling: "Supervisors may consider the use of internal capital models as a basis for a capital requirement as long as this model is assessed as adequate for the purpose by the supervisor."[894] Contrary to what the UK FSA hoped for, the IAIS Principles do not present a three-pillar approach to prudential insurance regulation along the lines of Basel II for banks.

Bargaining over the IAIS Principles failed to live up to lofty expectations. In 2000, IAIS Secretary-General Knut Hohlfeld had boldly announced that the "goal of the IAIS is to create a global standard or standards covering solvency (capital) requirements by autumn 2002."[895] The effectiveness of US opposition in the context of consensus-based, open rules proved this goal far too sanguine.

Post-bargaining outcomes for the first-mover UK FSA

After negotiations with US officials deteriorated at the IAIS, the FSA turned its attention to Europe: "Solvency II negotiations rapidly overrode the IAIS process. Conceptually the IAIS was useful, but the reality of Solvency II took over. IAIS took a back seat after that from the FSA's point of view. We still supported it, but our resources were more devoted to Europe."[896] With some legitimacy gained from its efforts at the IAIS to develop internal modeling-based capital standards, the FSA continued to push at the EU and domestic levels for dynamic, risk-sensitive rules.

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[894] IAIS (2002): 7.

[895] Quoted in Ratcliffe (2000).

[896] Interview with Ed Forshaw, London (8 May 2012).

As bargaining at the IAIS concluded in 2001, the FSA focused on addressing domestic scrutiny after the failures of Equitable Life and Independent Insurance. The FSA's Tiner Report,[897] published in November 2001, called for "minimum capital requirements that are more responsive to the risks which insurance firms face" and set at a "more realistic but proportionate level," as well as change in "inflexible accounting methods for technical provisions for general business" and a move to "a system which is broader in scope, fully encompassing all aspects of the 'three pillar approach' proposed by the Basel Committee for the banking sector."[898]

Soon thereafter, in December 2002, the EU Conference of Insurance Supervisory Services published an influential report on prudential insurance regulation. Paul Sharma led the drafting of the report; Sharma was Head of Prudential Risks at the FSA and chair of the valuation subgroup at the IAIS. By examining a wide range of factors contributing to insurer failures between 1996 and 2001, the Sharma Report advocated a holistic approach to prudential insurance regulation by detailing thirty-six different kinds of risk that caused various types of failure, decisions, and financial outcomes.[899]

Importantly, the Sharma Report proposed a "three-part" approach that corresponded to the three pillars of Basel II: capital adequacy and solvency requirements; early-warning and diagnostic tools to facilitate supervisory monitoring and intervention; and quality assessment of management and corporate governance.[900] The Report concluded that "management is the most common underlying cause" of insolvency—and recommended internal modeling to incentivize positive management.[901] The Report declared that "we

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[897] John Tiner was CEO of the FSA.

[898] FSA (2001): 30.

[899] Conference of the Insurance Supervisory Services of the Member States of the European Union (2002): 22.

[900] Ibid.: 70-74.

[901] Ibid.: 38.

believe solvency levels should be linked to a firm's exposure to risk."[902] It further endorsed catastrophic modeling and frequent stress-testing of adverse scenarios.[903]

Through its insistent bargaining at the IAIS, the Sharma Report at the European level, and the Tiner Report on UK insurance reform, the FSA influenced the European Commission (EC) in setting the agenda for Solvency II. Before the EC issued a proposal, it commissioned KPMG to produce a study on insurance regulatory reform that confirmed the FSA's preference for a Basel II-like three-pillar approach, internal modeling, and fair-value accounting.[904]

The FSA's CEO John Tiner concurred with the KPMG report's conclusions, hinting at his organization's role: "We have seen the draft of the European Commission's report by KPMG into Solvency II and it confirmed our own thinking…. I hope Solvency II is not deferred."[905] Market participants recognized the leading role of the FSA, which headed "a working party [in the EU] that is designing an approach to Solvency II…. It would be unusual if this body [European Commission] were to adopt a completely different approach, particularly since the FSA's proposals move insurance regulation to being closer in line with banking regulation."[906]

The Commission officially proposed Solvency II in 2007. It mimics the three-pillar approach of Basel II,[907] and it incorporated internal modeling in the calculation of capital requirements. Just as in Basel II, a risk-sensitive standard formula exists for smaller firms that would otherwise be burdened by the technology costs of implementing internal

[902] Ibid.: 71.

[903] Ibid.: 47, 51.

[904] European Commission (May 2002): 66-68.

[905] Quoted in *Post Magazine* (2002).

[906] Corinne Cunningham, analyst at Royal Bank of Scotland, quoted in *Euroweek* (2005).

[907] For a good comparative analysis, see Verma (2009).

models.[908] German officials successfully sought applications of the standard formula that would suit their small and medium-sized insurers.[909]

As at the IAIS, French officials were concerned with the use of fair-value accounting in Solvency II to determine capital requirements.[910] British representatives compromised with their French counterparts. Solvency II would not directly refer to fair-value rules in the International Financial Reporting Standards (IFRS) regime. Instead, "Solvency II ended up as a regulatory standard with its own valuation rules. It does not rely on other accounting standards. There was a vague expectation that it might have early on, but we [the FSA] moved on."[911]

After bargaining at the IAIS but before Solvency II negotiations produced any legally binding EU standard, the FSA reformed capital regulation of the London Market. For both Lloyd's and the general insurance companies, beginning in 2004, the FSA calculated minimum capital requirements using a factor-based model called Enhanced Capital Requirements and issued Individual Capital Adequacy Standards (ICAS) based on the quality of risk management and underlying risk profile of the firm.[912] Although it admitted that "there is no prescribed modelling approach for how a firm develops its internal model,"[913] the FSA encouraged firms to develop internal models as a substitute for FSA-prescribed risk assessments:

> Where firms develop alternative approaches to risk assessment such as holistic or economic capital models, and where they can demonstrate that these

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[908] The standard formula can account for the following risks: non-life underwriting, underwriting, health underwriting, market, counterparty default, and operational risks. See Purves (2011, 639-646) for details on all three pillars.

[909] *Dow Jones International News* (2007).

[910] *Post Magazine* (2005).

[911] Interview with James Orr, London (9 May 2012); Interview with Ed Forshaw, email (23 May 2012).

[912] FSA (2003).

[913] Ibid.: para. 2.4.51.

> models explicitly or implicitly capture adequately all of the risks covered in the guidance, they need not carry out the separate assessments.[914]

The FSA also requested that general insurance companies and Lloyd's submit their internal models and justifications of modeling assumptions for supervisory approval. Internal modeling-based capital standards thus comprise an iterative, individualized standard-setting process conducted by the FSA.

The FSA sought to incentivize the use of internal modeling to alleviate its own resource constraints. An official who directed Lloyd's risk management, and then prudential standards for general insurance at the FSA, reflected on the emphasis on modeling in the FSA regime and Solvency II: "We are all turning into life actuaries…. The UK's view is that the firms have more resources. So, they should do this work to calculate regulatory capital needs. The FSA is skeptical of what seems to be rules-based because if there are gains to be made, then the economic benefit to firms has to be central."[915]

Despite possible economic benefits, the FSA was not motivated to set a global "level playing field" in insurance regulation. If the FSA sought to boost the competitiveness of the London Market—as would be expected in the case of a coordinated state—then the FSA would have pressured other jurisdictions to implement the expensive internal modeling-based capital standards on an agreed-upon timeline. But, regulators in EU member states are not required to use the internal modeling-based capital standards in Solvency II until *January 2014* (as of writing).

