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Varieties of regulation: How states pursue and set international financial standards

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Varieties of Regulation:

How States Pursue and Set International Financial Standards

Rahul Prabhakar



The
**Global
Economic
Governance**
Programme



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

Rahul Prabhakar¹

Abstract

What explains the form and substance of international financial standards? 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. Second, the type of decision-making rule used in international 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.

Domestic and international institutional settings provide enduring opportunities and constraints for key players in global finance. 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. 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.

¹ This working paper is based on my doctoral thesis, which was officially submitted in June 2013 under the invaluable supervision of Walter Mattli. I especially thank Ngaire Woods and Emily Jones at the Global Economic Governance Programme and Blavatnik School of Government for their support of my research. Thank you to Ranjit Lall for his comments, helpful as ever, on this draft. Please write to prabhakar@post.harvard.edu if you wish to read a copy of the doctoral thesis, cited hereafter as Prabhakar (2013). The thesis includes cases on the Basel capital adequacy rules and the FSB Key Attributes standard, which are not discussed here.

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Introduction

In early September 2009, a group of British Members of Parliament met with American congressmen in London. They discussed the proposed Alternative Investment Fund Managers Directive (AIFM), which was being debated in the European Union. Michael Fallon, a Conservative MP, explained to the congressmen how the directive raised regulatory standards for hedge fund managers, private equity groups, and venture capital firms. He added, “The UK should strongly oppose this directive, since it would weaken London as a global financial center.”

Fallon and 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.² The congressmen were keenly interested in the debate. New York was 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.³ 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.

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 substantively 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 paper. 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?

I. The argument, briefly

I make two claims in this paper. One, a state’s domestic regulatory structure explains its preference for the form of an international standard as legally or non-legally binding (hard or soft law). A state with a coordinated structure, such as France, prefers legally binding standards. A state with a fragmented structure, such as the U.S., prefers non-legally binding standards. Two,

² The Guardian (2009).

³ HedgeFund Intelligence (2010).

the type of decision-making rule used in inter-state bargaining explains how much the policy substance of the standard changes 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. 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.

These two claims are the backbone of the two-step theory of standard-setting that I elaborate below. 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 does not demand the same legal obligation of actors.

Form and substance have critical distributional effects. Imagine states legally commit to and faithfully implement an international standard that entails significant regulatory change for financial firms and markets (a standard with “hard” form and “deep” substance). If such a standard generates perverse incentives for firms, then a common shock in markets can have devastatingly similar consequences in jurisdictions around the world.⁴

In addition to a theoretical framework that addresses several shortcomings in the international political economy literature on standard-setting (Sections II and III), this paper makes contributions in the areas of international hedge fund (Section IV) and insurance regulation (Section V) that serve as both tests of the two-step theory and original, compelling empirics in their own right.⁵ I conclude with some policy implications (Section VI).

II. The need for a two-step theory of international standard-setting

This section discusses 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” frameworks nor on complex models of decision-making, such as those applied to European Union institutions.

⁴ Hildebrand and Prabhakar (2012).

⁵ Prabhakar (2013) also includes chapters on the Basel capital adequacy rules and the Financial Stability Board (FSB) bail-in resolution rules.

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,” i.e. above the level of the state and including inter-state and supranational activity.⁶ 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.”⁷

Soft law is generally more common than hard law in international finance.⁸ Standards produced by the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) do not have legal obligations attached. Soft law reduces sovereignty and uncertainty costs for state actors. It facilitates compromise among actors with different interests and, given the difficulty of writing complete contracts, soft law allows actors to “learn” about the consequences of agreed-upon standards. International agreement, even if non-legally binding, legitimizes the substantive commitments of that standard.⁹

However, it is not self-evident that soft law in finance is the optimal approach to mitigating international market failures or constructing a 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. 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 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.”¹⁰ The EU has produced legally binding directives covering capital adequacy, investment services, market abuse, insider trading, credit rating agencies, and myriad other issue-areas.¹¹

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.¹² The rationalist 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 as well. Yet, in their legally binding implementation of the Basel III standard, the European Commission will apply the principle of “maximum harmonization,” that is, national regulators will be limited in

⁶ Mattli and Woods (2009): 2.

⁷ Davies and Green (2008): 15.

⁸ Giovanoli (2000); Simmons (2000).

⁹ Abbott and Snidal (2000); Raustiala (2005); Lipson (1991); Schachter (1977).

¹⁰ Story and Walter (1997): 253.

¹¹ Posner (2007).

¹² I take Abbott and Snidal (2000) as the definitive rationalist/legalization perspective.

their flexibility to impose higher than minimum capital requirements on their banks. British representatives vigorously objected 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 standard is much "softer" (non-legally binding and more discretionary) than the corresponding EU Capital Requirements Directives (legally binding and less discretionary). I argue that without reference to the domestic institutional settings in which actors operate and the decision-making rules used in bargaining, the rationalist/legalization perspective cannot explain the variation in states' preferences for the form of the two standards or variation in discretion for actors under the Basel standard versus the corresponding EU directive.

International financial standard-setting institutions

There exists an impressive variety of international financial standard-setting institutions. 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. These sectoral standard-setters, as well as the FSB, have produced soft standards across issue-areas, such as cross-border supervisory coordination, resolution regimes, consolidated supervision, and credit ratings.

The FSB and sectoral standard-setters are as "soft" as the non-legally binding standards that they produce. As institutions, they have few rules of procedure and minimal bylaws.¹³ For example, 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.¹⁴

Other international standard-setters can develop either legally 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 principles on corporate governance.¹⁵ It uses "one country, one vote" decision-making rules. The World Bank has produced principles on cross-border insolvency, as has the UN Commission on International Trade Law (UNCITRAL), which uses consensus in its decision-making process. State actors at

¹³ Zaring (1998).