Instead, the London Market faced major compliance costs ten years before other European companies did, as a result of the FSA's insistence on implementation. The FSA's ICAS regime served as forerunner to Solvency II for the London Market; it increased general insurance companies' capital needs by $4.64 billion, and 30 percent of companies were

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[914] Ibid.: para. 5.15, 42.

[915] Interview with James Orr, London (9 May 2012).

expected to fail the initial ICAS standards.[916] Compliance costs for companies reached £200 million by late 2010.[917] At Lloyd's, ninety-five auditors, actuaries, and risk management professionals had been hired during the ICAS regime and in advance of Solvency II implementation;[918] compliance costs for Lloyd's alone are expected to reach up to $480 million.[919]

Instead of moving consistently with other jurisdictions to create a level playing field, the FSA's approach to the London Market through the ICAS regime transformed discussions at the EU and the IAIS, despite the difficult bargaining over the Principles on Capital Adequacy and Solvency. A former chair of the IAIS Solvency Subcommittee argued, "Solvency II is theoretically sound, but it's become very complicated. That complication has been carried over into IAIS standards."[920] Yet, FSA officials insist that their approach, which Solvency II reflects, should be embedded in international standards: "For the FSA, one thing we would not want is for global standards to now undermine what was achieved in Solvency II."[921]

Although they produced only a very shallow IAIS standard, the FSA's efforts at the IAIS set the EU agenda on insurance reform that has now impacted the US NAIC and state-based regulators. Worried that the global insurance industry would quickly gravitate to EU regulations based on internal modeling, the NAIC launched the Solvency Modernization Initiative (SMI) in June 2008. The European Commission is evaluating US NAIC and state regulatory standards through its equivalence process. US insurers seeking continued access to the EU internal market may be barred if NAIC and state-based regulation is not deemed equivalent to EU standards. The SMI seeks to compare the NAIC's existing static risk-based capital (RBC) model to Solvency II and "consider the potential impact that Solvency II might have on US insurers, focusing on the following areas: capital

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[916] Miller (2004).

[917] *Review* (2010).

[918] Interview with Alastair Evans, London (4 May 2012).

[919] *Business Insurance* (2011).

[920] Interview with Michael Hafeman, phone (7 May 2012).

[921] Interview with Ed Forshaw, London (8 May 2012).

requirements; international accounting; group supervision; valuation issues; and reinsurance."[922] The SMI is indicative of the American response to the race-to-the-top "California effect" of the EU equivalence process discussed in Chapter 4 (p. 147).

The European Commission did not short-list the US for consideration as equivalent in the first round of evaluations—while Bermuda, Switzerland, and Japan were listed as such. NAIC and state regulators were irate, as New York's insurance superintendent remarked:

> There is a lot that is good in Solvency II, but there is an over-reliance on internal modeling. Do we need to go that far? I don't think so. Doesn't the over-reliance on internal models complicate the role for regulators? Do they understand it? And people will game it, the Enrons of the world. There is also regulatory forbearance and regulatory capture, where regulators don't want to upset a certain company, and regulatory error. People miss things. But in the US we have many eyes looking at things.[923]

Although traditionally allied with the US, as in the case of the EU AIFM Directive, the FSA and other UK officials have pushed the US Congress, NAIC, and state regulators to achieve equivalence with Solvency II—a "risk-based approach, a principle-based approach and an economic-based approach" contrary to prevailing US NAIC capital standards and statutory accounting.[924]

The US NAIC and state regulators are also under pressure from the newly created Federal Insurance Office (FIO), which was created in the post-crisis Dodd-Frank Act. While a number of smaller insurers objected to what they feared would be undue compliance costs, the largest insurance companies strongly supported granting FIO authority to negotiate international prudential standards and handle the equivalence process with the EU.[925]

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[922] NAIC (2008); see also NAIC (2009).

[923] James Wrynn quoted in *Reactions* (2010).

[924] Skinner (2009).

[925] Section 502 of the Dodd-Frank Act.

While FIO can negotiate at the IAIS and with the EU, it does not have a mandate for domestic standard-setting, which remains the prerogative of state regulators. Nevertheless, NAIC officials fear that FIO will commit to US implementation of group-wide standards at the IAIS. Currently, capital standards are not applied on a group-wide basis to insurance companies, and without binding authority on state regulators, the NAIC has no ability to set standards on a group-wide basis. But FIO has supported such an approach in recent IAIS negotiations—to the outright opposition of the NAIC and state regulators at the same discussions.

Conclusion

To my knowledge, this case study is the first attempt in the international political economy literature to analytically explain the soft and shallow IAIS Principles of Capital Adequacy and Solvency. This case is a relatively tough test of the two-step theory. The UK FSA was a fully consolidated financial supervisor of banking, securities, and insurance markets. The IAIS was not a well-resourced or developed international institution at the time the FSA sought a standard, and it had restrictive decision-making rules at the upper levels of the organization (but open rules in the relevant subcommittees and working groups). Nevertheless, evidence on the strategic incentives and interactions among actors at the domestic and international levels is consistent with the two-step theory presented in Chapter 2.

As predicted by the two-step theory in the case of a fragmented first-mover, the FSA did not pursue a hard standard at the EU first—this is because it lacked a domestic regulatory consensus on the usefulness of internal modeling, which posed substantial adjustment costs for the London Market. The lack of a consensus also made the OECD a less appealing choice because of its requirement for consolidated national representation, under which Her Majesty's Treasury or another UK ministry would be lead representative. In the context of the two-step theory, this case finds that supervisory consolidation is *not* a sufficient condition for a given state to prefer a hard international standard. It appears that the presence of encompassing and well-integrated industry associations and shared public authority greatly increases the probability that a state prefers a hard standard.

In other words, it takes two—both regulators and industry—to tango for a domestic regulatory consensus and, in turn, a preference for hard law to develop.

But, the FSA could negotiate free of domestic interference for a *soft* standard at the IAIS, where legitimizing its preferred internal modeling-based capital standard would also achieve its institutional objectives: alleviate resource constraints in supervision, deflect parliamentary scrutiny, and set the EU agenda on Solvency II.

It is clear that the FSA devoted significant time and resources to bargaining at the IAIS for a deep standard. The US NAIC and state-based regulators, whose fragmentation allowed them more seats on various subcommittees and working groups, had no incentive to sign up to a deep IAIS standard, especially after grueling state-by-state reform in US insurance standards. And so they repeatedly rebuffed the efforts of the FSA and its extensive coalition to set a Basel II-like insurance capital standard.

Alternative explanations

Can other perspectives or theories explain the soft and shallow IAIS Principles of Capital Adequacy and Solvency? For form, I consider the rationalist/legalization perspective, which, with its focus on uncertainty costs, may help explain the non-legally binding form at IAIS and the repeated delay in implementation of Solvency II across the EU. Further, I consider that the soft form of IAIS standards may be an instance of policy diffusion.

For substance, I disagree with the power-based argument that US-EU coordination is necessary for standard-setting: while the US may have one of the world's largest insurance markets, the US NAIC has little bargaining power—if bargaining power is measured only in terms of market power. However, an argument that considers the bargaining advantage of domestic constraints is consistent with a very shallow standard.

Form

The rationalist/legalization perspective on the non-legally binding form of the IAIS Principles would consider, in addition to sovereignty costs, the high degree of uncertainty in implementing new risk-based capital standards that embraced dynamic internal modeling. Uncertainty for banking regulators had been, by comparison, relatively low when the 1988 Basel Accord was negotiated: numerous European states had already used risk-based capital standards for at least a decade before the Accord was completed. By contrast, the prevailing UK and EU capital standards for insurance firms had been based for three decades on a static, risk-insensitive ratio. Although some global reinsurers, such as Swiss Re, had begun to experiment with internal models as part of their business models, for regulators, the impact on capital levels of a new, Basel II-like IAIS standard would have been much more uncertain.

Uncertainty of the impact of Solvency II partially explains the delay in its implementation in EU Member States—except for the UK, which is already compliant. Noting that the effect of Solvency II on capital requirements remained unclear, the chief executive of Hannover Re expressed frustration with the delay back in 2007: "It's always been five years. It will always be five years. So we won't see this any time soon."[926] Fears of the impact on insurers' investments in banks struggling for capital, negative impact on pension plans, and the effects on life insurers' ability to issue long-dated guarantees have been among the many reasons cited for Solvency II's delay.[927]

Policy diffusion between banking and insurance regulation could also conceivably explain the soft form of the IAIS Principles. As Beth Simmons and Zachary Elkins argue in the context of global macroeconomic liberalization, adoption of a given policy by one set of actors provides information on the costs and benefits of that policy to another set of actors; adoption by the first group can also alter the material or reputational payoffs for the second

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[926] Wilhelm Zeller quoted in *Best's Insurance News* (2007).

[927] Wadsworth (2012); Pilla (2012); Kirby (2012).

group.[928] As I have demonstrated above, UK FSA officials explicitly called for a three-pillar approach to insurance regulatory capital akin to what Basel II established for global banks—with internal modeling at its heart. With its adoption in over a hundred jurisdictions, the 1988 Accord had been viewed as a success of soft international financial law, and Basel II represented the latest regulatory innovation. Moreover, the elevation of the IAIS alongside the Basel Committee and IOSCO represented a belief that a flexible, soft international institution could achieve a technical consensus among regulators working in a de-politicized process, as opposed to the intergovernmental OECD Insurance Committee.[929]

Substance

The substance of the IAIS Principles represents minimal change from the international status quo. Daniel Drezner's model of regulatory coordination between "great powers" predicts this outcome when two great powers fail to agree. At the most general level, if the EU and its representation at the IAIS are considered part of a unitary bargaining position and the US NAIC and state regulators similarly constitute a single coordinated actor (presumably the NAIC), then Drezner's model is correct. At the time of bargaining at the IAIS, the US and EU were roughly at parity: the US was the world's single largest insurance market with total premium income of $865 billion, representing 35 percent of worldwide premium income; the EU had about 30 percent of worldwide premium income.[930]

I argue that a unitary representation of actors at the IAIS, however, clouds a crucial element of the standard-setting story. US state insurance regulators are not responsible for the group supervision of large US insurance companies, so the threat of denying market access to the huge US insurance market could not be the mechanism (as Drezner's model suggests) by which the status quo was largely preserved.

[928] Simmons and Elkins (2004).

[929] Brummer (2012).

[930] CEA (2002): 134.

Nor could the success of US officials in diluting the IAIS Principles be the result of a unified bargaining team. Instead, from my interviews and review of public sources, in the early 2000s, the US NAIC and state-based representatives at the IAIS did not coordinate prior to bargaining with their UK and European counterparts. Some representatives, such as Alessandro Iuppa of Maine and later the US NAIC, took a keen interest in participating at the IAIS to develop common international standards.[931] But generally, most US NAIC and state regulators consistently supported maintaining the international status quo, which would preserve their domestic autonomy. What matters for the substance of the standard is the distance of the most recalcitrant actor from the international status quo—and there were plenty of recalcitrant US insurance officials perched on the status quo.

However, one could view the US NAIC and state regulators as extremely domestically constrained in adopting an IAIS standard. State legislatures had long been involved in insurance regulation and were keen to protect their turf. It had been politically difficult in the 1990s for the NAIC to persuade state legislatures to adopt the simple risk-based capital rules based on an NAIC model law. Several state legislators, including those from major states like New York and New Jersey, had reacted by proposing oversight legislation to restore "the sovereign rights of the states" and to take retaliatory action against the NAIC or states using NAIC rules.[932]

The domestic and international constraints on the NAIC have, if anything, tightened since the most recent global financial crisis. The creation of the Federal Insurance Office (FIO) is an embryonic start to an increasing federal role in insurance standard-setting that may result in direct regulation of large US insurers. Nor does FIO's authority to negotiate with the EU on regulatory coordination augur well for the NAIC. The FIO Director recently assumed leadership of the IAIS Technical Committee and has reached out to the UK FSA

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[931] See for example, *Journal of Commerce* (1999).

[932] Resolution adopted by the National Conference of Insurance Legislators quoted in Otis (1995).

and other regulators in moving ahead on developing consistent capital standards.[933] If the propositions of the two-step theory hold true, then the NAIC should resist at all costs any moves to restrictive decision-making rules and consolidated national representation within the IAIS. The legacies of institutional settings persist long past the policy debates of any given time.

Table 6.2: The two-step theory and the IAIS Principles of Capital Adequacy and Solvency

Proposition	**Evidence**
Fragmented state: low level of integration, low degree of competition, no public authority for industry	UK FSA is consolidated financial supervisor without any rival insurance regulators, but industry associations are fragmented, competitive, and do not have public authority
Tenuous domestic regulatory status quo in fragmented state	*Laissez faire* in the London Market: minimal statutory capital requirements for general insurance companies; Lloyd's self-regulates
Fragmented state regulator has strong incentives to pursue non-legally binding international standard	UK FSA does not collaborate with fragmented insurance industry associations and faces severe resource constraints in addressing industry trends and domestic criticism after notable insurance company failures
Fragmented state regulator makes first move at soft law international institution	UK FSA leads IAIS Technical Committee and proposes draft internal modeling-based capital standards; support from Australia, Canada, France, Germany, Japan, and Switzerland
Recalcitrant actor prefers status quo on substance	US NAIC and state-based regulators developed static, risk factor-based capital standards in 1990s; do not prefer market-based accounting standards that complement internal modeling
Open decision-making rules advantage recalcitrant actor during bargaining; leads to shallow standard	US NAIC and state-based regulators, despite fragmentation, prevent IAIS Principles on Capital Adequacy and Solvency for prescribing or endorsing the use of internal modeling-based standards or market-based accounting; result is shallow, status quo standard

[933] This project is known as the Common Framework for the Supervision of Internationally Active Insurance Groups ("ComFrame").

CHAPTER SEVEN

Conclusions

Just as their central bankers were the "lords of finance" in the 1920s,[934] certain states remain the rule-makers of international finance in the 21st century. Influential central bankers and financial supervisors from the United States, Britain, France, and Germany confer with each other in Basel and Brussels, pressured by domestic demands to set prudential standards. But what *precisely* motivates these state actors to set international financial standards with certain types of form and substance? And how do they engage in that pursuit? This thesis is an attempt to answer those questions.