¹⁴ Slaughter (2000): 205.

¹⁵ Jupille et al. (2013).

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 to facilitate financial standard-setting among members.¹⁶

However, 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.¹⁷ A number of institutions have thus been sidelined. In its soft law capacity, the IMF has produced non-legally binding standards on transparency and data dissemination, instead of legally binding prudential standards. The FSB set the key international standard on resolution regimes, instead of the World Bank or UNCITRAL.

Scholars have usually focused on these questions of institutional choice, emphasizing developed versus developing country preferences. Powerful states can threaten to exit an institution when their interests are at stake and formal procedures prove cumbersome.¹⁸ 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 (though 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”¹⁹ or do outcomes depend on international institutional factors? Powerful states may attempt to change decision-making rules to their advantage, but in the short to medium term, such change is difficult to achieve—especially when the international institution is a focal point institution. In other words, decision-making rules are “sticky.”²⁰

States have not completely sidelined financial standard-setting institutions that use decision-making rules other than unanimity or consensus. In 2001, the EU introduced a standard-setting process (the “Lamfalussy process”) that uses qualified majority voting (QMV) rules and disadvantages slow-moving Member States.²¹ With its historical role in financial market integration,²² the Commission proposes standards and privileges the views of Member States who move quickly and supply timely information.²³ Prior to the use of formal procedures, negotiations among Commission officials, representatives in Parliament, and finance ministers at the Council—in the shadow of supermajority QMV rules—result in substantive bargains on new standards.²⁴

Two levels matter

¹⁶ Goodhart (2011).

¹⁷ Drezner (2007).

¹⁸ Stone (2011).

¹⁹ Drezner (2007).

²⁰ Jupille et al. (2013).

²¹ Quaglia (2007).

²² Jabko (2006).

²³ Héritier (1996).

²⁴ Farrell and Héritier (2003). See also Pollack (2006) and Steunenberg and Selck (2006) for further models of EU legislative process.

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. Until recently, theories of two-level games in international regulatory coordination have been tilted in their explanatory focus towards either the international or domestic setting.²⁵

Table 1. Perspectives on the form and substance of international standards

Perspective	Explanation of form	Explanation of substance
Rationalist (Abbott and Snidal 2000)	Sovereignty and uncertainty costs (soft) versus reduction in transaction costs and stronger credible commitments (hard)	Facilitating compromise over time (soft) versus resolution of incomplete contracting (hard)
Unipolarity (Simmons 2000)	Hegemonic preference	Hegemonic preference
Bipolarity (Drezner 2007)	Great powers' coordination	Domestic status quo in great powers
Institutionalist (Prabhakar 2013)	Domestic regulatory structure induces preference for form: fragmented (soft) versus coordinated (hard)	Decision-making rules explain substance: open (shallow, minimal change) versus restrictive (deep, significant change)

Many theories “black box” the domestic level. Some assume a unipolar financial world and attribute the hegemon's “preferred regulatory innovation” to exogenously determined reasons.²⁶ This fails to explain why the hegemon would not establish hard international standards that would legally bind its successors and mitigate market failures.²⁷ Others posit that state actors pursue international standards that conform to the domestic status quo.²⁸ Yet, 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.²⁹

I argue that the domestic institutional structure is crucial to explaining a state actor's preference for form, but most theories do not account for variation in such structures. Most theories have so far only considered fragmented domestic structures in which regulators and industry associations operate at arm's length from each other,³⁰ instead of also considering coordinated structures in which regulators and industry associations collaborate closely. Similar arguments

²⁵ Putnam (1988); Büthe and Mattli (2011); Farrell and Newman (2010).

²⁶ Simmons (2001).

²⁷ Keohane (1984).

²⁸ Drezner (2007).

²⁹ Hemel (2011).

³⁰ Singer (2007).

based on private-sector capture of public regulation do not explain why or how regulators set significant international standards contrary to powerful banks' preferences.³¹ Finally, Institutional Complementarity Theory (ICT) offers a two-level, institutionalist perspective, but has two main shortcomings.³² One, it posits that coordinated states (national standard-setters in terms of private governance) will have a first-mover advantage because they can better circulate information about international standard-setting and project domestic preferences. However, this proposition rests on the assumption that international standard-setting institutions are generally organized by "one country, one vote" membership and decision-making rules, whereas such rules can vary considerably. An implication of the two-step theory in this paper is that fragmented states succeed as first-movers when interacting in international institutions with open decision-making rules and membership rules.³³ Second, ICT focuses on standard-setters as the primary actors instead of exploring standard-setters' relations with industry associations. As a result, ICT is silent on how domestic preferences may vary according to regulators' institutional relationships with industry.

Generally, 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. 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.

III. Two-step theory of standard-setting

How do states pursue and set international financial standards? What explains the form and substance of such standards? In short, public-private domestic interaction induces regulatory actors' preferences for a certain form of international standard. Motivated state actors then bargain on the substance of a standard at an international institution according to decision-making rules, which explain how much the standard will change the status quo.

Step 1: Domestic regulatory structure generates preference for form

Structure

Consider that a state can be one of two ideal types: fragmented or coordinated. The type is based on different dimensions of a state's regulators and industry associations: level of integration, degree of competition, and extent of public authority. Level of integration refers to how many regulators are tasked with overseeing firms in a given market and how well-defined their mandates are. It also refers to whether industry associations are encompassing in their

³¹ Lall (2012). Chapters 3 and 5 of Prabhakar (2013) more directly address the "capture" argument.

³² Büthe and Mattli (2011).

³³ Prabhakar (2013) goes into further detail on the sources of first-mover advantage.

representation of firms in a given market. Degree of competition refers to the conflict 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 policymaking. Public authority refers to delegation by the executive and/or legislature to regulators or industry associations to establish standards and conduct supervision.³⁴

In the ideal-type fragmented state, numerous regulators are poorly integrated. They 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 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, and jointly set the agenda for the domestic rule-making process. They are ensconced in collaboration.

Incentives and preferences for soft or hard international standards

As a result of arm's-length 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 involved in writing standards for cross-border application. These institutions thus also legitimize their members' policy preferences that are substantively incorporated in standard-setting.³⁵ An international standard raises the profile of the dissatisfied

³⁴ The state can be more or less fragmented or coordinated depending on the market, e.g. the U.S. is more fragmented in insurance than in banking.

³⁵ Majone (1984); Quack (2010).

regulator's policy preference on the domestic agenda by posing a stark choice to other regulators and fragmented industry associations: accept or reject the international standard. 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, structural fragmentation reduces the likelihood of such domestic coordination and thus, for the dissatisfied regulator, makes the pursuit of hard law too costly in terms of time and resources. Regulators from fragmented states cannot negotiate legally binding standards at the international level without interference from rival domestic regulators, as well as other state actors with whom they would have to achieve common policy positions. For example, for US financial regulators, this negotiation would entail the involvement of the Department of State and congressional scrutiny, consultation, and ratification. 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 governance, well-integrated organizations, and low competition increase the likelihood of coordinated state actors 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 the coordinated state benefits distributionally: regulators and industry face no compliance in implementing and operating under the international standard, whereas other states must adjust.

The legally binding form appeals to coordinated state actors because of the distributional gains at stake. Legal obligations are difficult for other states and market participants to ignore. State practice suggests that states believe hard law promotes more compliance than soft law because a legal obligation reflects a stronger commitment on the part of states.³⁶

In sum: 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 or able to make regarding its behavior to other states and market participants. Hard law represents a more credible commitment than soft law.

How does a state actor 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. The first-mover's choice

³⁶ Raustiala (2005); Simmons (2000).

of hard or soft international standard-setting institution is a function of its preferred form.³⁷ 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: Decision-making rules in inter-state bargaining shape the substance of the standard

A state actor prefers a hard or soft international standard and begins the standard-setting process in a hard or soft international institution. As a first-mover, it bargains with representatives of other states in order to set the substance of the standard.³⁸ Below, I define substance and offer a simple spatial model of bargaining between actors. I then demonstrate that the type of decision-making rule used during bargaining explains variation in substance.

Substance is a succinct way to conceptualize regulatory change. 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.³⁹ Shallow substance means the new standard requires minimal shift from the prevailing international standard or practice. Deep substance means significant change from the prevailing international standard or practice.

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 derivatives issue-areas can be represented on a unidimensional policy space defined by a spectrum of actors’ preferences, ranging from laxity to stringency, for instance.

On the unidimensional 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.⁴⁰ The status quo represents an exogenous *international* policy outcome in

³⁷ I am not proposing a theory of institutional choice which explains why certain focal point institutions for path-dependent reasons are chosen by first-movers. Mattli and Woods (2009) use the same assumption of fixed international institutional supply. See Jupille et al. (2013) for a comprehensive theory of institutional choice applied to the World Trade Organization and other organizations.

³⁸ 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. For example, individuals may prefer low (casual dating) or high (marriage) levels of credible commitment irrespective of substantive interests; state actors can pursue international standards in the same sequence.

³⁹ Downs et al. (1996); Raustiala (2005).

⁴⁰ Singer (2007) and Mattli and Woods (2009) also explicitly incorporate crisis in their theories of regulatory change.

case bargaining on a standard fails.⁴¹ 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. For example, prior to the recent financial crisis, no such international derivatives standards existed. The international status quo could be considered an “uneven” playing field wherein international firms followed national regulations depending on the location of their activities.

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.⁴² 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.

Is there a first-mover advantage? Under open rules, there is no first-mover advantage. Power during open rule bargaining 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. The following two sub-sections bear out these propositions.

Bargaining under open rules

Consider bargaining between three state actors in an international standard-setting institution, as shown in Figure 1 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,⁴³ 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

⁴¹ Krehbiel (1998) also defines status quo as the exogenous policy outcome.

⁴² See Crombez and Swinnen (2011), Crombez and Hix (2012), and Pokrivcak et al. (2006) for studies on the frequency of legislative activity versus gridlock under different bargaining rules.

⁴³ In reality, the number of members is often higher, e.g. the G-7, the 27 Member States of the EU, and the 27 member jurisdictions of the Basel Committee.

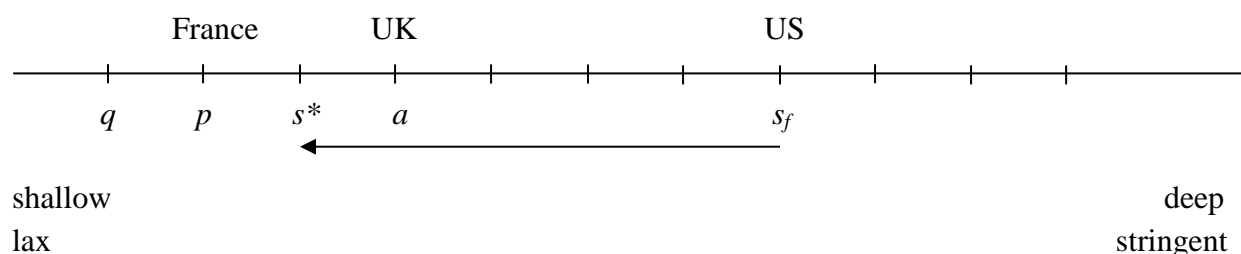
versus restrictive rules between Figure 1 and Figure 2 below, I identify the actors as representing the US, UK, and France.