I found the existing scholarship on these questions to be unsatisfactory. Scholars from a rationalist/legalization perspective posit many reasons for why non-legally binding ("soft") standards would be preferable to legally binding ("hard") standards, including uncertainty and sovereignty costs. But by observing the divergent preferences of state actors towards the form of standards in the *same* issue-area (e.g. the UK and France on hedge funds), we see that the rationalist/legalization perspective generates varying predictions. To explain the shallow or deep substance of standards (defined as low or high change from the international status quo), international political economists have usually argued that "great powers" set the rules of international finance because they can implicitly or explicitly threaten to deny market access to recalcitrant states. Yet, some of the most powerful actors, such as the US Federal Reserve at the Basel Committee, the Bank of England at the Financial Stability Board, or the UK Financial Services Authority at the International Association of Insurance Supervisors, have repeatedly and significantly conceded to other, less powerful state actors. And finally, most studies neglect to explain both the domestic political incentives to pursue international regulation *and* the bargaining dynamics among states at international standard-setting institutions.

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[934] Ahamed (2009).

In response to this gap in the scholarship, I have proposed a two-step theory of international standard-setting. Simply put, a state actor first prefers and pursues a certain form of an international standard. This preference emerges from the incentives contained in the strategic interaction and structural relationships among regulators and industry associations within the state. A first-mover then negotiates in a soft or hard law international institution according to certain decision-making rules.

The arm's-length relationships among regulators and industry associations in fragmented states lead to ad-hoc, status quo domestic regulatory outcomes, which are not viewed as legitimate by all actors. Regulators and industry associations constantly seek to undermine each other in terms of autonomy, reputation, and wealth. This antagonistic interaction incentivizes a *dissatisfied* regulator to pursue a non-legally binding standard to improve its domestic political position; the pursuit of hard law would be too costly in time and resources and invite intervention by other state actors. In coordinated states, regulators and industry associations are ensconced in collaboration: they routinely share information, sit on each other's boards, and jointly set standards. As a result, coordinated state actors are more likely to come to a durable consensus on how to regulate a given financial sector or market. In turn, they seek to export this consensus internationally through a legally binding standard because distributional gains will achieve their public *and* private interests. In short: the strength of credible commitments at the domestic level reflects itself in a state actor's preference and pursuit of standards at the international level.

The fragmented or coordinated state actor then becomes a first-mover and begins bargaining on the substance of the standard with representatives of other states at an international institution. International institutions display a variety of decision-making rules, which I succinctly categorize as open or restrictive. Ideal-type open rules, such as unanimity requirements, allow any member of the institution to voice an objection to the first-mover's proposal at any time during the standard-setting process: agenda-setting, drafting, negotiations, and even just before the standard is finally issued. If there is a recalcitrant state actor who prefers the international status quo, then the first-mover will have to satisfy that actor, otherwise the standard will not be passed. In other words, when actors disagree in the context of open rules, the most powerful and "pivotal" negotiator is not the one who represents the largest financial market, but the one closest to the international status quo.

Unlike open rules, restrictive decision-making rules, such as majority voting, present a bargaining advantage for first-movers who are able to assemble a coalition and quickly project their preferences. Once the first-mover has extended any necessary inducements or concessions to a pivotal voter, it can then resist the demands of a recalcitrant state actor whose preference is closest to the international status quo. When bargaining among actors is harmonious, then open and restrictive rules produce the same shallow or deep substance—but, given the potential adjustment costs, bargaining is usually discordant. When actors disagree, restrictive rules produce deeper standards than open rules do if the first-mover successfully builds a coalition that prefers significant change from the status quo.

Empirics

The findings within and across cases largely validate the two-step theory's predicted strategic interaction, incentives, and preferences towards form and substance. In this section, I briefly survey the main findings of each case and compare them to alternative explanations of form and substance in key international financial standards.

<u>Basel capital rules</u>

The US Federal Reserve's engagement at the Basel Committee is a "most-likely" case of the two-step theory. The extensive fragmentation of US banking regulators and industry associations means that the "structural possibility"[935] of a state actor pursuing a soft standard to improve its domestic political position is high. The Basel Committee, moreover, uses very open, consensus-based decision-making rules that allow recalcitrant actors, such as Germany, to resist the preferences of first-movers—no matter how

[935] Reinicke (1995).

financially powerful those first-movers are. My case study has greater empirical detail than the most widely cited Basel studies to date because of new data on actors' preferences during bargaining. As a result, existing alternative explanations of form and substance are not very successful. The rationalist/legalization perspective indeterminately predicts form, while arguments based on market power, private-sector influence, and domestic constraints do not satisfactorily explain the shallow substance of the Basel capital standards.

During the mid-1980s in the US, the Fed was opposed in its efforts to establish risk-based bank capital standards for US bank holding companies by the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC); these other bank regulators also sought, with some support from the Reagan Administration, to dissolve the Fed's regulatory responsibilities. This domestic rancor incentivized the Fed to seek a non-legally binding standard that would allow it to control the domestic policy agenda and enact a risk-based capital standard for bank holding companies that would simultaneously expand its mandate over FDIC and OCC-supervised subsidiaries.

In 1987, at the Basel Committee, the Fed proposed a middle-ground capital definition with the Bank of England, but was forced to move to a definition whose stringency was consistent with the European Commission's proposal. Despite facing a US and UK coalition, open decision-making rules ensured that German officials' firm stand in support of a more stringent standard (which would be more consistent with the international status quo) garnered them substantive concessions, eventually resulting in a shallower standard, the 1988 Basel Accord.

Evidence on the standard-setting of Basel II and preliminary findings for Basel III provide further support for the two-step theory's perspective. In the late 1990s and early 2000s, the Fed sought a new standard because the 1988 Basel Accord and US bank capital standards were not risk-sensitive *enough*, again disagreeing with the FDIC and OCC. By holding key positions at the Basel Committee, the Fed decisively pushed the Committee to draft proposals for a capital standard based on banks' internal risk modeling. The Fed, however, only sought to apply internal modeling-based standards to the largest, most internationally active US banks—not all banks, which was the scope of the 1988 Accord.

However, German negotiators again proved the most recalcitrant. For historical reasons associated with their universal banking model, they insisted that Basel II should apply to all banks regardless of size. Open decision-making rules at the Basel Committee forced the Fed to concede on scope to German officials, leading to an extremely detailed standard that limited supervisory discretion. Although Germany achieved its substantive preferences at the Committee and promptly implemented Basel II, the Fed was unable to implement the new internal modeling-based standard over the objections of the FDIC and OCC.

Initial findings on Basel III re-affirm empirical support in this issue-area for the two-step theory. The Fed sought to keep the Securities and Exchange Commission (SEC) at arm's length in the development of US liquidity standards, and so pursued a soft, deep quantitative liquidity standard at the Basel Committee. Along with French support, German officials, preferring their existing liquidity standard, successfully made the standard considerably more shallow and lax than the Fed's preference.