These actors' preferences lie on a unidimensional policy space, running here from regulatory laxity to stringency (in terms of depth, shallow to deep).⁴⁴ 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.⁴⁵

In this example (Figure 1), 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.

However, the first-mover does not have a bargaining advantage under open rules. Consensus or unanimity requirements 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 1: 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

⁴⁴ I am using the example of a space defined by laxity and stringency only for illustrative purposes.

⁴⁵ These are assumptions adopted by Krehbiel (2008) and (1998), and are also used in median voter theories.

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.

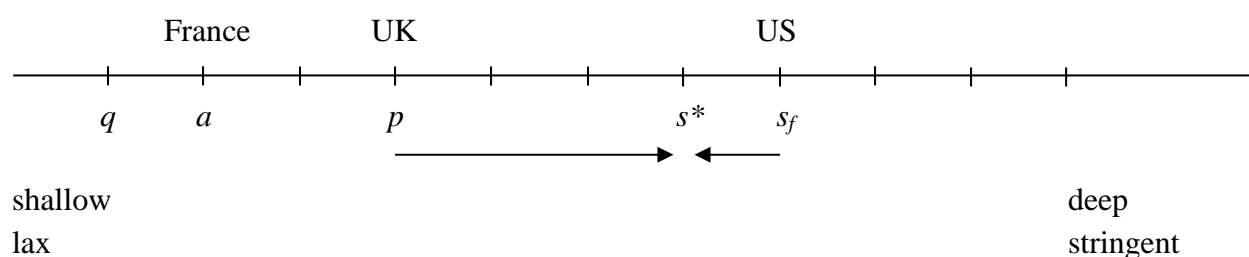
Bargaining under restrictive rules

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 below, identical to the configuration of preferences in Figure 1 (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 1, but the pivotal actor in Figure 2 has changed as a result of the simple majority voting rule: UK is now p and France is now a .

Figure 2: 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, 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 1), it does not do so under restrictive rules (Figure 2), 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.⁴⁶

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 below (S = substance of final standard; F = form of final standard; E = examples).

Table 2: Outcomes in international financial standard-setting

	Open decision-making rule	Restrictive decision-making rule
<p>Fragmented</p> <p>F first-mover</p> <p>E</p>	<p>Shallow</p> <p><i>Non-legally binding standard</i></p> <p>Basel Committee capital rules, FSB bail-in standard, Joint Forum principles for supervision of financial conglomerates</p>	<p>Deep</p> <p><i>Non-legally binding standard</i></p> <p>OECD Principles on Consumer Financial Protection, IMF Special Data Dissemination Standard (non-mandatory)</p>
	Shallow	Deep

⁴⁶ 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.

Coordinated first-mover	<i>Legally binding standard</i> EU directives in financial services prior to 1986 Single European Act	<i>Legally binding standard</i> EU directives on alternative investment fund managers, credit rating agencies
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Case selection & testing

In the following two sections, I present empirics which test the theoretical claims that domestic regulatory structure induces a state actor's preference for form and that decision-making rules explain the substance of an international standard. The case of EU hedge fund regulation is a "most-likely" case, that is, the independent variables (domestic structure and decision-making rule) are at high values. France is a well coordinated state and EU decision-making rules for financial standards are semi-restrictive, thus French officials should be successful if they can assemble a favorable coalition. This case also demonstrates that restrictive rules provide the requisite bargaining advantage to first-movers seeking to set deep standards. The case of international insurance regulation is a "less-likely" case (domestic structure is at a low value, decision-making rule at a high value). Britain is a weakly fragmented state and has access to both hard and soft law standard-setting institutions. The soft and extremely shallow International Association of Insurance Supervisors (IAIS) Principles of Capital Adequacy and Solvency reflect the resistance of recalcitrant US state-based regulators under open decision-making rules at the IAIS.

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."⁴⁷ It builds upon recent work on "the consequences of institutional legacies in specific, intrinsically important contexts."⁴⁸ 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.⁴⁹

IV. 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. Accustomed to the light regulatory touch of the UK Financial Services Authority, London fund managers had paid little attention to rumors about the proposal. Infuriatingly,

⁴⁷ Farrell and Newman (2010).

⁴⁸ Büthe and Mattli (2011): 196-7.

⁴⁹ George and Bennett (2005): 272.

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?

Coordinated French regulatory structure for securities markets

Securities markets regulators and industry associations in France operate in a coordinated structure.⁵⁰ When the European Commission proposed the AIFM Directive in 2009, the *Autorité des Marchés Financiers* (AMF) was the sole securities market regulator and worked with both the banking regulator and the Banque de France. 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, including the asset management industry.⁵¹

The AMF 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 financial services legislation and which can be overridden by the Finance Minister only in the case of disagreement after a second round of consultation.⁵² Below high-level exchanges, formal collaboration in rule-writing has entrenched credible commitments between the AMF and the French asset management industry.

The asset management industry, which includes hedge funds, is represented by the *Association Française de Gestion Financière* (AFG), a highly integrated, non-profit industry association that faces no competition for members. 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, as expressed in the Monetary and Financial Code, to officially represent and advocate on behalf of its members.⁵³ The big banks' asset management companies are represented through the AFG, which is itself represented by the peak-level *Association Française des Etablissements de Crédit et des Entreprises d'Investissement* (AFECEI). Lobbying is “un gros mot” because of its adversarial connotation, but is also a moot concept in France because regulators and industry associations are deeply ensconced in collaboration.⁵⁴

Over the course of the 2000s, collaboration between French regulators and the asset management industry produced a stringent legal framework for alternative investment funds. The 2003 Financial Security Law and subsequent legislation established prudential standards for fund managers and funds, including requirements for leverage limits, depositary liability, disclosure, and valuation. Investor protection rules set minimum investment thresholds and

⁵⁰ Abdelal (2007); Bertero (1994); Coleman (1996); Zysman (1983); Hall (1986).