EU Alternative Investment Fund Managers Directive (AIFM)

The French victory in setting legally binding, deep alternative investment standards is a most-likely case of the two-step theory. The French regulatory structure in securities markets features a well-integrated regulator who works collaboratively to set standards with an encompassing industry association. Decision-making rules in the EU financial standard-setting process are mostly but not completely restrictive: qualified majority voting (QMV) rules weight votes in favor of large states. If the French had pursued a soft standard or conceded much on the prudential substance of the AIFM Directive, then the two-step theory would be in trouble. Most alternative explanations fall short. Legally binding form contradicts a rationalist/legalization prediction for soft law, while the Varieties of Capitalism approach does not specifically consider form as a regulatory preference. An argument based on "great power" regulatory coordination clearly fails to explain the deep substance of the prudential AIFM standard, as does an argument based on the role of supranational actors. However, a consideration of domestic constraints in France and Britain would also predict deep substance.

In the early 2000s, French regulators and asset management industry sought to claw into the lucrative global hedge fund and private equity markets. They developed a domestic regulatory consensus that reflected itself in a legal framework for alternative investments. This consensus incentivized French officials to pursue a legally binding international standard, which would bring significant distributional gains as they sought to boost the asset management industry in Paris. A legally binding EU directive and the corresponding third-country equivalence process could moreover be used to raise the overall level of stringency of global alternative investment regulation, affecting US fund managers and offshore financial centers.

French representatives at the EU deftly allied with their German colleagues to force the European Commission to propose the AIFM Directive. Subsequently, French officials built a coalition in the Council of Ministers that supported a stringent AIFM prudential standard on issues such as depositary liability. The Council's QMV rules allowed French officials to resist making any concessions on prudential rules to UK negotiators. However, France had less support on the issue of third-country access and could not gain a qualified majority because of German support for third-country fund managers' access to the EU single financial market. Gridlock resulted, and the European Securities and Markets Authority will decide in 2015 whether third-country fund managers should receive an EU passport.

The deep substance of the AIFM prudential standard reflects the inability of UK officials to draw upon the country's financial market power to resist French and German demands for a stringent standard. Market power was neutralized by the bargaining power wielded by French officials under QMV rules in the Council. First-mover French officials were motivated by high domestic demand for regulatory change, had considerable technical expertise and resources, and featured coordinated representation that complemented the membership rules of the EU standard-setting process. Yet, while these were necessary conditions for first-mover success, the semi-restrictive decision-making rules at the EU proved sufficient for the French-led coalition to set a stringent prudential standard. Overall, the type of decision-making rule—rather than any other feature of the standard-setting process or actors' characteristics—appears to succinctly explain significant substantive change from the status quo.

FSB bail-in standard

This study serves as a successful "less-likely" case of the first stage of the two-step theory because the UK is not nearly as fragmented as the US in terms of its regulatory structure. Prudential regulatory authority has been consolidated into the Bank of England (and was previously the remit of the UK Financial Services Authority). The UK has access to focal point soft and hard law international institutions, so this case tests whether institutional choice is a function of an actor's preference for form: indeed, the Bank of England aimed to first set a bail-in standard in the soft law Financial Stability Board (FSB) instead of coordinating with other UK actors to set a standard at the EU. This study is a most-likely case of the second stage of the two-step theory because decision-making rules at the FSB are equivalent to ideal-type open rules. The rationalist/legalization perspective and private-sector influence argument strongly (but incorrectly) predict legally binding form. Moreover, this case disputes explanations of substance based on "great power" regulatory coordination and on unity of the bargaining team. This case supports my contention that restrictive rules create a first-mover advantage, whereas open rules do not.

Despite criticism of the Bank of England's actions prior to the failure of Northern Rock in 2007, the Bank deftly gained power at the expense of the UK Financial Services Authority in the British regulatory structure. Yet, the regulatory response to the run on Northern Rock (the Special Resolution Regime) did not offer financial resolution tools that would apply to the largest British banks. Indeed, taxpayer-financed bailout or "temporary public ownership" (i.e. nationalization) would likely be required. Crucially, if such a bank were to fail, the Bank of England would lose control of the resolution process to Her Majesty's

Treasury. Thus, the Bank sought a non-legally binding standard on a credible alternative to bailouts: the "bail in" (i.e. write down) of creditors in the faltering bank without legally shutting down the bank.

At the FSB, the Bank of England had to bargain under open rules that allowed a recalcitrant actor, which wasn't even officially a member of the appropriate FSB committee, to shape a shallow bail-in standard: the US FDIC. The FDIC preferred the international status quo of closed-bank resolution tools, and it had no threat to its control over the special resolution process in the US. Despite the shallowness of the FSB bail-in standard, the Bank of England has effectively shaped the substance of the EU Bank Recovery and Resolution Directive, which is now an important plank of the regulatory response to the eurozone banking crisis.

IAIS Principles on Capital Adequacy and Solvency

This chapter is a less-likely case of preference for form because of the UK FSA's consolidated supervisory authority and a less-likely case of rule-determined bargaining effects because restrictive rules exist at the upper-level committees of the International Association of Insurance Supervisors (IAIS), but not at the subcommittees and working groups where the substantive drafting of standards takes place and decision-making proceeds according to consensus-based, open rules. But even when the independent variables of domestic structure and decision-making rule are at lower values, the two-step theory holds up. Nevertheless, perhaps to be expected in a robust less-likely case, alternative explanations have merit. Given the novelty of internal modeling for insurance regulatory capital, the rationalist/legalization perspective also predicts the soft form of the IAIS standard. This may also be a very likely case of policy diffusion, reflecting the impact of Basel II in banking regulation. On substance, arguments based on market power and the unity of the bargaining team fall short, but domestic constraints for the US also help explain the shallow substance.

After its creation in the late 1990s, the FSA served as consolidated financial supervisor, but consolidation did not entail structural coordination. Domestic interactions between a fragmented British insurance industry and the consolidated FSA reflected the lack of a regulatory consensus. Unlike its counterparts in France and Germany, the FSA encountered severe resource constraints in handling the regulatory arbitrage practices of *bancassurance* companies and notable insurance company failures. UK insurance industry associations were fragmented, competitive, and did not express a single voice at the domestic or international level. Confronting these challenges and lacking collaboration with industry, the FSA sought a low-cost method to regulate the London Market: risk-sensitive capital standards based on internal modeling. By legitimizing its preference for such a standard in non-legally binding form at the international level, the FSA could meet its domestic demands and set the nascent EU agenda on insurance regulatory reform.

At the IAIS, the FSA marshaled an impressive coalition that included most major jurisdictions. However, FSA officials had to bargain under open decision-making rules at the level of subcommittees and working groups. In these settings, they confronted the US National Association of Insurance Commissioners (NAIC) and state-based regulators, who had just gone through a decade of regulatory reform and had no desire to pay more adjustment costs to move away from the international status quo. As a result, the IAIS Principles on Capital Adequacy and Solvency constitute a soft and extremely shallow standard that merely acknowledges the possible use of internal modeling for regulatory capital purposes, instead of an endorsement or prescriptions for its regulatory use.

Validity

Key elements of the cases help bolster the validity of the empirical findings. First, regarding form, it appears that different varieties of fragmentation or coordination can be considered alongside each other by focusing on basic strategic interactions: do regulators and industry relate amongst and to each other at arm's length? Or do they work cooperatively to set standards? The basic conceptualization of the state in terms of level of integration, degree of competition, and public authority of regulators and industry associations consistently predicts actors' preferences across states for legally or non-legally binding standards—despite differences in the type and degree of fragmentation or coordination, such as adversarial legalism in the US and market-driven fragmentation in the UK.

Second, I selected cases in which first-movers pursue deep standards, while allowing the type of decision-making rule and characteristics of recalcitrant actors to vary. This necessarily meant that these would not be cases of harmonious negotiations, which allowed me to test the impact of decision-making rules when there are divergent policy preferences. Moreover, the variety of recalcitrant actors was notable: negotiations featured coordinated state actors (Bundesbank and BaKred/BaFin at the Basel Committee), fragmented state actors (the US NAIC at the International Association of Insurance Supervisors and the FDIC at the Financial Stability Board), and economically powerful actors (UK at the EU). In each case, the type of decision-making rule successfully explains the substance of the final standard without the need to incorporate characteristics of recalcitrant actors.

I selected two cases in which a British regulator was first-mover because the UK has access to both traditionally soft law focal point institutions, such as the Basel Committee, and the hard law EU financial standard-setting process. In both cases (bail-in, insurance capital standards), the relevant UK actor (Bank of England, Financial Services Authority) aggressively pursued standards in soft law institutions. This evidence is consistent with my theoretical proposition that state actors' preference for form is analytically prior to the form of the international institution, that is, the FSB bail-in standard is soft not only because the FSB is a non-legally binding organization, but also because the Bank of England (with its autonomy threatened) deliberately chose to pursue a soft standard to keep Her Majesty's Treasury at arm's length and selected the FSB accordingly. And the FSA pursued a soft standard at the IAIS to legitimize its preference for internal modeling-based insurance capital regulation, which was not embedded in a regulatory consensus with industry associations in the London Market—or indeed anywhere else.

Additionally, in reviewing the effective French strategy to enact the EU AIFM Directive, I outlined conditions that would spur state actors to make the first move at an international institution: high demand for regulatory change, expertise and resources, and institutional complementarity (e.g. on the basis of membership rules). I find that these all appear to be necessary, but are not *sufficient* by themselves to explain the substance of standards: only in restrictive rule environments is the first mover able to resist recalcitrant actors and set deep standards when it has assembled a supportive coalition.

Generalizability

Can the two-step theory of standard-setting apply to issue-areas outside of finance? As this thesis demonstrates, the bargaining stage of the theory can easily be applied to any negotiations among any set of actors in settings as diverse as the Financial Stability Board and European Union; the necessity of conceptualizing bargaining across a single policy dimension, I argue, forces an analytical rigor that is otherwise lacking in most discussions of international standard-setting.

Is the first stage of the two-step theory equally generalizable? Perhaps. I first consider why international finance may be a unique area of study, but also how the two-step theory could be extended to explain international environmental or trade agreements.

In many respects, international financial standard-setting is unique. There are a plethora of international organizations, all independent of each other and established at different times, with different form, issue scope, membership criteria, and decision-making rules. The G-20/FSB, the three main sectoral standard-setters (Basel Committee, IOSCO, IAIS), Committee on Payments and Settlement Systems, the BIS Economic Consultative Committee (where benchmark rate reform is taking place), IMF, World Bank, OECD, various UN bodies (e.g. UNCITRAL and UNIDROIT), and the EU are all feasible and active forums for bargaining over the rules of international finance for any given issue. And since the most recent crisis, the new Legal Entity Identifier Initiative (nominally under the auspices of the FSB) purposefully brings together public and private actors to address a major data gap in derivatives regulation. The international institutional "menu" available to actors from fragmented or coordinated states may be more extensive than in other areas—and thus domestic incentives readily lead to international "solutions."

But if my definition of the state is slightly modified, then the importance of domestic institutional structure for a state's preference towards form may also be applied to cases of international environmental or trade agreements. Consider that generally across states, executive and legislative branches of government are much more involved in trade and environmental issues than in financial regulation. Legal scholar Kal Raustiala argues that states demonstrated varying preferences for the UN Convention on Biological Diversity (CBD) because of domestic institutional structure: the unitary Westminster system in the UK made commitment and implementation of the CBD straightforward, whereas it was "potentially difficult in the competitive, fragmented U.S. system and threatened to disrupt established patterns of federal-state regulation and strengthen disfavored domestic legislation."[936]

Furthermore, consolidated negotiating authority for the US President is a crucial explanation for the legalization of the international trade regime in the form of the World Trade Organization (WTO). The US Congress buttressed the President's negotiating authority through the Reciprocal Trade Agreements Act of 1934, which helped overcome protectionist opposition to trade agreements.[937] In Section 301 of the Trade Act of 1974, Congress delegated to the President the ability to apply retaliatory sanctions to non-compliant countries, as determined by the US Trade Representative. During the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in the late 1980s and early 1990s, US negotiators successfully established the new dispute resolution mechanism of the WTO on the basis of the Section 301 statute, which outlined a multi-stage panel process for applying sanctions on non-compliant countries.[938] In other words, as the US

[936] Raustiala (1997): 506. The British Parliament, however, has delegated financial standard-setting to the UK Financial Services Authority, Bank of England, and other institutions over time.

[937] See for example Hiscox (1999) and Bailey et al. (1997).

[938] Goldstein and Steinberg (2009): 225-6.

became more coordinated in trade policy, it was more willing and able to credibly commit to legally binding form at the international level.

Contributions

This thesis makes novel theoretical and empirical contributions to the post-crisis research agenda in International Political Economy. Since the most recent crisis, many scholars have asked how exactly state actors set international financial standards. For example, Henry Farrell and Abraham Newman ask, "When states or sub-state actors use their domestic regulatory leverage in order to shape international outcomes (or alternatively domestic outcomes that have international repercussions), what will their preferred goals be?"[939] Eric Helleiner and Stefano Pagliari argue that scholars focused on inter-state interactions need "to conceptualize power in international regulatory politics more broadly than just in terms of 'market size' and 'power-as-influence.'"[940] Orfeo Fioretos has called for historical institutionalist scholarship which theorizes "finer variations in how states engage international institutions, the conditions under which states are willing to compromise, and why they readily embrace some and reject other international designs over time."[941]

International political economists continue to search for a theory of actors' motivations, the exercise of various types of power, and the conditions under which different bargaining outcomes occur in international finance. Such a theory does not only seek to find correlation between certain independent and dependent variables, but also propounds a causal chain of strategic interaction at the domestic and international levels. In other words, the goal is not merely to be right—but to be right for the right reasons.

This thesis tackles all of these challenges. In a historical institutionalist vein, the first stage of the two-step theory specifies how institutions structure enduring relationships among

[939] Farrell and Newman (2010): 610.

[940] Helleiner and Pagliari (2011): 196.

[941] Fioretos (2011): 386.

regulators and industry associations, resulting in varying incentives to pursue different forms of international standards. Structural coordination reflects a high level of state capacity—its own type of power—to generate strong credible commitments at the domestic and international levels.[942] In the tradition of rational-choice institutionalism, the second stage of the two-step theory highlights how compromise in standard-setting is virtually guaranteed when discord exists in the context of open decision-making rules. Open rules confer bargaining power on recalcitrant actors, who can neutralize the first move of much more financially powerful states. The theory is then applied to empirical cases, only one of which (the Basel capital standards) has received any sustained attention; to my knowledge, only a handful of case studies of the EU AIFM Directive exist in IPE scholarship,[943] while there are none on the FSB bail-in standard or IAIS Principles of Capital Adequacy and Solvency.