⁵¹ AMF (November 2010).

⁵² Author interview with AMF official, Paris, 12 January 2011.

⁵³ AFG (2013).

⁵⁴ Author interview with industry official, Paris, 12 January 2011.

safeguards to prevent mis-selling to retail investors. Finally, the standards made it all but impossible for offshore funds to become successfully registered in France, boosting the competitiveness of non-bank-owned French asset management firms as they sought to expand their market share in France, EU, and the rest of the world.

Preference for a legally binding international standard

The French regulatory consensus would be distributionally valuable for French firms if it served as the backbone of EU alternative investment standards. The domestic regulatory consensus 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 through 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.”⁵⁵ 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 universal banks.⁵⁶

Equivalence is powerful because of the depth and wealth of the European single financial market.⁵⁷ Financial depth in the eurozone was 356 percent compared to 424 percent for the US in 2006.⁵⁸ The size of EU capital markets was nearly \$52 trillion in 2002, compared to \$54 trillion for the US.⁵⁹ 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.⁶⁰

However, hedge funds and other alternative investment funds are concentrated mostly 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

⁵⁵ Bach and Newman (2007): 836. See Birnhack (2008) and George et al. (1997).

⁵⁶ Draghi and Pozen (2003).

⁵⁷ Nicolaïdis and Shaffer (2005); Posner (2007).

⁵⁸ Farrell et al. (2008): 12. Financial depth is equal to financial assets as percent of GDP.

⁵⁹ Drezner (2007): 36.

⁶⁰ Interview, Brussels (23 November 2010).

directive would similarly affect New York managers, who comprised 47 percent of the global market in 2009.⁶¹

This means that the “California effect” is widespread and pronounced for New York and London fund managers.⁶² 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 would pour into the European market, while French firms—much more tightly regulated—would be disadvantaged. In this way, an EU directive could set the bar for legally binding international standards for the global alternative investment fund industry.

Bargaining on the AIFM Directive under semi-restrictive rules at the EU

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 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 3 below). Actors’ preferences map on to a policy space measured on a single dimension (Figure 3), running from laxity (the status quo) to stringency.

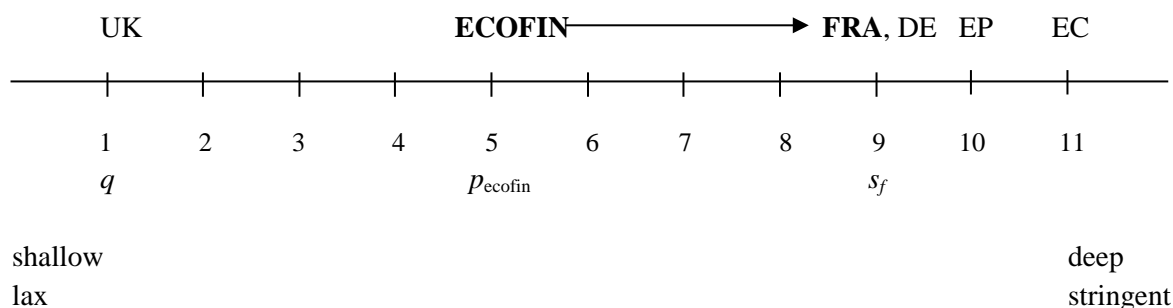
Table 3: Decision-making on prudential substance of AIFM Directive

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 the Council (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

⁶¹ IFSL (2010): 36.

⁶² Vogel (1997); (2012).

Figure 3: Overall bargaining outcome on prudential substance of AIFM Directive



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.⁶³ The UK FSA focused on overseeing London managers, not the funds themselves. 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.⁶⁴

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, registration, 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.⁶⁵

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. 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.

The French 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. When Germany chaired a 2007 G-8 summit in Heiligendamm, Chancellor Angela

⁶³ IFSL (2010).

⁶⁴ FSA(March 2006).

⁶⁵ IOSCO (2009).

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.⁶⁶

However, between 2006 and 2008, 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 resisted efforts to increase the stringency of alternative investment regulation.

But the perfect political storm was raging by autumn 2008, and French and German support for alternative investment regulation echoed efforts by prominent members of the European Parliament. 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.⁶⁷ 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.⁶⁸

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 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.”⁶⁹

European Commission President José Manuel Barroso placed pressure on McCreevy. Facing re-election in 2009 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.⁷⁰ 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.⁷¹

⁶⁶ Jones (2007).

⁶⁷ 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.

⁶⁸ Evans-Pritchard (2007).

⁶⁹ *Europolitics* (2008).

⁷⁰ Interview, Oxford (8 October 2010).

⁷¹ Interview, Brussels (23 November 2010).

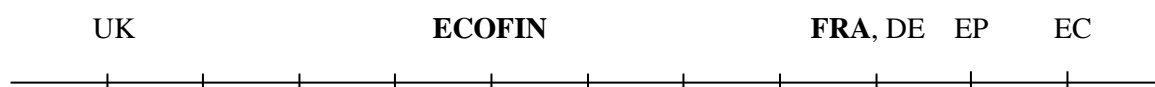
Commission officials and staffers recounted that some aspects of drafting went beyond their control. For example, Commission staffers did not include hard limits on the amount of leverage alternative investment fund managers could hold, yet such limits appeared in later versions. French officials were involved “early” in the drafting of the prudential standards, as well as the provisions on equivalence affecting third-countries, such as the US.⁷²

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 supermajority Qualified Majority Voting (QMV) rules, and not the median voter in Parliament.