Form or substance first?

Beyond the immediate post-crisis research agenda, this thesis questions long-held assumptions about the priority of form versus substance. In *The Choice for Europe*, Andrew Moravcsik presents a theory in which actors prefer certain substantive policy outcomes, bargain with other states on the substance, and *then* choose the form of the agreement, that is, how credibly to commit to following the substantive bargain. Agreeing with this theoretical sequence, William Riker famously criticized some parliamentary lawyers' view that "if one believes that form alone is important, one appropriately concentrates on the form of rules, largely ignoring questions of whether or not their substance is efficient, or fair, or reasonable."[944] While I do not dispute that substance is crucial in explaining overall outcomes, there is no *a priori* reason that actors bargain first on substance and then on form in international standard-setting. Just as individuals in their personal lives may prefer low (casual date) or high (marriage) levels of credible commitment irrespective of common substantive interests, actors can pursue international standards in the same sequence.

[942] Büthe and Mattli (2011) make a similar argument in global private regulation.

[943] Ferran (2011); Woll (forthcoming); Helleiner and Pagliari (2010); Zimmerman (2010).

[944] Riker (1958).

My analytical priority for the form of international standards neatly coincides with a constructivist, historical perspective on the post-1945 financial world. In *Capital Rules*, Rawi Abdelal draws a distinction between the preferences of American and French economic officials. The US preference has been for "ad-hoc" financial globalization, that is, tolerance for the development of Eurodollar markets in London, unilateral liberalization of capital flows as the Bretton Woods exchange rate regime crumbled, and the delegation of credit rating responsibilities to Standard & Poor's and Moody's.

The French preference expressed through the European Union, OECD, and IMF has been instead for *mondialisation maîtrisée* or "managed globalization." This French doctrine is based on the use of formal rules to liberalize capital flows within Europe and internationally, as well as the use of liberal economic policies for social purposes—a position adopted by the French Left in the 1980s.[945] Indeed, the primary push in the 1990s to amend the IMF Articles of Agreement in order to mandate complete capital liberalization came from French officials—instead of the US Treasury, which opposed formally mandated capital account liberalization for every IMF member state.[946]

Abdelal concludes that the influence of the French vision of managed globalization has been indispensable to the modern era of financial globalization: "The decisive confluence of worldviews was in Europe—in Brussels, London, Frankfurt, Amsterdam, and, most important, Paris. Europe did not merely acquiesce; Europe made financial globalization. Without an EU open to the world's financial markets—Europe's 'open regionalism'—this era of global finance could not have emerged."[947]

This parallels my conception of France as exercising a type of power unlike the market power enjoyed by the US and Britain: power in terms of state capacity and coordination. Abdelal and I both argue that the French exercise their power with purpose very different

[945] Abdelal (2007): 28-29.

[946] Abdelal (2007): 140-1.

[947] Abdelal (2007): 4.

than that of the United States. But whereas Abdelal offers a sociological perspective on the influence of French preferences on capital liberalization, I propose an institutionalist theory and empirical account of how coordination among regulators and industry creates credible commitments that incentivize the pursuit of legally binding, international *prudential* standards.

Distributional battles

Most accounts of domestic and international financial regulatory institutions do not analyze salient distributional battles. For example, in the public policy literature, William Coleman and Andreas Busch empirically detail the characteristics of "policy networks" of regulators, governments, and industry in key states, such as US, Britain, France, and Germany, and describe variation in the development of those policy networks.[948] Anne-Marie Slaughter describes the flexible technocracy and non-legal form of transnational policy networks, such as the Basel Committee or IOSCO, without discussing any of the distributional conflicts in standard-setting.[949] Christopher Brummer argues that the soft law standard-setters compel compliance even though they feature open decision-making rules, but does not explain substantive bargaining among actors.[950]

Once any detailed analysis of bargaining takes place, however, the veneer of de-politicized technocracy covering the Basel Committee and other standard-setting institutions easily rubs off. Although the Committee and many other soft international institutions partially justify the technical legitimacy of their standards by citing their open decision-making rules, the nefarious effects (intentional or not) of consensus have been long noted. As Alexander Hamilton wrote in *Federalist* no. 22:

> The necessity of unanimity in public bodies, or of something approaching towards it, has been founded upon a supposition that it would contribute to security. But

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[948] Coleman (1996); Busch (2009). Busch discusses Switzerland, not France, in his book. See also Moran (1986); (1991).

[949] Slaughter (2000); Porter (2005).

[950] Brummer (2012).

> its real operation is to embarrass the administration, to destroy the energy of the government, and to substitute the pleasure, caprice, or artifices of an insignificant, turbulent, or corrupt *junto*, to the regular deliberations and decisions of a respectable majority.[951]

Occasionally, open decision-making rules protect an international status quo that may be beneficial, for instance German officials' defense of a more stringent capital definition the 1988 Basel Accord and the US NAIC's opposition to internal modeling-based insurance capital standards at the IAIS. But, entrenched defense of the status quo can also have downsides, such as how the German preference for a wide scope in Basel II explains that standard's bewildering complexity.

In sum, consensus may not only be used to legitimate standard-setting. It can be used to forestall—*among* the richest and most powerful states, not merely between advanced and developing states, as Daniel Drezner argues.[952] Even though I present a rather simple bargaining model, to my knowledge, no scholar has previously offered an analytical account of how decision-making rules affect negotiations in international financial standard-setting institutions on very specific policy dimensions.

Limitations

Unfortunately but expectedly, this thesis has several limitations for reasons of space and time, namely theorizing of the various causal paths that lead to different domestic institutional structures and of the design of international institutions.

I have not theoretically explained the evolution of fragmented or coordinated institutional structures, nor have I surmised whether and how these structures may change in the future.

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[951] Hamilton was arguing that the Articles of Confederation (the predecessor of the US Constitution) impeded the development of commercial treaties between the central government and foreign countries because of unanimity required among the states. It appears that state-based fragmentation hindered the ability of the central government to credibly commit to legally binding treaties.

[952] Drezner (2007).

The causal paths to fragmentation or coordination appear to vary considerably: adversarial legalism in the US, market-driven factors in Britain, *dirigiste* coordination in France, and associational, corporatist governance in Germany. I suggest, though, that domestic institutional structure is not simply a function of domestic markets. Peter Katzenstein's *Small States* demonstrates that there is nothing inherently contradictory about extremely competitive financial markets and structural coordination, as in Switzerland, where the market capitalization of listed companies is 141 percent of GDP.[953] Nor is a coordinated market economy, such as the *keiretsu* structure in Japan,[954] antithetical to the arm's-length relationships between banking regulators and industry that are characteristic of a fragmented state.[955]

France and Germany have remained coordinated despite their deliberate policy reforms over thirty years towards financial integration and internationalization.[956] Meanwhile, the US has remained extraordinarily fragmented, without undergoing British-like bouts of consolidation. What variables—legal, legislative, and otherwise—condition the structure and the pace of changes in states? Can changing the domestic institutional structure, say from fragmented to coordinated, actually alter domestic regulatory outcomes from resembling a *status quo* to representing *consensus*? These questions remain to be tackled.