In ECOFIN, French officials sought a stringent standard that would satisfy the pivotal voter. AMF Chairman Jean-Pierre Jouyet publicly laid out the French position that reflected its 2003 domestic regulatory consensus. Jouyet called for “profound” amendments to allow for the depositary requirements to correspond with the UCITS Directive (previously crafted by the French); 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.⁷³ Corresponding with Parliament’s position, 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).

Figure 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 supermajority 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 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: Bargaining on the AIFM prudential standard (late spring 2010)



⁷² Interview, Oxford (8 October 2010); Interview, London (23 November 2010).

⁷³ Jouyet (2009).

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 delegations at ECOFIN's Working Party on Financial Services did not budge.⁷⁷ 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."⁷⁸

As Figure 4 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 Commission acceded to ECOFIN’s position because its pivotal voter was closer to the status quo.

A French victory: AIFM Directive set to transform global industry

⁷⁸ *Europolitics* (19 May 2010).

The final prudential substance of the AIFM Directive reflects the French model. 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 regulatory loss for the British.

The rules on liability for depositaries were especially irksome to the FSA and City of London, which followed a 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].”⁷⁹ 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.”⁸⁰

Further, the AMF and AFG agreed with the Directive's final treatment of leverage limits.⁸¹ 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.

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.⁸² 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.”⁸³

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

⁷⁹ Interview, London (24 November 2010).

⁸⁰ Interview, Brussels (24 November 2010).

⁸¹ AFG in House of Lords (2009); Jouyet (2009).

⁸² Interview with Thierry Francq, Paris (12 January 2011).

⁸³ AFG in House of Lords (2009): 195.

authorised funds with streamlined investment rules (“ARIA” funds) that could be used for ‘alternative investment fund management’ strategies.... The introduction 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.”⁸⁴ 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.”⁸⁵

Despite bargaining that stretched out over nineteen months, the stringency of the AIFM prudential standards did not change much. 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 fund managers at €1.4 billion,⁸⁶ 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.⁸⁷

Finally, 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. 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. 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. A Commission official explained, “We had the idea of using equivalence to create incentives for other countries to have similar regulatory outcomes.”⁸⁸

Table 3: The two-step theory and the EU AIFM prudential standards

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 (<i>Autorité des Marchés Financiers</i>) and AFG industry association (<i>Association Française de Gestion Financière</i> under peak-level AFECEI)
Domestic regulatory consensus	2003 Financial Security Law defined framework for alternative investments; collaborative reports by regulator-

⁸⁴ AMF (2012): 6.

⁸⁵ AMF (2012): 7.

⁸⁶ Charles River Associates (2009): 112.

⁸⁷ European Parliament (2009): 24.

⁸⁸ Interview, Brussels (23 November 2010).

	industry committees 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 supermajority Qualified Majority Voting rules, which allows it to resist UK demands for laxer standard

V. 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?

Fragmented UK insurance regulatory structure

In the late 1990s and early 2000s, the UK government was rebuilding the British insurance regulatory structure. Catastrophic losses in the London Market had revealed the inadequacy of the prevailing structure. The Insurance Directorate in the Department of Trade and Industry (DTI) did not have an encompassing or well-defined mandate over the London Market, which is composed of Lloyd's and the general insurance companies. DTI supervised the Market through

“informal understandings, voluntary compliance, and minimal public accountability.”⁸⁹ Even as Lloyd’s and the general insurance companies sought to improve their capital adequacy regulation, the status quo remained a tentative *laissez faire* regulatory approach as the consolidated Financial Services Authority (FSA) opened its doors in 2000.

As in the UK banking and securities markets, the London Market has long been represented by competing industry associations that do not coalesce into a single, peak-level body. The most prominent association, the Association of British Insurers (ABI), does not represent the London Market. Lloyd’s itself is split: the Corporation of Lloyd’s handles prudential issues, while Lloyd’s Market Association concerns itself with syndicates’ interests. Both British and international general insurance companies join the International Underwriters Association (IUA).⁹⁰ Lloyd’s is not formally linked to either the ABI or IUA.

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 others will get a competitive advantage if trends in business or risk profiles are disclosed.”⁹¹ The associations respond to consultations from the UK government or the FSA at arm’s-length.⁹²

When a Labour government assumed power in 1997, it swept away the fragmented regulatory structure that had existed since the 1986 Financial Services Act. Several high-profile regulatory failures across markets buttressed Chancellor Gordon Brown’s case for supervisory consolidation and the creation of the FSA.⁹³ 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. Upon passage of the Financial Services and Markets Bill in 2000, the FSA gained full statutory authority to set prudential insurance standards.⁹⁴ It found itself in a unique position: its officials could begin proposing its preferred standards while unthreatened by rival regulators.

Preference for a 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. Challenges posed by the insurance industry—through the *bancassurance* conglomeration trend, inconsistent London Market

⁸⁹ Ford (2011): 267.

⁹⁰ Howard (1991).

⁹¹ Interview, London (4 May 2012).

⁹² Ibid.

⁹³ *Financial Times* (1997).

⁹⁴ Graham (1998); Adams (1998).

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.

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 2000.⁹⁵

The now-infamous “light touch” approach of the FSA partially arose out of its statutory obligation to operate with minimal costs.⁹⁶ 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.⁹⁷

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. In Britain, Lloyd's TSB (a bank) purchased the Scottish Widows insurance company for £7.3 billion, while National Westminster pursued a £10.7 billion purchase of Legal & General.⁹⁸

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.”⁹⁹

⁹⁵ Jackson (2005): 33-36. 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). 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.

⁹⁶ Quoted in Brown-Humes (1998).

⁹⁷ BaFin (2002): 180.

⁹⁸ Felsted (2000).

⁹⁹ Quoted in Felsted (2000).

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 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.¹⁰⁰ Meanwhile, Lloyd's wanted to completely prevent prudential standard-setting by the FSA.¹⁰¹

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.¹⁰² 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.¹⁰³

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."¹⁰⁴ 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."¹⁰⁵ 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."¹⁰⁶

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

¹⁰⁰ Beatty (1998).

¹⁰¹ Adams (1997); Banks (1999).

¹⁰² Quoted in Harris (1997).

¹⁰³ Adams and Graham (1998).

¹⁰⁴ David Gittings, director of regulation at Lloyd's, quoted in Felsted (1999).

¹⁰⁵ Quoted in Bolger (2000).

¹⁰⁶ Quoted in Guerrero et al. (2001).

more generally.”¹⁰⁷ 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 Section IV) or capital adequacy in Germany.¹⁰⁸ But no such formal, collaborative public-private undertaking between the FSA and the London Market occurred. What did the FSA pursue instead?

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.¹⁰⁹ The Basel II banking framework—with its internal ratings-based approaches—had not yet been completed. Still, in early 2001, FSA 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.”¹¹⁰

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.”¹¹¹ 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.”¹¹²

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.”¹¹³

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.

¹⁰⁷ Quoted in House of Commons (October 2001).

¹⁰⁸ Chapter 5 in Prabhakar (2013).

¹⁰⁹ Quoted in *Asia Insurance Review* (June 2000).

¹¹⁰ *M2 Presswire* (2001).

¹¹¹ *Ibid.*

¹¹² Interview, Oxford (11 May 2012).

¹¹³ Interview, London (8 May 2012).

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 the late 1990s, the EU was only mooting the possibility of more risk-sensitive capital standards. The European Parliament 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.¹¹⁴

As the Commission began to survey the industry, the FSA sought to influence the direction of future EU reform.¹¹⁵ 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.

Bargaining on an international capital standard at the IAIS

At the “soft law” International Association of Insurance Supervisors (IAIS), the UK FSA was well-positioned to influence the standard-setting process.¹¹⁶ 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.¹¹⁷

Martin Roberts, Director of the FSA Insurance and Friendly Societies Division, served as chairman of the Technical Committee. 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.”¹¹⁸ 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.”¹¹⁹

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. All three EU Member States preferred to move away

¹¹⁴ *Reactions* (2001).

¹¹⁵ Quoted in Alcock (2002).

¹¹⁶ To my knowledge, the only other account in the literature on the politics of international insurance regulation is in Singer (2007), which devotes four paragraphs to the bargaining I describe below.

¹¹⁷ Kawai (2004).

¹¹⁸ Interview, phone (7 May 2012).

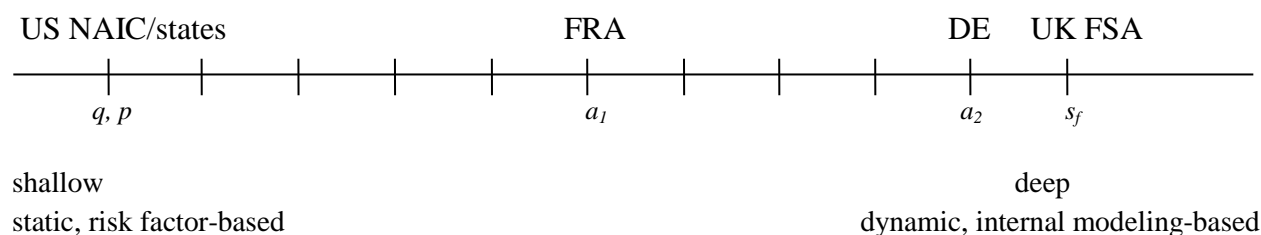
¹¹⁹ Interview, phone (10 May 2012).

from the prevailing risk-insensitive capital standards and towards risk-sensitive internal modeling-based standards.

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 basis (“fair value”) that could result in more volatility in the measured solvency of an insurer.¹²⁰ 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 differing from the French Generally Accepted Accounting Principles.¹²¹ Despite their resistance on valuation, the French did not seek to halt the standard-setting process.¹²²

With the support of national regulators from the largest European insurance markets (as well as Denmark, Finland, Italy, the Netherlands, and Switzerland),¹²³ the FSA had considerable momentum towards a non-legally binding standard—until it confronted the recalcitrance of the US National Association of Insurance Commissioners (NAIC).

Figure 5: Preferences at the IAIS on risk-based capital standards



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. After over five years of negotiations, the NAIC devised a risk-based capital (RBC) requirement for general insurance companies 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.¹²⁴ These rules sufficed to keep Congress from usurping states’ insurance regulatory prerogatives, and so in the early 2000s, the NAIC did not want to disturb either the domestic or international status quo.

Despite the extremely fragmented U.S. insurance regulatory structure, the NAIC and state regulators agreed on one objective: resist the development of any standard at the IAIS that would endorse a more risk-sensitive, internal modeling-based approach. Such a standard

¹²⁰ Ibid.: 113.

¹²¹ Interview, email (23 May 2012).

¹²² Interview, phone (30 May 2012).

¹²³ Belgium, Portugal, and Spain appeared content to wait for a final EU standard before reforming national rules. Taylor-Gooby (2007).

¹²⁴ CEA and Mercer Oliver Wyman (2005): 28; Bannister (1993).