Another clear limitation is that I have not offered a theory of long-run international institutional choice, design or development, although I have briefly described the history and structure of the relevant institutions in each of the case studies. I do not assume or argue that the form and decision-making rules of an international institution are correlated. But it is unmistakable that the EU produces hard law and uses restrictive decision-making rules, while the Basel Committee and other standard-setters produce soft law and use open rules. (The EU did have open decision-making rules before the Single European Act, while the OECD has produced soft law using restrictive rules.)

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[953] As of 2011, according to the World Bank dataset, http://data.worldbank.org (accessed 6 March 2013).

[954] Hall and Soskice (2001): 34.

[955] Kentaro (2003).

[956] See Jabko and Massoc (2012) on France.

The two-step theory simply states that a first-mover pursuing soft or hard law initiates bargaining at a soft or hard law international institution. Why do some international institutions become focal points for setting standards? How do the institutions themselves change over time?[957] Does the mostly non-legally binding form of the international financial regulatory architecture reflect the preferences of the largest states, such as the US or UK,[958] or the lack of international consensus on what constitutes appropriate prudential financial regulation?[959] Institutional design is beyond the scope of this thesis. But, it is likely that my "micro" two-step theory on the form and substance of international financial standards complements "macro" theories on institutional design, which tend not to analyze specific cases of standard-setting.

Just as one theory can fill the gaps of others, the setting of certain international standards can complement the broader trajectory of global financial governance. For example, the French-inspired EU AIFM Directive sets the bar for global regulation of hedge fund managers. But, its extraterritoriality—binding US fund managers as well as off-shore financial centers to follow EU standards—is not just a sneaky way for non-hegemonic states to set global rules. The *Harvard Law Review* has argued that "extraterritoriality may support the core values of the international order as often as it harms them."[960] The US-EU equivalence process and mutual recognition agreements to resolve disputes may inch the global financial regulatory architecture towards legally binding form, as alternative investment regulation, Basel capital standards, and over-the-counter derivatives reform have been enveloped in a web of extraterritoriality—without any explicit international treaty.

[957] Jupille et al. (2013) tackle these questions.

[958] Drezner (2007) and Stone (2011).

[959] Woolcock (2012).

[960] Development in the Law (2011): 1228.

In other words, a "Lockean world of binding rules"[961] may be *de facto* established through the setting of standards in key areas, not through a grand bargain among major players. Would such ad-hoc change in global financial governance be legitimate?[962] Other than noting that state actors draw on the supposed technical rationality of international institutions and standards to legitimize their policy preferences, I have not explored whether specific standards or institutions are legitimate for the US and EU—or for that matter, emerging markets and developing economies.

Policy implications

Are there any lessons to be drawn from this project for present and future international financial regulation? I briefly discuss two: how policymakers can benefit from understanding their foreign counterparts and the consequences of deciding a particular form.

For policymakers, the two-step theory possibly offers an "image of the adversary."[963] Adversaries come in different types. Policymakers from states other than a first-mover state can better understand the first-mover's domestic political incentives and motivations for the pursuit of legally or non-legally binding standards. By recognizing domestic discord in a fragmented state that could cause a dissatisfied regulator to move internationally, another state may seek to preemptively control the agenda at an appropriate international institution.

By recognizing the formation of a domestic regulatory consensus in a coordinated state, other states should expect to see a coordinated state actor attempt to export that consensus in the form of hard law. For opposing states, it may be beneficial to quickly set a standard that endorses a policy preference contrary to the consensus of the coordinated state. Indeed, perhaps learning from its experience with France and the AIFM Directive, this is

[961] Drezner (2009).

[962] Helleiner (2011).

[963] George and Bennett (2005).

precisely what Britain has done in its recent attempts to use soft law international institutions to prevent French officials in the EU from again extracting distributional gains.[964]

There is another adversary for states to contend with: decision-making rules. When first-movers seek deep standards under open rules and there is a recalcitrant actor satisfied with the international status quo (which there generally is), open rules thwart success. Even if unanimity or consensus-based voting rules cannot be changed, it may be in the first-mover's interest to pursue institutional reform prior to proposing the standard, such as requirements for recalcitrant actors to technically justify their objections to proposals and for deadlines on the submission of amendments. Some countries have sought to reform the Financial Stability Board exactly along these lines, and the FSB recently adopted a set of procedural guidelines that have not yet been publicly released.

Finally: explaining the formal and substantive implications of institutional incentives and constraints, as I hope this thesis has done, provides a new perspective on why it is so difficult to overcome discord in global finance—and why pronouncements of international cooperation should be taken with a grain of salt. Consider the precipitating event of the 2008 financial crisis: the failure of Lehman Brothers, which was composed of 7,000 legal entities around the world and became the largest bankruptcy case in history. To help sort out the failure and establish which creditors were owed how much, a cross-border insolvency protocol was created between the US-based headquarters and thirty-three non-US Lehman entities—but, "since the protocol is not legally enforceable, its aims are largely *aspirational*." The protocol's inefficacy arose again when the US sought to apply a soft law produced in 1997 by the UN Commission on International Trade Law (UNCITRAL) to the Lehman case—however, the relevant non-legally binding UNCITRAL Model Law "cannot prevent courts in different jurisdictions from reaching opposite conclusions about the same issue," a bedeviling outcome which has already occurred.[965]

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[964] Interview with David Wright, Oxford (8 October 2010). Gabriel Cumenge, advisor to the French Executive Director at the IMF, also pointed this out to me.

[965] Development in the Law (2011): 1302.

Without a legally binding treaty on cross-border resolution, national regulators are free to "ring fence" the capital and liquidity of foreign firms within their jurisdictions, in order to pay out national creditors first. The decision of the US and UK to firmly support a non-legally binding framework for cross-border resolution (of which the FSB bail-in standard was part) will surely impact how national regulators handle the next failure of a global bank. This incentive for ring-fencing in the absence of legally binding agreement has already led to the fragmentation of some capital markets and global banking operations.

Presently, French officials are pressuring the European Commission to seek a legally binding international arrangement that will *ex ante* apportion responsibilities for sharing the financial burden of a failed global bank. If enacted and followed, this *ex ante* formula may end up unfairly over-burdening some countries if regulatory and supervisory failures occurred outside those countries. There are no easy answers. At the very least, this clash among the four rule-makers of global finance demonstrates that it is necessary for scholars to explain not only the fact of international regulatory coordination, but also its form and substance.

You can distill this battle to set the rules of international finance as a *Bloomberg News* journalist did for me at Chatham House recently: "In a bar fight, you punch the guy you don't like. Not the guy who started the fight." After crises sweep through, whatever the cause of financial instability, regulators and industry pursue standards that will let them escape unscathed and help them win—at home and abroad. I have provided one explanation of this high-stakes bar fight, but naturally, more questions arise. What kinds of international cooperation are more or less likely if market fragmentation across national borders intensifies? Will continued disputes over extraterritoriality force the United States to re-consider its approach to the form of global financial governance? Have these battles already undermined the legitimacy of international standards?[966] These are daunting questions—and they are also energizing, motivating, and important. A Wall Street firm may seem to fail overnight, but the domestic battles—or collaborations—between bankers and regulators have global effects that unfold over years.

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[966] See Helleiner and Porter (2010); Rodrik (2011): 260-266.

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LIST OF INTERVIEWEES

Interviewee names have been redacted from the dissemination copy of this thesis.

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