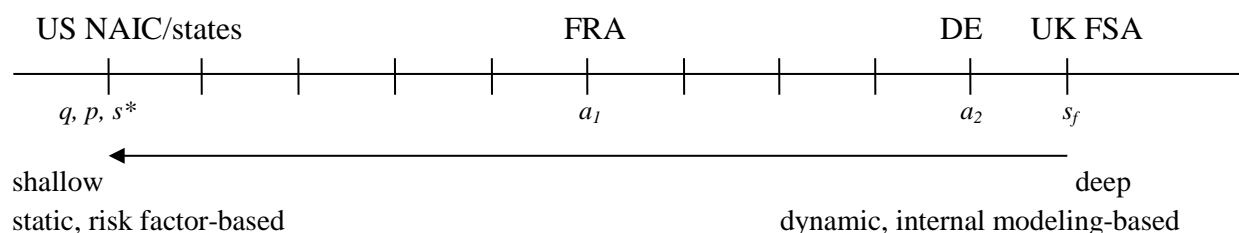
would require extensive changes to the NAIC risk-based capital rules, as well as prevailing insurance accounting practices. US fragmentation was actually an asset at the IAIS, which had flexible membership rules: different NAIC and state officials could easily serve on the Solvency Subcommittee, relevant 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.”¹²⁵

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.¹²⁶ 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 a member 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.¹²⁷

Figure 6: 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). 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

¹²⁵ Interview, phone (10 May 2012).

¹²⁶ Interview, London (8 May 2012).

¹²⁷ Interview, phone (7 May 2012).

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.”¹²⁸

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 7). 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.

Adopted in January 2002, 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 Principles 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.”¹²⁹ 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.”¹³⁰ The effectiveness of US opposition in the context of open bargaining rules proved this goal far too sanguine.

The FSA focuses on Europe—and pushes the US to reform

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.”¹³¹ 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.

¹²⁸ Interview, 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).

¹²⁹ IAIS (2002): 7.

¹³⁰ Quoted in Ratcliffe (2000).

¹³¹ Interview, London (8 May 2012).

Through its insistent bargaining at the IAIS, a major report at the European level,¹³² and its domestic reform efforts, the FSA influenced the European Commission (EC) in setting the agenda for Solvency II. 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.”¹³³

The Commission officially proposed Solvency II in 2007. Reflecting UK preference, it mimics the three-pillar approach of Basel II,¹³⁴ 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 models.¹³⁵

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.¹³⁶ Although it admitted that “there is no prescribed modelling approach for how a firm develops its internal model,”¹³⁷ the FSA encouraged firms to develop internal models as a substitute for FSA-prescribed risk assessments.¹³⁸

The FSA sought to incentivize the use of internal modeling to alleviate its own resource constraints. An official involved in risk management at an insurance company, and then developing standards at the FSA, reflected on the emphasis on modeling in the FSA regime and Solvency II: “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.”¹³⁹

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

¹³² Conference of the Insurance Supervisory Services of the Member States of the European Union (2002).

¹³³ Corinne Cunningham, analyst at Royal Bank of Scotland, quoted in *Euroweek* (2005).

¹³⁴ For a good comparative analysis, see Verma (2009).

¹³⁵ 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.

¹³⁶ FSA (2003).

¹³⁷ *Ibid.*: para. 2.4.51.

¹³⁸ *Ibid.*: para. 5.15, 42.

¹³⁹ Interview, London (9 May 2012).

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 expected to fail the initial ICAS standards.¹⁴⁰ Compliance costs for companies reached £200 million by late 2010.¹⁴¹ 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;¹⁴² compliance costs for Lloyd's alone are expected to reach up to \$480 million.¹⁴³

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.

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. 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.¹⁴⁴

The US NAIC and state regulators are also under pressure from the new Federal Insurance Office (FIO), which was established 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.¹⁴⁵ As of writing, FIO and the EU have yet to agree at the IAIS on a revised international capital adequacy standard.

Table 4: The two-step theory and the IAIS Principles of Capital Adequacy and Solvency

Proposition	Evidence
Fragmented state: low level of	UK FSA is consolidated financial supervisor without

¹⁴⁰ Miller (2004).

¹⁴¹ *Review* (2010).

¹⁴² Interview, London (4 May 2012).

¹⁴³ *Business Insurance* (2011).

¹⁴⁴ Skinner (2009).

¹⁴⁵ Section 502 of the Dodd-Frank Act.

integration, low degree of competition, no public authority for industry	any rival insurance regulators, but industry associations are fragmented, competitive, and do not have public authority
Tenuous domestic regulatory status quo in fragmented state	<i>Laissez faire</i> 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

VI. Conclusion

Just as their central bankers were the “lords of finance” in the 1920s,¹⁴⁶ 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?

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. Unlike open rules,

¹⁴⁶ Ahamed (2009).

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.

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 embodied 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.

French representatives at the EU deftly allied with their German colleagues to force the European Commission to propose the AIFM Directive. The deep substance of the AIFM prudential standards 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 supermajority QMV rules in the Council. Overall, the type of decision-making rule—rather than any other feature of the standard-setting process or actors' characteristics—succinctly explains significant substantive change from the status quo.

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, which 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 produced in 2002 constitute a soft and 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.

Policy implications

Are there any lessons to be drawn from this project for present and future international financial regulation? For policymakers, the two-step theory possibly offers an “image of the adversary.”¹⁴⁷ 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 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.¹⁴⁸

Beyond the “great powers” in international finance, there is yet 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.

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

¹⁴⁷ George and Bennett (2005).

¹⁴⁸ Interview, Oxford (8 October 2010). A senior French IMF official also pointed this out to me.

standards?¹⁴⁹ International finance operates not on a level playing field, but rather a pitch where national regulators try to level each other.

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¹⁴⁹ See Helleiner and Porter (2010); Rodrik (2011): 260-266.

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